Nine steps to strengthen Asia's bond markets

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Federal Reserve Board chairman Alan Greenspan trusts the bond markets. In 2000 he described the US domestic market as the banking sector's spare tyre, recalling the 1998 collapse of hedge fund Long Term Capital Management when fully functioning debt markets prevented the paralysis of the banking industry – with help from Greenspan's New York Fed colleagues.

More recently, the capital markets remained liquid when US banks reacted to Enron's failure by withdrawing corporate standby lines of credit, hindering the renewal of maturing commercial paper. Liquidity may ebb in one sector but remains buoyant elsewhere.

By contrast, Asia's central bank leaders are reckless. Their post-Asian crisis risk aversion in managing external reserves is laudable. But the region's reliance on bank credit is now widely perceived as hazardous. Asia's local and principal currency debt capital markets are subordinate in every way to its banking sectors despite commendable growth in new issue volumes since the mid-1990s.

The debt markets offer a borrowing channel that is often effective and act as a balance sheet management tool for central banks in controlling short-term liquidity. Yet these markets fail to provide an additional, non-correlated medium of intermediation, or contribute effectively to macroeconomic risk management. In a second crisis of confidence, Asia's debt markets would offer little guard against contagion or a credit freeze.

Governments are aware of this weakness and have made it a central issue for working groups within regional forums of the Asean+3 (Association of Southeast Asian Nations) and Apec (Asia-Pacific Economic Cooperation), which are looking at market reforms. But the success of any solution will be limited if governments fail to address legal, regulatory and systemic impediments that deter activity and penalize market participants throughout non-Japan Asia, even in markets regarded as fairly advanced.

What to do?

Governments will address differing issues in overcoming these obstacles and omissions. But in general they must work together to implement legislative and regulatory change. This will help market users, particularly institutional investors, both at home and abroad.

It is also essential to avoid duplication and competition in the creation of systems and financial architecture. This will increase confidence and reduce participants' direct costs.

The model capital market is well known, if seldom seen. Successful markets have accommodating legal systems and bankruptcy procedures, and are regulated independently, with clarity and fairness. Settlement, payment and custody systems are simple to use, coordinated and minimize risk. A core of institutional buyers of term securities supports the market. No aspect of market issuance or trading distinguishes unreasonably between classes of issuer or investor.

Despite their expansion, Asia's markets are commonly identified as under-used and weak in stabilization qualities. Some countries, notably Hong Kong, Malaysia and Singapore, have built well-integrated domestic system infrastructures, but their performance under stress is untested. The cross-border market for Asian risk is transactional, mainly illiquid, and the participation of institutional investors is limited; its Asian bid is drawn predominantly from commercial banks. While funding transactions became feasible by 1997 in almost all non-Japan Asian currencies, no sector offers the reliability of continual dealing that characterizes the leading (non-Asian) markets and builds confidence among new borrowers or investors.

Those advocating bond market expansion argue that Asia may become less prone to contagion after shocks or shifts in sentiment by lessening its financial system's reliance on the banking industry, and improving the efficiency with which it mobilizes savings. Bond markets help circumvent collapses in bank liquidity only if they represent another means of intermediation.

Developed economies often show a positive correlation between debt issuance and bank credit expansion and the US domestic debt capital market is no exception. Its effectiveness in backing up the banking system springs from the two sectors being neither wholly separate nor entirely commingled. In non-Japan Asia's economies, by contrast, commercial banks are the dominant investor class in all public debt issues.

Reform has seldom been proposed in a fashion specific enough to provide reliable guidance for legislation or rule changes. One reason is the opacity of existing rules. For example, nearly all Asean withholding tax regimes are unclear in some key respect, whether it be their application, tariffs, amelioration or the reliability of collection.

The following practical policy proposals are all suitable for the region. All are feasi-

Reforms are vital to bring life to Asia's debt markets

Obstacles, omissions and disparities

	Obstacles	Omissions	Disparities
Legal	Poor enforcment of judgments. Limited creditor rights in bankruptcy. Barriers to true sales.	Indeterminate title and rights in transfer. Notice requirements.	Risk of borrower set-off in asset sales. Credit rating practice for structured finance. Creditor status.
Fiscal	Stamp duties and taxes. Taxes on transfer.	Declared benchmark issuance programmes. Transparent interest rates.	Withholding taxes. Taxes on repurchases. Taxes on foreign investors.
Regulatory	Corporate and offshore issuer constraints. Investor constraints. Foreign investor limitations. Bars to retail investors.	Weak reporting and disclosure. Framework for interest and currency derivatives. Money market instruments.	External capital controls. Mark-to-market valuation. Liquidity requirements. Investor participation. Registration and listing.
Systemic	Bank and interest rate cartels. Rating methodology (data deficiencies). Trading (for instance repurchase restrictions).	No price mechanism in primary sale. Price visibility. Market determined yield curve (for instance trading intervention rather than repurchases).	Settlement days. Custody. Settlement risks (no book entry, real-time settlement or central depositary).

ble. Taken together they would be ideal.

- For each currency and for the region as a whole, standardize and broaden the range of available feasible debt instruments, increasing the range of issuers and maturities.
- Create benchmarks (normally government securities) across a declared range of maturities, and introduce and stick to visible debt issuance programmes, nationally or regionally.
- Remove restrictions on trading techniques, including bond or note repurchases on all investment grade issues and short selling, and allow the freest use of exchange traded and over-the-counter interest rate and currency derivatives compatible with declared exchange rate policy.
- Where necessary, require market makers to provide defined trading liquidity in benchmark notes and bonds; ensure that bank regulatory requirements and day-to-day central bank operations do not hinder market liquidity; and ensure that trading systems allow an open, efficient price discovery mechanism visible to all end users.
- Standardize clearing (real-time book entry settlement and delivery) and custody systems to provide reliability and eliminate principal risks in the settlement process to encourage investor confidence.
- Promote securitization and other asset-transfer mechanisms through regulation or legislation to allow the dependable structured pooling of risks (to generate both short and medium-term instruments) to enhance weak credits and assist liability management by banks.
- Remove regulatory restrictions that prevent non-bank institutional investors from buying or trading in debt securities of any kind, subject only to agreed credit rating floors that are purposefully harmonized.
- Where necessary, remove common barriers that prevent investors creating a legal basis for trading, ownership and settlement.
- Remove, or, as a minimum, standardize and simplify, withholding taxes on the sale of securities and collateral assets, and eliminate differential treatments among interest-bearing and other debt instruments.

Omissions and inconsistencies

Lawmakers must address three problems to meet these objectives: deliberate or implicit blockages; omissions of law or practice; and inconsistencies within and among markets. Each area has four facets, the aggregate effect of which is to prohibit or deter issuance and investment (see table).

Policy formation must address all institutional blockages, including the framework and application of regulatory guidelines for banks, pension and mutual funds, insurance companies and borrowers, as well as how they hinder activity.

Policies must lessen obstacles in relation to: withholding taxes; differentials in the application of taxes and tax treaties; restrictions on settlement or custody; arbitrary differences in creditor status that constrain institutional investment; legal risks for investors; creditor claims; and property rights in receivership or bankruptcy.

Lawmakers must also examine cultural factors that may obstruct corporate governance and ownership. Finally, for structured finance techniques to become a significant aspect of capital market activity, each legal and accounting system must provide simply for the true sale of financial claims.

Broadening market usage requires not only a significant and predictable rise in benchmark bond issuance, but also the removal of all practical hindrances. It may also involve the development of vehicles to support widely generated asset-backed transactions, and the creation of national or regional agencies to facilitate new types of issuance, for example, to achieve improvements in the risk profile of new bond issues.

Harmonized action

The 1987 Single European Act may be a model for harmonized action. This Act gave EU members broad guidance for the steps needed to bring about the free movement of capital, but mandated national authorities to introduce reforms to meet agreed objectives. It will be more practical to harmonize minimum standards than seek exact convergence in legal and regulatory systems.

For the markets to flourish and deliver their full value, governments in Asia must encourage usage, not only with specific fiscal, regulatory and legal reforms, but also with persuasion and innovation.

Six years after the financial crisis began there are reasons to expect reforms that may have a lasting effect on Asian debt market activity. Now that policy momentum has increased, dealing with market irregularities and impediments will promote usage and facilitate future reform.