

**“Creating an Efficient Asian Bond Market –
The Private Sector Perspective”**

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- Distinguished participants, fellow speakers, ladies and gentlemen
- It is my great honour to be invited to this conference to present our opinions on this very important topic of the Asian Bond Market

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- The next 15 to 20 minutes will revolve around the following statements:
 - Asia's domestic local currency bond market presents a very promising new asset class yet to be fully explored by global fixed income investors
 - This new concept of the "Asian Bid" demonstrates the potency of the Asian investor base
 - An Asian bond market does exist. But it exists as an Asian sub-sector of the international market
 - Asia's local currency markets - what needs to be done to develop them into a regional market? Re-visiting the prerequisites of an efficient bond market from different perspectives, where you will see how critical the role is of the government.

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- *Asia's domestic bond market is a promising new asset class yet to be explored*
- To provide you with some statistics:
 - HSBC estimates the size of the domestic bond market in Asia (ex-Japan) to be US\$1.5 trillion. Japan's domestic bond market, on its own stands at US\$5.5 trillion.
 - Looking at the returns provided by different asset classes:
 - HSBC's Asian US Dollar Bond Index (ADBI) provided a 3-year return of 35.3%
 - The HSBC Asian Local Currency Bond Index provided the best return the past three years, yielding 35.7%
 - Both these indices compare significantly better than the return on US Treasuries (with similar duration) which yielded 19.8% to investors
 - And the S&P500 which, in the past three years, provided a negative return of -22.1%.

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- *Where do the gains come from?*

- Let's look at the table below on the screen:

- The return of the ALBI is 35.7% p.a.

- The gains on US Treasuries with similar or comparable duration is 20.4%.

This means that the ALBI outperformed returns on the US Treasuries by a significant 15.3%

- The ALBI also provided excess returns of 11.2% over Capital Gains and Carry Income

- And 4.1% excess return over currency gains

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- **The emergence of The Asian Bid proves that Asian demand does exist**
- What once was an afterthought for borrowers in the international capital markets has emerged as a critical source of funds for a broad range of issuers. Asian fundamentals, including economic growth, a rapid increase in central bank reserves since the Asian Crisis and high savings rates, both pre and post the crisis have combined to perpetuate the huge amount of liquidity in Asia known as the “Asian Bid “
- At one time almost exclusively dominated by central banks focusing on US and European Government paper, the Asian investor base has developed a taste for credit and currency risk. A lack of supply of bonds from Asian issuers and a sustained low-yield environment have led to the growing acceptance of non-Asian credits to satisfy demand.
- It is estimated that around 30/40 pct of all new issues by US based agencies are sold into Asian investors.
- **But has the Asian Bid resulted in the emergence of an Asian bond market?**

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- One can argue that an Asian Bond Market does exist, but is best described in the context of an Asian sub-sector of the international bond market
- As the pie chart shows, more than half (US\$7.8bn) of all Asian G3 issues so far in 2003 have been recycled through the primary bond market in Asia
- Further evidence of this bond market is the emergence of Asian paper as an asset class of its own, here we show the HSBC Asian Dollar Bond Index, the JPMorgan Emerging Market Bond Index, and the Lehman US High grade corporate Bond Index.
- As the chart shows, the performance of Asian dollar bonds, represented by the grey line, has been significantly less volatile and even, perhaps, a better return than the performance of the overall Emerging Market bond sector as well as even the high grade sector since January 2002

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- The success of this market has at least partially been due to the vitality of the international bond market with Asian investors able to choose between Global or Eurobond formats that follow accepted standards of issuance in their structures such as
 - Internationally recognized credit ratings
 - Standardization of documentation
 - Adoption of accepted international law, usually English, and/or New York law
 - Tax, certainly free of tax at point of payment, but more importantly consistency in its treatment
 - An accepted clearing system, such as Euroclear, DTC
 - The existence of a liquid market (to varying degrees) and a commitment from the underwriting community to maintain this.
- But as good as we like to think the international markets are, there is always room for improvement
- We find that much of Asia's capital is leaving the region with Asian demand not being met by Asian supply
- The objective, as we see it, is to achieve a securities framework that encourages increased capital flow within the region and recycles this ample liquidity within Asia, to the ultimate benefit of the Asian economies.

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Here we re-examine the six foundation stones of an efficient market. For each one, there are improvements that can be made even within the G3 experience

In no particular order

Establishment of Intermediaries

- Network of dealers pledged to making a market in Sovereign / Agency securities and intermediaries prepared / committed to making regular two-way prices in all securities in marketable size and to promoting a vibrant secondary market by virtue of **price transparency** and **price competition**

Creation of Benchmarks

- Currently, few Asian sovereigns follow a consistent policy of maintaining on-the-run benchmarks in the international market. The establishment of a consistent and well publicized issuance schedule is a common practice among sophisticated issuers in the international markets. A commitment by Asia's sovereign's to issuing, say, two benchmark G3 bonds per year (for example a 5- and 10-year), would be warmly welcomed by investors (and non-government issuers) and by increasing supply would do much to further develop the Asian G3 market.

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Clearing and Settlement Procedures

- While the international markets have several efficient and trusted clearing and settlement systems, such as Euroclear, Clearstream and DTC, currently only Hong Kong and Singapore are linked with a global clearing house. Greater efficiency could be gained for the regional investor base by having other countries follow this model
- Robust/efficient settlement and clearing systems reduce settlement risk and transaction cost – thereby encouraging investor flow.

Hedging Availability

- The breadth of hedging instruments available to Asian investors continues to grow, but is once again very much dependent on the local regulations of the investor's home country.
- Interest among regional investors, and therefore market liquidity, will be enhanced by availability of wide range of hedging instruments, such as a readily available swap market, both interest rate and currency with active market makers / counterparties
- Developed currency, interest rate and commodity forward and futures markets
- Other derivatives, such as Credit Default Swaps

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Credit Awareness

- The absolute number of Asian issuers accessing the international markets is actually quite low, meaning that the vast majority of Asian would be issuers remain unknown to the world. For most Asian investors, knowledge of Asian credits outside the regular issuers and familiar domestic entities is limited.
- For public companies, government encouragement – or perhaps requirement – for an international credit rating would be one means of increasing the availability of information.
- A commitment to transparency of information would assist.
- At this point, I also wish to point out the importance of raising the credibility of local credit rating agencies to promote investor flows.

Full Range of Debt Structures

- Asia has been slow to develop an environment whereby new and innovative debt structures can be employed. In many cases, it is the requirement for regulatory change that stands in the way of implementing these new instruments. Revising restrictions would have a beneficial impact on spurring the adoption of valuable financial tools. (Products such as REITS and Covered bonds)
- But a simple idea of Asian Sovereign's issuing fixed and floating rate instruments with common maturities might add value.

- Many of these initiatives that I have mentioned may not initially, result in the most cost efficient funding, but do work towards the final objective of encouraging the flow of funds within the region – which would have economic benefits beyond saving the last basis point on the most recent transaction.

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- The recent growth of local currency bond markets is evidence of not only increased liquidity, but most importantly the respective government's efforts to develop their local markets
- This chart shows the **surge** in issuance in Asia's local bond markets. True, we still see significant **foreign** currency borrowing. But unlike before some of this is hedged back into local currency or actively risk managed. The development of the local markets has been remarkable in a very short period of time and they now provide an **invaluable source of sustainable and lower risk financing** for the region's borrowers.
- Unlike the G3 market, where issuers must conform to an accepted standard (which in turn arguably defines a market), the region's domestic markets are at varying stages of development and are too diverse to be considered a 'Regional Market'
- However, in HSBC's view, it is through the continued and co-ordinated development of Asia's local currency markets that a "Regional Market" can best be achieved.
- Asian markets need to be less divergent and become more convergent in respect of market practices, legal documentation, clearing and settlement, i.e. the building blocks that we have just been looking at. Accordingly, the markets

should be developed concurrently with continuous and co-operative consultation
between regulators and driven by market participants

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- Many markets within the region are well on their way to putting the previously mentioned six foundation stones in place (pictured here in the centre of the slide)
- However, for an Asian Market to emerge, we have to, I am afraid, revisit the prerequisites of an efficient market – identified here on the left as,
 - Government sponsorship
 - Issuer Base
 - Investor Base
 - Legal / Documentation Framework
- While in many of the domestic markets these prerequisites exist, for a regional market these must achieve a degree of harmonization so that eventually the individual markets are similar enough to represent a true regional market– with equal treatment and procedures throughout

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Government Sponsorship

- For a Regional market to develop incorporating the local currencies, the participating governments will have to show unequivocal support for not only their own domestic markets but also a regional bond market – not through words but through actions. It will be the responsibility of the governments to prove the viability of the market through acting as,
 - **Regulators** - Since so much of what is required for a viable regional market lies within the authority / control of Government bodies, their support is essential. Decisions made by the authorities in each country influence all aspects of the market place through changes to existing laws and regulations and the creation of new ones. Regulators need to work towards removing barriers to the efficient flow of funds.
 - **Issuers** – It will be incumbent upon governments (and their related entities) to establish the market by being the first to issue. While common credit rating standards will help in establishing relative values, [for greatest efficiency, each government should establish a yield curve in each market so that investors will have benchmarks of country risk. Without this, pricing for private sector non-resident issuers will be less efficient.]

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- *Investors* – To address investor concerns over liquidity, government participation in the secondary market as investors will be required to ensure sufficient liquidity in the ‘early days’. For example, the expansion of eligible Central Bank holdings to include sovereign issuance in domestic currencies would greatly increase the investor base

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Issuer Base

- Expansion of the issuer base in each currency / market will be a key deliverable of a common market
- A diversified issuer base delivers more investment options to the investor base, be it through credit ratings, sectors or products offered
- Regulations should encourage issuance from domestic and regional issuers, as well as international issuers such as multi-nationals and supranationals
- Foreign issuers can fill a gap in the credit curve where local entities are absent (for example, the ADB's and IFC's recent interest in issuing in various domestic markets around the region)
- Beyond dropping regulatory barriers, incentives should also be used (such as tax breaks and accounting policies) to encourage issuance
- Governments have the ability to influence the behavior of domestic issuers as well as control foreign issuers' access to the market

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Investor Base

- The extension of the Investor Base - from domestic to regional - is another key deliverable
- In a regional market, the investor base would no longer be confined to the domestic investors in each market, but open to investors throughout the region, or for that matter the world (this however, is very much dependent on the availability of appropriate hedging tools – an issue that would be absolutely key to the success of any such initiative)
- The potential exists, therefore, to greatly increase market liquidity as well as diversify the investor base by sector (participation by more sophisticated investors from another market in itself drives development)
- While outside funds are desirable, I am sure that regulators (and market participants) will not forget the lessons learned from the financial crisis where the flow of hot money did much damage
- Once again, it is Governments who will invariably define the accessibility to their domestic markets

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Legal / Documentation Framework

- HSBC suggests that a worthwhile medium term goal would be the development of a “Pan-Asian IPMA”, IPMA being the International Primary Market Association, established in 1984 in order to bring some consistency to the Primary issue Process in the multicurrency, multijurisdictional Eurobond markets. **Effectively establishing common standards in advance of a common market**
- By establishing a set of agreed recommendations among regulators and major market players relatively early, participants in each market will begin to operate under similar guidelines making the transition to cross-boarder business less painful as the markets converge
- We feel that it is important that the markets continue to move towards best international market practice covering market conventions such as disclosure and new issue procedures as this will deliver greater confidence in the marketplace and will avoid the possibility of the regional market being perceived as of an inferior standard

- While a common regulator (such as the SEC or SFC) may not be feasible, a mutually accepted SRO, self regulatory organisation, such as IPMA would be helpful and constructive

Conclusion

There is a robust and growing Asian Bond Market for G3 denominated product. A commitment to supply, developing clearing systems, transparency, and hedging availability will encourage the Asian Investor to participate further.

The local currency markets in Asia are at an earlier stage of their development – and as such it is difficult to prescribe a solution that fits all markets. The markets need to converge to a level playing field before real progress can be made. So we suggest, fix domestic markets before completely opening up an intra regional market place. A robust domestic market does not promote “hot money” it might be considered the first line of defence.

Engage market participants - empower them to propose market changes whilst at the same time maintaining regulatory control.

In the words of Winston Churchill, “To build may have to be the slow and laborious task of years. To destroy can be the thoughtless act of a single day”.

An enabling infrastructure model exists in the Eurobond market but in perspective, we are where we are today in the Eurozone only after 40 years of development. It was in 1963 that the Italian Motorway Company (“Autostrada”) raised US\$ in what

is recognised as the first ever Eurobond. The path is long –but the objectives and the benefits are clear