The 2nd Annual Conference of PECC Finance Forum

Issues and Challenges for Regional Financial Cooperation in the Asia-Pacific

Hilton Hua Hin Resort & Spa, Hua Hin, Thailand
July 8-9, 2003

SessionⅢ: Developing Regional Bond Markets in East Asia: Issues and Proposals

Background Paper

Asian Bond Markets

The Role of Securitization and Credit Guarantees

Hung Q. Tran
Deputy Director
International Capital Markets Department, IMF

And

Jorge Roldos
Deputy Chief, Emerging Market Study Division
International Capital Markets Department, IMF

ASIAN BOND MARKETS
The Role of Securitization and Credit Guarantees

The 2nd ASEAN Central Bank Governors Meeting
Bangkok—8,9/6/2003

By

Hung Q Tran[1]
Deputy Director
International Capital Markets Department, IMF

&

Jorge Roldos
Deputy Chief, Emerging Market Study Division
International Capital Markets Department, IMF

1. I am honored to be invited to speak to you today. The topic which I have been asked to speak on, "ASIAN BOND MARKETS: The Role of Securitization and Credit Guarantees", is something which you care a lot about, and have done a lot to foster their development in the region. I hope to contribute to the discussion by benchmarking recent developments in Asian bond markets—including the use of securitization and credit guarantees--against developments in other emerging bond markets, as well as in mature bond markets. I will then identify lessons that can be learned from international experiences, and highlight areas of possible policy actions and reforms that can help further develop the Asian bond markets.

I. Recent Developments in Asian Bond Markets

2. Since the Asian financial crisis of 1997-98, local bond markets have grown considerably in emerging market countries, and have gradually become an important source of funding for local sovereign and corporate borrowers. There is a widely-held view, which I fully share, that developing local bond markets can be an important means of reducing countries' exposure to maturity and exchange rate risks and "sudden stops" in access to international capital markets. Local bond markets can also be beneficial in diversifying funding sources, especially for corporate borrowers, from their generally heavy reliance on domestic banks, many of which have been undergoing restructuring themselves. In addition, improving local bond markets can help strengthen corporate governance and transparency, developing a

[1] The views expressed here are the authors' own views, and do not necessarily reflect those of the IMF.

credit culture in emerging market countries. As a consequence, many governments in emerging market countries have actively taken steps to develop local bond markets.

3. There are regional differences in recent developments of local bond markets. In Asia, the need to finance budget deficits which emerge after the 1997-98 crisis, including the need to recapitalize banking systems, has given a strong impetus to developing local government bond markets. For countries and economies which have always had fiscal surpluses and therefore no financing needs (like Singapore and Hong Kong SAR), the governments have made a conscious decision to issue government securities to create a liquid government market, complete with a benchmark yield curve—as key building blocks to develop local bond markets. The weakness in bank lending has also contributed to some increase in corporate bond issuance, in Asia as well as Latin America. In Latin America, the strong growth of local institutional investors, especially pension funds, has created a continually growing demand for local bonds, while the corporate sector has large refinancing needs due to difficult external financing conditions. In central/eastern Europe, the harmonization of regulations (and institutions) in the process of accession to the EU has stimulated the growth of local bond markets, including attracting foreign investors putting on so-called "convergence trades".

3. The total outstanding amount of bonds issued by Asian emerging market borrowers in both local and international capital markets has increased rapidly to reach $1.1 trillion at the end of 2001, slightly more than half of the total outstanding amount issued by all emerging markets. Together, however, emerging bond markets account for just 5.6% of the global bond market. Compared with other regions, emerging Asia has issued less international bonds (13% of the Asian total outstanding), more government bonds in local markets, but not so dominating (50%), and a large private sector share: 20% for financial institutions and 17% for corporates. The composition of the Asian bond markets is thus similar to that of mature bond markets: domestic governments bonds account for 49%, financial institutions 22%, corporates 11%, and international bonds 18%. By contrast, Latin America has issued more international bonds (32%--mainly by sovereign borrowers) and government bonds in local markets (55%), leaving a small share for the private sector (13%). Similarly, EMEA (Eastern Europe, Middle East, Africa) has also issued more international bonds (23%) and government bonds in local markets (73%), with a negligible share of 4% for the private sector.[2]

4. In terms of the size of domestic bond markets relative to GDP, Asia is around 38%, of which the corporate sector is about 8%. By contrast, the U.S. bond market is about 150% of its GDP, and the corporate market is about 24%. Japan's corporate bond market is about 17% of GDP, while Australia's is over 10% of GDP.

---

[2] For a detailed discussion of emerging local bond markets, see IMF, 2002, *Global Financial Stability Report*, September

5. Asian local bond markets have become an important source of funding for both public and private sectors. In 1997, local bond markets supply less than 3% of the funds raised by Asian entities in all local and international loan, bond and equity markets. In 2001, the share of local bond markets rose to 38% of total financing, as local bond market volume of $150 billion catching up with domestic bank lending of $180 billion. Over the same period, the share of international bond and bank financing fell from over 30% to less than 15%.

6. In Asia, the largest corporate bond markets are in Malaysia (equivalent to 51% of GDP in 2001) and South Korea (28% of GDP). Measures by Malaysia's Securities Commission to streamline the process of capital raising have supported further growth of the already deep corporate bond market. The cost of bond issuance has reportedly fallen below that of bank loans in Malaysia, and bond issuance has overtaken bank credit as a source of corporate funding since 1997.[3] In South Korea, corporate bond issuance concentrated among the major chaebols, guaranteed by commercial banks, and placed with bank-owned Investment Trust Companies. These linkages led to the collapse of the bond market when a chaebol defaulted. The authorities have repeatedly supported the local bond markets through periods of instability since 1997-98—more about this later.

6. Besides issuing more government securities, governments in many emerging market countries have implemented measures to improve market infrastructure, including the establishment of primary dealers. In particular, the HKMA has continued to upgrade their trading, clearing and settlement systems, more recently linking up with Euroclear and Clearstream, and other local markets such as Korea in 1999 and China in 2002. Secondary market activity, as measured by trading volumes, has recovered strongly in the past years to exceed pre-crisis levels. The increase in secondary trading has been most noticeable in Malaysia and South Korea.

7. Despite their relatively rapid development, Asian local bond markets still remain somewhat underdeveloped by the standards of mature markets—even though there is a wide regional variation in terms of size, depth, liquidity and sophistication. The main problem is that a modern bond market requires internationally best practices in a wide range of inter-related fields so as to make them mutually reinforcing—from legal and regulatory framework to market infrastructure and foundation, to supporting markets such as repos and derivatives, as well as the presence of established investor bases. Weaknesses in one or two areas, despite progresses elsewhere, can still cause problems for modern investors, causing "the market" to move elsewhere. In fact, the main challenge of development, and not just of bond markets, is to attain a certain level of competence in such a comprehensive manner. Specifically, the Asian local markets are illiquid, especially for corporate bonds. They remain segmented and insulated from each other, and in the case of China, within the same country. In China, segmentation exists across investors, instruments and trading mechanisms. Investors in

---

[3] See Moody's Investors Services, 2002, "Malaysia's Debt Capital Markets Assume New Importance," Special Comments, Global credit Research.

several countries are not allowed to invest outside of their home market, and international investors face difficulties and relatively high costs in hedging exchange risk when investing in local currency bonds. There is also a lack of standardization across the region in bond contracts, underwriting, clearing and settlement rules and procedures, market regulation and taxation. Lack of transparency and lingering questions regarding corporate governance contribute to difficulties in pricing credit risk, helping to retard the development of a credit culture. Name recognition to some extent still influences investment decisions, instead of rigorous credit analysis. Although the relatively large amount of government issuance has helped to establish benchmarks in local bond markets, it may have crowded out some corporate issuers. Moreover, local institutional investors for prudential reasons are often constrained in the range of instruments they can invest in, which also reduces the available funds for corporate bonds.

8. At the present juncture, given the developments so far and the challenges that remain, it is important that authorities in the region continue to focus attention on implementing measures—in both primary and secondary markets--that can help further develop the Asian bond markets. In this context, the role of securitization and credit guarantees has received a lot of discussion lately.

II. The Role of Securitization

9. Securitization refers to the issuance of new bonds collateralized by a pool of assets which can be other bonds, loans, or any receivables with a regular cash flow. This is usually done via a Special Purpose Vehicle (SPV) specifically set up to own and receive the income from the pool of assets, with which to service the bonds it issues in its name. The proceed from the bond issue is used to pay the original owner or owners to acquire the pool of assets. The SPV can be set up by the original owner or owners of the assets, or by a third party.

10. The pooling of assets can provide diversification benefits to potential investors. The asset-backed securities can be issued in several tranches of different maturities and offering different risk-return configurations, and can be rated at different credit levels. Specifically, credit guarantees can be used to enhance the credit worthiness of some of the tranches, making them eligible to a wider range of investors. Credit enhancement can also be achieved through the over-collateralization of the asset-backed securities. The asset-backed securities can be issued in bigger sizes than usually the case in emerging corporate bond markets, and therefore likely to have better liquidity in secondary markets—again desirable characteristics for investors.

11. Consequently, securitization can contribute to the development of corporate bond markets by overcoming the problems of the small size and low credit quality of most emerging market issuers—problems which have plagued the emerging corporate bond markets. By participating in a securitization program, or by collateralizing their future receivable cash flows, small and medium corporates are able to tap capital markets. In particular, securitization has been an important tool to clean up banks' balance sheets and improve their capital ratios in a bank restructuring process.

12. The best example of the use of securitization to develop bond markets and create economic benefits is the development of the U.S. mortgage-backed securities (MBS) markets. The government-sponsored enterprises (GSEs) such as Ginnie Mae, Fannie Mae, Freddie Mac etc. have played an important role in securitizing diversified pools of mortgages, and offering them to a wide range of investors—creating a stable and probably cheaper flow of financing to the housing sector, thus supporting the public policy goal of encouraging home ownership in the U.S. These GSEs in turn have issued so-called Agency securities to fund the MBS, creating in the process a deep and liquid market rivaling the U.S. Treasury securities market.

13. More recently, the "True Sale Initiative" in Germany has facilitated the establishment of a consortium consisting of Kreditanstalt fur Wiederaufbau (KfW) and five commercial banks to securitize bank loans and offer them as asset-backed securities to a wide range of investors, including international institutional investors. This program is designed to help banks better manage their balance sheets, improve their capital ratios, and eventually become more inclined to extend credit to the small and medium-sized companies that currently find it difficult to obtain financing.

14. Essentially, securitization is a derivative product, being packaged from existing securities or other debt instruments. For the securitization market to function properly, the market and market infrastructure for the underlying assets have to be already in good working order. On top of that, legal clarity and predictability on things like the true sale of assets, the taking possession of collateral and realizing its market value etc. also needs to be sufficiently assured. Consequently, some analysts doubt if securitization can be used as a means to help develop bond markets, as the cash market has to be relatively developed before a market for securitized instruments can be introduced. In addition, to be viable, an asset-backed securities market needs to have in place institutions ready and able to provide credit guarantees or to buy the higher-risk "mezzanine" tranches of the securitization program. In emerging Asia, however, since bond markets have been in existence for some times, albeit with large regional variations in terms of sizes, depth, liquidity and sophistication, securitization can be useful in identifying gaps and deficiencies in cash market infrastructures and foundations. This in turn can help stimulate further reforms and developments in cash markets and beyond, in order to accommodate the proper functioning of securitization markets. Research work done by the HKMA is consistent with this line of thinking.[4]

15. In emerging Asia, Korea has the largest asset-backed securities markets, roughly equivalent to 45% of the corporate bond market--which is not bad compared with a ratio of 59% in the U.S. The exponential growth of this market was triggered by the need to mobilize financing to address the problem of non-performing loans (NPLs) resulting from the 1997-98 crisis, and to restore liquidity to the banking system. Also helpful was the approval of the

---

[4] See HKMA, 2002, "Further Study on Securitization and Credit Enhancement in Asia"

Asset Backed Security Law in 1998. During 1999-2000, collateralized loan obligations (CLOs) and collateralized bond obligations (CBOs) accounted for the bulk of transactions, as the focus was on addressing the NPL problem and the refinancing of corporate bonds. In 2001-02, the focus was on securitizing credit card receivables, the quality of which eventually suffered in the competitive rush for growth in credit card business. The Korean authorities had to step in to arrange rescue of affected credit card companies. Interestingly, even though residential and commercial mortgages have been securitized, they are not the preferred assets for securitization as is the case in many other countries.

16. Recent experiences in the Korean corporate bond and securitization markets, and their inter-relationship, are relevant in the debate about whether or how much securitization—as well as credit guarantees-- can help develop local bond markets. Corporate bonds were guaranteed by commercial banks prior to the 1997-98 financial crisis. They were concentrated in the largest five chaebols, and were little different from loans (only 17% of corporate bonds were not guaranteed in 1996, compared with 97% in 2001.) They were then placed with Investment Trust Companies owned by the same banks. Waves of corporate defaults in 1998 and beyond have led to runs on investment trust companies. The government had to step in to support the bond markets, similar to current operations to support securitized credit card receivables markets. Thus although corporate bond markets have grown in volume, it is not clear how much it has helped improve the assessment and pricing of credit risk.

17. Thailand has also passed a Securitization Law in 1997, but the ABS market has not visibly picked up. Market participants attributed this slow growth to the fact that, unlike the Korean law, the Thai law does not seem to clarify adequately some issues, critical to securitization, such as the valuation and repossession of collateral, the legal status of SPVs, and taxes. The bankruptcy and foreclosure regime is also seen as inefficient and difficult to enforce.

18. The creation of Cagamas in Malaysia in the mid-1980s contributed to the development pf a deep mortgage market. However, this market leveled off during the 1997-98 crisis, and has not picked up in a meaningful way—despite the approval of the Securities Commission Guidelines on ABS. Market participants note that while the regulatory framework is favorable to securitization, it is not as clear as the Korean law. Also they note that the bankruptcy law does not appear to treat SPVs as bankruptcy-exempt. [5] The lack of financial guarantees has been identified as a major constraint to the development of the market in Malaysia: banks and finance companies used to provide guarantees in 1995-98 with similar results to Korea. The authorities have recognized the need for stand-alone financial guarantee companies, similar to the monoline insurance companies in the U.S. and elsewhere, and have studied measures to develop these institutions,

[5] See Dalla, Ismail 2002 “Asset-backed Securities Markets in Selected East Asian Countries” World Bank Report, July.

19. The financial centers of Singapore and Hong Kong SAR have well developed regulatory frameworks for securitization, but it is unclear how much this has contributed to the development of local bond markets. In Hong Kong SAR, the HK Mortgage Corporation has played a key role in developing a deep MBS market, but issuance has slowed down lately due to weakness in the housing sector. Some analysts argue that Singapore could play an important role in promoting securitization at the regional level, through the establishment of a new regional credit guarantee corporation, or the revival of ASIA Ltd..[6] This is the first and only regional credit guarantee corporation established in Singapore in 1995. A restriction to provide credit guarantee to non-Asian and developed Asian debtors is seen as the main reason for the corporation's limited success.

20. In Latin America, cross border asset-backed securities are relatively more common than domestic ABS transactions, a situation similar to the bond markets. Cross border structured finance products have been around since 1993-94, but issuance slowed down considerably in 2002 due to the financial turmoil in the region which resulted in the first defaults on rated structured finance products in the emerging markets. By contrast, 2002 was a relatively strong year for domestic structured finance products.[7] Countries like Chile, Colombia, Mexico and Peru had banner years for local market securitization. Much of the growth was driven by private sector pension funds, that are required to invest in instruments with high ratings, as well as the increasing adoption of partial guarantees. The credit-enhancing effect of securitization has allowed many issuers to access an otherwise closed market, further attesting to the positive impact of pension funds in local bond markets.

III. The Role of Credit Guarantees

21. Credit guarantees or insurance assure bondholders of payment of principal and accrued interest in the event bond issuers fall into default, or any mutually agreed "credit event". Therefore, credit guarantees upgrade the credit quality of a bond issuer to that of the credit guarantee provider. Consequently, credit guarantees can be used to enable borrowers of weak credit quality to access domestic as well as international markets. Providers of credit guarantees can be private companies, government agencies or international financial institutions (IFIs). Credit derivatives markets also allow investors to hedge against default risk, in addition to providing a transparent pricing of corporate and sovereign default risks.

22. Private sector credit guarantees or insurance have been provided by monoline insurance companies for a long time in the U.S. Becoming active in the U.S. municipal bond guarantees markets in the 1980s, U.S. monoliners have expanded since then, including offering financial guarantees in international and emerging markets. In the past two years,

---

[6] ibid

[7] See Fitch, 2003

U.S. monoline insurance companies have come under pressure as several of them were downgraded themselves due to the default of some of the CDOs or CBOs they had guaranteed. Consequently, some insurance companies are rethinking their participation in this business activity.

23. In emerging Asian markets, the economics of providing credit guarantees to individual corporate issuers is not yet compelling. To become a viable business, financial guarantors have to be able to insure a well diversified pool of credits, with a reliable and long enough history of default and recovery rates in order to correctly price the insurance premium. Absent these conditions, a financial guarantor can either not enter the business, or quote such a high premium that makes it prohibitively expensive for small and medium companies to buy insurance to enhance their bond issues.

24. Given the small size of local corporate bond markets, both in terms of issue size and the variety of borrowers, it seems more fruitful to think about providing financial guarantees at the regional level, as there are more opportunities for diversification. It also seems more feasible to arrange insurance for asset-backed securities, as the pool of underlying assets is already diversified to some extent.

25. In this situation, established international monoline insurance companies do have a competitive advantage over any potential local companies, but they also provide added value to the development of local guarantees markets. They have compiled historical default and recovery rates for other regions, which they can modify to use as a rough guide for the Asian market. Their involvement in local guarantees markets can serve as a training model for local firms.

26. Governments can set up agencies to provide credit guarantees to targeted borrowers, usually small and medium companies in “strategically” chosen sectors. If these agencies do not charge commercial premiums, they actually provide state subsidy to local companies. This in turn raises issues of transparency, fairness and potential for corruption, and last but not least, potential fiscal costs to tax payers. Such subsidy may also not be compatible with WTO trade rules. In addition, they may relieve pressure for corporate restructuring, thus delaying the strengthening of the corporate sector. Finally, there is no reason why government agencies can be better than private companies in assessing credit risk, which after all is the key challenge in developing a local credit culture.

27. Multilateral Development Banks such as the World Bank and Inter-American Development Bank have offered financial guarantees to some emerging market borrowers, including Argentina (issuing a series of six $250 million zero coupon bonds in 1999, maturing sequentially over 2000-04), the Electricity Generating Authority of Thailand ($300 million bond issued in 1998) and Colombia ($ 1 billion amortizing bond issued in 2001). The intention of the guarantee program was to provide additional security to potential investors at a time when the issuer was having difficulty accessing international capital markets. However, examination of secondary market trading particularly of the more liquid Colombian issue suggests that investors have priced in the pure financial benefit of the

guarantee, but have given limited additional benefit for the implied incentive for the issuer not to default on the bond because such default would result in an obligation to a preferred creditor status IFI. This was vividly confirmed when the WB offered Argentina generous terms for the reimbursement of the $250 million guarantee payment the WB had made to bondholders on October 15, 2002—making it unlikely that Argentina would repay the Bank by the mid-December 2002 deadline for the guarantee to be reinstated for the October 2003 bond payment. In general, guarantee structures such as the one used for Argentina (rolling reinstatable guarantees) are somewhat penalized in the markets because of the difficulty in modeling and valuing the enhancement incorporated in the bond. As a consequence, the MDBs are of the view that this type of guarantee is not an effective use of their resources, and are rethinking the program. A few sovereign borrowers may also be reconsidering their plans to issue bonds backed by such guarantees.

28. In addition, credit derivatives markets also enable investors to hedge their credit exposures. However, in emerging markets, credit default swaps are currently only available for international bond issues by sovereign borrowers, and a few top quality financial institutions and corporates.

IV. Six areas for policy actions and reforms

29. Asian bond markets have grown substantially in recent years. Governments in the region should leverage this momentum to implement further reforms to bring the region's bond markets to a higher level of development. In the foreseeable future, the focus of policy will likely remain improving local markets. However a longer-term vision of a more integrated regional market should be sketched, at least in broad terms, so that national reforms in policies and market infrastructures can be done with a view to facilitate, not hinder, the eventual process of regionalization. One concrete example: electronic trading, clearing and settlement platforms should be built with a view of rendering them communicable and then inter-operable with each other among countries in the region.

30. As a historical example, the development of European bond markets offers many useful lessons. Despite decades of gradual integration, including 7 years of the Single Market (1992), European bond markets were integrated only when the euro was introduced at the beginning of 1999. The common currency has changed the investment practice of investors—some institutions such as insurance companies had faced restriction on foreign currency exposures—and enabled the rapid take off of corporate bond issuance. Even then, while money markets have been fully integrated, bond markets (let alone equity markets) are still segmented to various degrees, compared to the U.S. market, due to the less than perfect harmonization in a variety of areas, including technical trading, clearing and settlement platforms.

Following are six areas of potential policy actions and reforms.

31. **Market infrastructure and foundation**

- Improving corporate governance and transparency, including accounting and auditing standards.

- Establishment of common financial disclosure and registration rules for bond issuers. This could help improve market ability to price credit risk.

- Standardization of bond contracts, underwriting standards, clearing and settlement procedures.

- Harmonization across countries of market regulation and taxation.

32. **Legal framework—**particularly important for securitization markets

- Strengthening respects for contracts, including enforcement of contracts and predictability in the resolution of contractual disputes.

- Clarity in the assignability of receivables, and the definition of "true sale" of assets.

- Clear legal status of Special Purpose Vehicles—especially when used to securitize assets.

- Bankruptcy law and foreclosure practice.

- Clarification of data privacy and bankers' confidentiality.

33. **Repo markets**

- A functioning repo market (multilaterally for all market participants, and not just bilaterally between commercial banks and the central bank) can facilitate the funding and liquidity management of market participants.

- This can help to improve bond underwriting, trading and management activities, leading to better liquidity in the secondary market.

34. **Derivatives markets**

- Put in place regulation (including disclosure requirement) and supervision to encourage the development of financial derivatives markets so that market participants can hedge their interest rate, foreign exchange and credit risks.

- Credit derivatives markets are useful in improving the efficiency of price discovery in local bond markets.

35. **Investor bases—**Asia needs to develop a diversified range of institutional investors to complement the banks.

- Experiences from Chile, Mexico and other Latin American countries which implemented pension reforms decades ago show that pension funds, with their continually growing assets and demand for securities, have played a key role in developing local bond markets, increasing their depth and stability.

- Mutual funds are an important tool to mobilize household saving and channel it to capital markets. Experiences in Brazil, where a thriving domestic mutual fund industry has gathered more than $150 billion in assets under management (or 30% of GDP), suggest that the mutual funds have played an important role in developing, and bringing stability to, local bond markets.

- Easing of restrictions imposed on institutional investors so they can have a fuller impact on local markets.

- Gradual dismantling of capital controls so non-resident investors in the region as well as internationally can participate in local markets.

36. **Credit culture—**an intangible but crucial ingredient which marks the maturity of a bond market

- Protection of creditors' rights.

- Adoption of a requirement that all bond issuers be rated by a credit rating agency.

- Again, experiences in Chile show that maintaining a competitive environment for established international credit rating agencies and local agencies over the past 20 years has produced local agencies with a high degree of professionalism and credibility—a sign of the maturity of Chile's credit culture.

V. Concluding remarks

37. As concluding remarks, I would like to make some comments on the recently launched Asian Bond Fund (ABF). Even though the immediate direct impact of the ABF is likely to be modest, given its small size and the fact that international dollar bonds issued by Asian sovereign borrowers—the current investment target of the fund—already enjoy a strong local bid, its symbolic meaning is significant. It is another concrete evidence of regional cooperation to develop regional financial markets. Managed by a "third party" of sterling reputation—the BIS--, and with a transparent investment policy and guidelines, the ABF can be a tool for peer pressure to adopt best practices in the development of bond markets. This role will become even more relevant when eventually the ABF contemplates investments in local currency bonds.

38. In conclusion, I wish you continued success in further developing the region's bond markets, and eventually the Asian regional bond market, one that can efficiently mobilize saving and channel investment to support growth and development of the whole region. Thank you very much for your attention.