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Session III
Assessing and Building Capacities for the Development of Bond Markets
in the APEC Region

Development of Bond Markets:

A Public/Private Sector Partnership

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John Farrell, NZPECC Finance Forum IAG Member

I am delighted to have the opportunity to participate in this 3rd Annual PECC Finance Conference. I am grateful to our Coordinator, Dr Soogil Young, and his colleagues for the invitation.

You will see from the programme that I am a New Zealander and that for a lengthy period I was a securities regulator. I shall adhere strictly to the business in hand, the development of domestic bond markets, but I shall inevitably be influenced by my background as a New Zealander and a regulator.

We are informed in our programme that

> "The development of local currency bond markets is vital for the achievement of economic growth in the APEC region".

Why is this so? The reasons include:

- domestic bonds are an important source of domestic debt finance, reducing borrowers' dependence on banks, providing an alternative source of funds where the banks are unable to help;
- they may enable borrowers to achieve more readily their currency and maturity needs, reducing the risk of mismatch – all the more so as there are many types of bonds including equity/debt hybrids;
- they reduce the cost of borrowing if the issue is managed and marketed on a cost-effective and competitive basis;
- they broaden capital markets, leading to the more efficient pricing of risk;
- they provide increased investment opportunities for financial institutions and retail investors;
- they offer the potential for deeper markets by attracting reputable foreign investors;
- they contribute to financial stability by diversifying the sources of debt financing in a community.

The issue and public trading of bonds may also offer opportunities for more general promotion of the issuer and its business.

The core tasks of any corporate bond market development programme will be

- to promote, maintain and enhance the standards of transparency in securities markets, both primary and secondary, both wholesale and retail, in respect of market transactions and market participants including borrowers;
- to promote, maintain and enhance corporate governance, judgment and technical competence in our banks and other financial institutions, in our borrowers, in our market makers, the exchanges and those managing OTC markets, and their respective members, and indeed in our regulators, in particular, the central banks and the securities regulators;
- to ensure that the law, the codes of behaviour and governance, the standard forms of contract and so on contribute to the efficient intermediation of investors' funds and at the same time contribute to the development of markets of integrity, markets in which investors both domestic and foreign can have confidence in making their investment decisions.

For the purposes of today's presentation I have two simple points:

1. we should carefully identify in any economy all the parties or interest groups which have a positive contribution to make to the development of domestic bond markets;
2. we should ensure that they are consulted and their views taken into account on a continuing basis on questions of market development, and are made to feel accountable for the advice they give, in short, are drawn into a public/private sector partnership for market development.

We need to know who the parties are to this market development entreprise, what tasks they perform as market participants and how best they can cooperate to achieve the desired outcomes of their participation in the partnership. In the days before printed programmes in the theatre, for example, in the days of the playwright, William Shakespeare, the actors would come out on stage in full dress before the play began to introduce themselves to the audience. Similarly we should identify clearly the participants in the development of bond markets and allow them to introduce themselves.

The role of the host government is the most complex. The government is ultimately responsible for all aspects of national policy including setting optimum macro-economic policies and the optimum regulatory framework. It has a direct involvement

- in procedures for the supervision of banks and the structure and administration of securities market regulation, relying on internationally accepted models such as the Basel Core Principles for Effective Banking Supervision, the IOSCO Objectives and Principles of Securities Regulation and the IAIS Insurance Core Principles;
- in the taxation of market participants, whether as imposts on revenue or transactions;
- in procedures for dealing with market default and the insolvency of corporates;
- in rules about the participation in markets by foreigners and others domiciled outside the jurisdiction;
- in the markets themselves as a market participant, as the issuer of government stock or shorter term Treasury bills or as a trader in these instruments, whether directly or through the agency of a central bank.

There are a number of reasons why a government may wish to issue debt securities,

- to meet its borrowing needs;
- to manage shorter term liquidity in the economy;
- to establish bench-mark yield curves for debt markets, a significant contribution to the development of domestic corporate bond markets.

It is very important to the development of corporate bond markets that the return on government bonds should be set by open and competitive processes, both because governments like other borrowers need to be able to attract the best available terms and because government bonds can be expected to be a benchmark for and a direct competitor in the market of corporate bonds, taking into account the general terms of the offer including interest and maturity and an informed assessment of the risks.

With the diversity of its responsibilities the government will wish to consult widely and, I suggest, publicly in formulating its policies for the development of corporate bond markets.

The core tasks of the central bank will relate to monetary policy, banking, credit and overseas exchange. The main functions of the Reserve Bank of New Zealand are

- operating monetary policy to maintain price stability;
- promoting the maintenance of a sound and efficient financial system, including the registration and supervision of the banks;
- meeting the currency needs of the public.

There will be other main functions in other jurisdictions.

There may be a separate and independent agency responsible for the prudential supervision of banks and other financial institutions and the promotion of stability in financial markets.

There will be a securities commission or equivalent organization responsible for monitoring securities and futures markets and the offer of securities to members of the public and others, promoting adherence to best industry standards and, as appropriate, enforcing the law. The core objectives of a securities commission, as enunciated by IOSCO, are

- protecting investors
- ensuring markets are fair, efficient and transparent
- reducing systemic risk.

These are directly relevant to the development of corporate bond markets.

The primary task of the regulator is to ensure that all information which is material to the offer of and trading in securities is readily available to the market and to investors. The investor must be in a position to make an informed investment about the potential risks and rewards of an investment. The standard form of offer document for corporate bonds to the public is the prospectus. This document contains information about

- the issuer, the entity itself including its directors, its business, its financial position and its financial performance,
- the terms of contract including interest rates, maturities and the ranking of the claims of bond holders on the insolvency of the issuer, and
- any material interests or benefits of the directors of the company, or of the promoters or guarantors of the issue.

The prospectus will be signed by the directors in their personal capacity as well as the company and they will be personally liable to investors for the consequences of any misstatements.

Traditionally in some jurisdictions the securities regulator was expected to evaluate the merit of securities to be offered to the public. However this is becoming less common as the emphasis passes to clear, complete and timely disclosure of information, the investor then being expected to take responsibility for making his or her own decisions, relying on qualified and independent investment advisers to help out where necessary.

The central bank, the prudential supervisor and the securities commission need to have clear and public mandates, to be organizations of independence, competence and integrity and to be empowered to cooperate with other regulators in the jurisdiction and with foreign counterparts.

Similarly the exchanges must demonstrate high standards of corporate governance, no less than those they supervise or regulate. They must administer effective rules about market making, the conduct of members and, through the listing rules, the conduct of listed companies which are the issuers of equities and corporate bonds. There will be equivalent expectations of those who administer OTC markets.

PECC has its own project on the corporate governance of banks in the APEC region. This is a very important project. If it is a catalyst to improved governance in the region PECC can be very well satisfied. The major credit for this project must go, as I understand it, to Dr Estanislao and Dr Parreñas.

There is the borrower. IOSCO undertook a survey of corporate bond markets through its Emerging Markets Committee. Typically the "emerging market" borrower will be a bank, a utility company, a non-bank finance company, an infrastructure or telecommunication company, a leasing company, perhaps also a manufacturing company. Borrowers all need to have high standards of competence and corporate governance. From time to time a borrower will establish a special purpose non-guaranteed subsidiary to be the primary borrower. The investor needs to understand the effects of this.

Then there is the lender, the investor in the corporate bonds. IOSCO reports that the foremost investors in corporate bonds in the emerging markets are banks, investment management companies, pension funds, insurance companies and individuals. Their information needs may differ but their respective interests all need to be taken into account in the further development of domestic corporate bond markets. In all circumstances there will be the primary offer documents. There will be an obligation, whether arising by contract or by law, to prepare and publish in due time financial statements which comply with prescribed financial reporting standards. The investor must be able to evaluate the investment risk at the time of issue of the corporate bonds and on a continuing basis.

Sitting in behind these financial statements will be the independent auditor whose views will need to be articulated in the public/private sector partnership.

In some jurisdictions there will be an independent trustee company appointed to represent the interests of the bond holders in their dealings with the issuer. Typically the trustee will undertake

- to ascertain whether the trustee has complied with the terms of the trust deed and the offer of securities as set out in the formal offer documents
- to ascertain whether the issuer has the wherewithal on a continuing basis to meet repayment obligations as they arise.

The trustee company itself is expected to demonstrate high standards of competence and corporate governance. The views of the trustee company are an important to the development of domestic corporate bond markets.

The rating agency has an important role in an increasing number of jurisdictions. Rating will impact on pricing and investor type. As with others its competence and its views on market development are important.

It is also relevant to securities market development that many jurisdictions have a competition regulator which has authority to intervene where it considers that market activity is being conducted in an anti-competitive manner. This may affect the rights of securities firms such as broking firms and underwriters to participate in the market, the price at which market services are offered, access by borrower companies to listing and quotation. The offer of incentives to award contracts on other than the nature and quality of the service offered and the price quoted will also attract the attention of regulators.

The manner in which the public/private sector partnership is established and conducts its affairs will vary from jurisdiction to jurisdiction. In many jurisdictions there is a statutory obligation on the government to consult publicly about proposals for new financial regulation. The government may empower an independent authority, a central bank or a securities commission, to make recommendations on new regulatory policies or new regulation and require the authority to consult widely before making its recommendations. The government may establish public/private sector working groups which are charged under terms of reference with consulting widely and making recommendations for further development of fundamental policies. Similarly the exchanges will need to consult widely when proposing or making new rules. Whatever approach is adopted the process should be transparent, records of proceedings or of views expressed should be maintained and the records should be accessible to those who come after. The purpose of the public/private sector partnership, like the law and the market rules, is to serve the common good.

All law, all codes of conduct, all rules of the market such as stock exchange rules should be practical and sensible, should be reasonably necessary to meet the objectives of market development, in particular enabling the investor to make responsible investment decisions, and should be consistent with fundamental policy.

The law must be the servant not the master. If there is such a thing as the master in our shared objective of local currency bond market development it is the public/private sector partnership.

6 June 2004