Tony Latter: Bond markets - where are we heading?

Speech by Mr Tony Latter, Deputy Chief Executive of the Hong Kong Monetary Authority, to the conference "The Credit Revolution: Charting Change in the Asian Debt Markets", at the Conrad International, Hong Kong, on 12 July 2000.

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A notable feature of the world's leading national bond markets over the past couple of years has been the adjustment required of both issuers and investors to the often remarkable shifts into surplus, or much reduced deficit, that have occurred in the financial positions of governments in most major economies - with the notable exception of Japan - as a result of the successful application of fiscal discipline, assisted in some cases by favourable economic growth or a beneficial cyclical position.

This has led to significant net retirement of government debt, notably in the United States and the United Kingdom. For example, in January the US Treasury projected buy-backs of $30 billion this year, and some observers now expect that figure to be exceeded. The design of debt retirement strategies has itself posed some unfamiliar, though perhaps not entirely unpleasant, challenges for the authorities, as they search for the most cost-effective means in terms of prospective interest savings, grapple with the novelty of reverse auctions, or consider how best to sustain and possibly reinforce liquidity of the key remaining benchmark issues.

There are a number of significant consequences of this transformation of government finances for markets more generally.

First, the yield curve for government bonds may become distorted and lose its normal relationship to other yields. This has been especially noticeable in the United States, where the concentration of buy-backs in the longer dates has caused an inversion of the Treasury yield curve which has not been paralleled in, for instance, the swap curve.

As a result of this distortion of the historic pricing relationship between government issues and the rest of the market, that yield differential may become less well representative of intrinsic credit spreads, so that investors may have to discover or devise new benchmarks in other parts of the credit spectrum.

Next, one might expect the reduction in the stock of government debt to open the way to so-called "crowding-in" of private sector debt issuance. Indeed, in the US and the international markets there has been quite a surge in corporate bond issuance. But the process is not so smooth or straightforward as one might imagine. Because investors in government paper are typically those who are the more risk averse, they would expect to earn a suitable risk premium as compensation for moving down the risk ladder into corporate paper - at any rate a better return than typical existing holders of such paper would be content with. Consequently, although top-rated corporate paper may benefit from the scramble for quality, lesser ratings may face a rather inelastic demand for any additional issuance. Thus, although overall private sector issuance may increase as a means of closing the sector's financing gap, there is some evidence - perhaps not conclusive - that this may be at the cost of some hardening of yields relative to government yields, at least for lesser names. Of course, in some cases the increase in yields may just be the more straightforward consequence of a rising level of corporate gearing. There are also indications that increased debt market activity may have been more evident in the floating rate sector than for longer-dated fixed rate issues, where it may have been difficult to establish appropriate new benchmarks.

Thus, although crowding-in may be occurring, the process is more complex than the simple like-for-like substitution of corporate for government paper.

Another consideration for certain investors is that they increasingly have to accept that a strategy based simply on purchasing the paper of top-rated issuers such as governments or multinational organisations may no longer be feasible or economic. Yet, if they are going to embrace lesser-rated paper in their portfolios, they may need to shift their approach towards a somewhat more sophisticated

portfolio strategy, which permits the holding of lower-rated paper at prices which appropriately reflect the risks, with the risks balanced across the whole portfolio. This may necessitate changes in the ways in which fund managers are instructed to address their task and in the tools which they need to perform it.

Given these developments, the role of credit rating agencies may assume a still higher profile in guiding investors.

I have mentioned these global trends in order to illustrate how even those markets which are regarded as mature have to adapt continually to changing circumstances; and I haven't even mentioned the potential role of internet trading, virtual exchanges and the like, which may pose still greater strategic, managerial and operational challenges.

If we turn now to consider the debt markets specifically in this part of the world, we encounter at least as great an array of challenges, albeit in somewhat different circumstances: for example, in a number of Asian countries government issuance has still been on the increase.

Last year saw something of a milestone for regional markets with the publication, by a working group under the chairmanship of the Hong Kong Monetary Authority, of the APEC compendium of sound practices to facilitate the development of domestic bond markets. This comprised a comprehensive list of recommendations covering topics such as government involvement in the market, level playing fields, consistent tax policies, sound regulation, clarity of responsibilities, transparency, robustness and efficiency of market systems, and so on.

Crucial though these considerations may be for the foundation of sound markets, they are, by and large, just the basic tenets. Even when they have all been observed or put into practice, there is no certainty that active debt markets will emerge. In other words, whilst these may be a set of more or less necessary conditions for market development, they are unlikely to prove sufficient. However good the infrastructure may be, it is the issuers, investors and financial intermediaries which eventually determine whether there is a active market or not.

Here in Hong Kong the debt market has grown significantly in the recent past, and the increase in issues by non-financial corporates has been encouraging. But we cannot escape the fact that we are still a relatively small market and that, despite the increases in primary issuance, secondary activity remains subdued.

"So", people ask me, "what is the Hong Kong Monetary Authority going to do about it?" In fact I am not particularly comfortable with the implied presumption that we should be the first port of call when any problems or deficiencies are identified. Thus, while I should like to take this opportunity to explain what we are in fact doing or intending to do, I want also to indicate what, in my view, we cannot or should not do.

We are involved in the working group established by the Securities and Futures Commission to review Hong Kong's laws and regulations relating to offers of securities. Over the years, several of the procedures have become outdated or have failed adequately to accommodate market innovations. In some instances they are an obstacle to bond market development. There are some complex legal and administrative issues here, which will take time to address. The next step in the process is likely to be the issuance by the SFC of a consultative paper.

Another area which we are looking at is taxation. We acknowledge that there are serious anomalies in the current arrangements for taxing interest income in Hong Kong but, given the uniqueness of Hong Kong's overall tax structure, and the conflicting aims of retaining international competitiveness on the one hand and preserving fiscal revenue on the other, there is no very easy solution. What we are doing is to sponsor, under the auspices of the Hong Kong Institute for Monetary Research, a fundamental study of the taxation of financial intermediation in Hong Kong. This study will hopefully further inform the debate on this tricky subject. I would not at this stage wish to guess as to the direction in which our advice will eventually point.

We are also overseeing the development of a US dollar payment clearing system for Hong Kong, which will provide an enhanced framework within which the market in US dollar debt securities could develop if issuers and investors so wished.

There are also two initiatives on which we are actively engaged in collaboration with others in the region, though each is still very much in its early stages.

One is the question of a possibly wider role for credit rating agencies. I am not referring here to any desire to usurp the role of those global agencies which are household names to us, even though we may sometimes feel that their understanding of economics and business in this part of the world could be deepened and the rating process itself made more transparent. They focus mainly on rating internationally traded paper. What this region may need is better arrangements for rating domestic and regional issues. How and by whom this might be effected is for discussion. Plainly, it is essential that the investor community has confidence in the expertise and integrity of rating agencies. A more local focus by established agencies, perhaps operating via joint ventures, might ensure such confidence. If that is achieved, then the broader application of ratings may help expand the investor base, notably to embrace those institutional or individual investors who cannot themselves afford to make credit assessments of every issue but who are favourably disposed towards bond investment in principle.

The other initiative in hand is to study the potential for more activity in credit enhancement. In some other centres, notably the United States, there exist insurance or guarantee corporations, typically of triple A status themselves, whose business is to sell their backing to the bond issuance of a lesser name so that the latter will be attractive in the market. There has hitherto been only limited activity of this sort in this region, although there were signs of it building up before the Asian financial crisis struck.

One of the difficulties faced in trying to encourage this business is that the major providers, such as the so-called “monoline” insurance corporations in the United States, may not find it profitable to work on what for them may be relatively small, plain vanilla deals, when compared to the fees available from larger and more complex deals in North America. Another problem is that such companies tend not to look to enhance securities with original ratings below triple B. This in turn raises questions about fundamental credit quality in the region as well as about the potentially wider role for rating agencies.

Another area where we might expect to see further innovation is the securitisation of pools of assets such as mortgages or receivables. We have recently witnessed the resurgence of the mortgage-backed security market in Hong Kong, spearheaded by the Hong Kong Mortgage Corporation. This market has the potential to develop even further if the property market recovers buoyancy. But there is also probably scope for more activity in the securitisation of such things as credit card receivables, leasing receivables and the like. These could form attractive debt securities, although, as we have seen with so many issues of securities, the existence of the securities does not necessarily mean that there is an active market in them after the initial placement or sale.

Thus, we are by no means standing still. But, speaking for the Monetary Authority itself, we see our role as confined largely to that of a catalyst for innovation or a provider of public goods in cases where market mechanisms are unable to respond effectively to an evident need - although it may in practice be difficult to define particular situations in quite such clear-cut terms. It was, for example, partly in that catalytic role that we first issued Exchange Fund paper a decade ago as a means of kick-starting the debt market and supplying high quality assets for liquidity management purposes, accompanied by the establishment of the Central Moneymarkets Unit as a centralised electronic depositary for debt instruments.

More recently the CMU has established electronic links with Euroclear, Clearstream and some other national depositaries in our own region. In some of these developments, as in the emergence of initiatives to develop internet trading in bonds, we may be seeing the beginnings of a more global and potentially more liquid and transparent market than has hitherto been typical for debt instruments.

Returning to the matter of the Monetary Authority’s role, we do not seek to coerce any parties to use a particular market; nor without very sound reason to stimulate activity artificially; nor to take a lead as issuer, investor, arranger or market-maker when others should be equally capable of fulfilling such

functions; nor ourselves to subsidise activities the viability of which ought clearly to be left to market determination.

It is against this background that we have, for example, resisted suggestions that we raise the volume of Exchange Fund paper issuance in order merely to satisfy the market's appetite. We would much prefer to see other issuers coming forward. We are anyway constrained by our currency board arrangements only to increase the outstanding quantity of Exchange Fund paper to reflect interest payments or in response to enduring inflows into Hong Kong.

Another aspect of debt market development which merits some discussion is the potential for retail activity. It is worth reminding ourselves that, although in several countries retail investors have historically been loyal direct holders of government or municipal paper, invariably for long-term investment rather than trading, only in the United States has there been much direct retail interest in the corporate paper market. We have been happy in Hong Kong to provide the means for the small investor to access Exchange Fund notes or Mortgage Corporation notes by listing them on the Stock Exchange, but one should acknowledge that bond markets as a whole tend to be dominated by professionals, trading on an over-the-counter basis, and we should not be surprised, therefore, if retail activity is relatively modest.

This does not mean, however, that the man in the street has no need in his wealth portfolio for instruments in this section of the risk-reward spectrum. Rather, because of the difficulty of making individual credit assessments and the probably relatively high transaction cost facing the small investor, he is more likely to have indirect exposure to the debt market through collective investment schemes, pensions, etc, or to keep money in a bank deposit while the bank invests in debt instruments - a growing feature of bank balance sheets nowadays as an alternative to conventional lending.

Mandatory provident funds are one example of such collective arrangements, and their advent in Hong Kong may be expected to add to the demand for good quality debt instruments. The prospect of an additional channel of demand should to some extent stimulate interest in issuance from the supply side.

In sum, there are many opportunities for innovation and development in our debt markets. I have mentioned rating agencies, credit enhancement, more varieties of asset-backed securities, potential for more channelling through collective investment vehicles, the important though perhaps modest role of the direct retail investor, opportunities relating to MPFs, and so on. These are, by and large, activities for players in the banking and finance industry to follow through themselves if they see the commercial justification. I am sure that at least some of you here today are already giving attention to at least some of these topics. I hasten to add that not every bright idea necessarily results in a viable business proposition. But I would expect that there is enough potential here to ensure that the debt markets in Hong Kong as well as in the wider region continue to develop and prosper as we look ahead.