Comments on Oh and Park's paper "ASEAN+3 regional guarantee mechanism"

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The joint paper by Professor Oh and Mr Park on the regional guarantee mechanism for Asia provides a comprehensive discussion of credit guarantee mechanisms and securitisation in the context of the ASEAN+3 Asian Bond Markets Initiative. The purpose of credit guarantees is to bridge the perceived credit quality gap between the generally low credit rating of many issuers in the region and investor demand for high-grade bonds. The authors propose that a new regional credit guarantee agency be established, preferably in the form of a multilateral, public sector organisation with an AAA rating. My main question concerns its financial viability, even if profit maximisation were not its goal. In this regard, my comments focus on the possible costs associated with extending the guarantee coverage to non-investment grade credits, the use of securitisation, the dilemma of risk concentration and the difficulties in risk mitigation.

The first question is whether the proposed regional credit guarantee agency would be financially viable, being possibly the only financial guarantor in the world that would insure a substantial sum of non-investment grade credits. Existing financial guarantors are considered by the authors as inadequate in the Asian context - they generally are available only for credits rated BBB or above before insurance. In fact, about three quarters of the credit enhancements are on credits rated A or above before the guarantees. This chosen risk profile excludes many Asian corporate credits, which are mostly non-investment grade - about two thirds of the credits in Asia are non-investment grade and thus are not potential customers of the existing financial guarantors. It is proposed that the new credit guarantee agency would distinguish itself from existing guarantors by extending its coverage to non-investment grade credits, so that a substantial number of Asian corporate credits could benefit from its credit enhancement services. This could involve substantial costs for the agency.

- First, to maintain the agency's AAA rating, the leverage ratio needs to be substantially reduced in order to cover lower-quality credits.
- Second, the premium charged by the agency needs to reflect the risk the agency undertakes. However, this could be constrained by the need to provide incentives for issuers to actively use the credit enhancement services to achieve a lower funding cost, and the need to be competitive with other competing financing channels such as bank loans.
- Third, the loss rates could be high, because the default rate is substantially higher for non-investment grade credits compared to investment grade credits.
- Finally, a guarantee programme run by the public sector frequently suffers from ultimately costly moral hazard and adverse selection problems. Hong Kong SAR's use of co-insurance in small and medium-sized enterprise (SME) financing is a classic response to these problems. The Special Finance Scheme for SMEs was launched in August 1998 to help address the liquidity crunch in the aftermath of the Asian financial crisis. The government provided a 50-70% guarantee on loans extended to SMEs by commercial banks. Thus, the credit assessments were performed by banks without government interference. Recently disclosed data show

[1] The views expressed here are those of the author and do not necessarily reflect those of the BIS.

that out of about 12,000 approved guarantees to SMEs, over 1,700 loans (or 14% of the total) went into default. Out of total guarantees of HKD 5.8 billion (USD 0.7 billion), HKD 435 million worth of claims have been filed by banks with the government, a default rate of 7.5%. Whether co-insurance would work as well in economies with more corruption or weaker financial systems is an open question.

The second question is whether securitisation can serve to narrow the credit quality gap between issuers and investors, thus mitigating the need for the credit guarantee agency to move down the credit spectrum. Using senior-subordinate tranches, securitisation could offer bonds with a credit rating higher than the underlying assets. However, it should be noted that securitisation can repackage credit risks but cannot reduce such risks, which show up in the subordinate (or equity) tranches. The lower the underlying asset quality, the larger the equity tranche. In general, the subordinated tranches are illiquid and hard to market to investors. In Korea's corporate bond securitisation, they were bought by government-supported agencies. Even if equity tranches are sold, possibly with deep discounts, they shrink the size of senior tranches available to a broader range of investors and raise the cost of funds created through securitisation.

The third question is how realistic it is for the credit guarantee agency to mitigate its risk by diversifying its market coverage. Instead of focusing on insuring only Asian credits, the proposed credit guarantee agency could cover credits from the developed countries. This is indeed one of the lessons from ASIA Ltd, the first and failed Asian credit guarantee company with heavy public sector involvement. During the Asian financial crisis, credit risks between Asian economies became highly correlated and ASIA Ltd was downgraded and went out of business. The key lesson is the need to diversify outside Asia to reduce risk concentration. However, this conclusion raises two questions. First, it is hard to justify a publicly funded regional institution writing insurance that is not closely related to the aim of developing local bond markets. Second, a more practical issue is how this newly established agency could compete outside Asia with existing guarantors in their home markets.

The fourth question is how realistic some of the proposed risk mitigation options for the credit guarantee agency are. One proposed option is cooperation with local guarantee agencies. To the extent that they compete for business, it is hard to imagine why local guarantee institutions would assume first loss and source possible deals for the regional agency, unless it is a public or publicly owned entity not operating strictly in line with commercial principles. The second option is to establish trust funds as shock absorbers with contributions from regional governments and donors. This would certainly help shift some of the costs out of the agency, but the overall support or subsidy needed for writing credit guarantees is not reduced. To the extent that the regional credit guarantee agency would have an expected low return that would not be attractive for private sector investors, or even incur large losses to be absorbed by trust funds under adverse market conditions, it implies that the initiative could potentially require significant public subsidy to support bond financing. Whether such subsidies are the best use for public money is beyond the scope of the paper; in practice, burden-sharing among Asian governments for financing the agency could be an important issue to consider.

The final question is how serious an impediment to bond market development the perceived credit quality gap between issuers and investors is. Strong demand from investors for high-grade bonds should exert heavy market pressure on corporate issuers to improve their creditworthiness through greater reliance on equity financing. Looking forward, the credit quality gap is likely to narrow, with or without the credit guarantee agency. With rapid growth and prudent macroeconomic and financial policies, sovereign and corporate credit fundamentals have indeed improved substantially over the past year, evinced by record upgrades in the region by international rating agencies. Improving corporate credits in the region would certainly benefit the proposed credit enhancement agency.