Comments on Francis Braeckevelt's paper "Infrastructure in the Asian bond markets: clearing, settlement and depository issues"

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This paper provides an excellent and comprehensive survey of the differences in mechanisms of Asia's bond settlement and clearing systems. More importantly, the author goes on to propose various models for achieving a coherent structure that could alleviate some of the problems plaguing the current infrastructure.

It is easy to agree that the successful evolution of an efficient Asian bond market depends on demand and supply side dynamics. And it is also well acknowledged that poor liquidity conditions and investor (in many cases in Asia, offshore investor) restrictions are constraining the ability of regional and international players to transact in Asian bonds, especially local currency issues. Slow acceptance of Asian bond benchmarks is also a major stumbling block. And on the supply side, the lack of issues and the competition with excess liquidity in loan markets limit the playing field.

Naturally, good infrastructure, like settlement and clearing systems, facilitates transactions, increases trading efficiency and minimises costs and risks. Although these issues are secondary, they are also important in minimising overall development costs in an industry where yields are at historical lows and in a region where standards are extremely heterogeneous.

1. Differences in Asian clearing and settlement systems

Francis begins by highlighting the historical evolution of clearing and settlement systems in the United States, Europe and Asia. While the benefits from homogeneity are evident in the United States, Europe is still going through a rationalisation and consolidation process that is aided by capital market deregulation and public sector oversight. While Europe provides the best learning curve for Asia, the regions have different starting points, although the initial market structures have similarities. First, Europe is ahead in its convergence, with financial market integration being an intermediate stage towards a true union. Asia undeniably shows diversity in standards and regimes. And while the European standardisation process is proving very costly in terms of efficiency and distortions, the costs for Asia are likely to be at least comparable if not higher.

The author concludes that domestic systems would probably emerge, with limitations on convergence in standards. I would be more hesitant to make that prediction. But I would agree with the author that some form of integration is likely to evolve. With more global institutional custodians expanding into the region and increasing global capital flows, it may well be that domestic systems will eventually converge to a global or regional standard. It just makes market sense for them to do so simply because the successful development of an embryonic asset class is extremely sensitive to costs in terms of both transaction and spreads. And with yields at historically low levels, cost consideration is too important a factor to ignore. An example is the prevalence of multiple layers of custodian services in some sectors due to divergence in expertise, sophistication or breadth of services offered. It is costly both for clients and for investment managers to contend with both local and global custodians, in terms of not only fees, but also risk management, efficiency, time, and instruction flows. One issue we have found to be pervasive in the region is the lack of understanding and maturity among institutional investors in the asset class that still prevails. Naturally, this can only be addressed in time, but it does pose a challenge that cannot be underestimated.

2. Applicable models for Asia

The paper then proceeds to propose three possible models for Asian bond markets, taking into account regional differences in existing infrastructure, current transformation trends in the region, and the basic compatibility of most systems with Rule 17f-7 of the US Investment Act. The models differ in the extent of integration across the system.

The first proposal, which the author terms the "Interlinked Depository" model, essentially retains domestic differences while allowing for some degree of integration across the region between sovereign entities. Absent regional leadership, I would agree that this is the most realistic and achievable option. While the attraction of this model would be its limited "direct" costs, its "indirect" costs from the structural inefficiencies that may arise in the "interlinking" process and its limited scalability in the system are ultimately less attractive.

The second model, the "Full Consolidation" approach, provides more complete integration and scalability but incurs more direct or developmental costs. The requirement would be the presence of an oversight body that may be difficult for sovereign countries to agree on.

Third, and perhaps most improbable at this stage, would be the "Private Central Institution" proposal, which operates seamlessly as if the region were one bloc. The author rejects this model due to the difficult arrangements that are required from various countries.

While I would agree that the first model presents the most feasible and realistic option, I would postulate that the overall costs (direct and indirect) might prove higher. Clearly, with the relatively short period that local economies have had to incubate their bond markets, an important question that arises is whether this short history constitutes an advantage for the region in making it possible to bypass the standard domestic development in favour of a more standardised platform. Global standards are evolving and generally converging to a commoditised structure, but it does take time to gravitate to an "end equilibrium". If this were a process governed by pure market forces, then the speed and direction of that gravitation would be obvious. But given the structural differences in the region in terms of regulation, tax and operational issues, it would be hard to disagree with the paper.

3. Conclusions

This paper points to a "first-best" solution that could be reached if Asia were a homogenous region. But it highlights issues that suggest extremely challenging work to seriously address the limitations of the current financial infrastructure. A comforting point is the speed at which some countries have addressed these issues and restructured their systems. The hope is that while we have seen the impressive speed in the convergence of the real Asian economies, the day may not be too far away when we finally witness the convergence of the Asian financial sector.