Bond market regulation and supervision in Asia

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Executive summary

Modern economies need efficient financial markets. In Asia, financial market development has primarily been centred around banking and to some degree equity markets. Bond markets always played a smaller role and some people believe that the absence of large and robust local bond markets may have helped to cause the Asian crisis. True or not, Asian policymakers have focused on local bond market development since the crisis. Indeed, local bond markets have grown in size, but are still viewed as underdeveloped.

This has raised the question, on the one hand, of whether there are too many restrictions that hamper market development. On the other hand, there is also the question of whether current prudential regulatory standards are sufficiently sound. The purpose of this paper is to analyse and compare the different degrees of liberalisation of Asian local bond markets and their prudential standards. The key findings are as follows.

- The extent of bond market liberalisation and prudential regulation varies substantially within the region. Only Hong Kong SAR and Singapore are on a par with global standards and best practices.
- There is ample room for liberalisation and deregulation in most countries to promote the development of local bond markets.
- Prudential standards are not grossly out of line with the respective degrees of bond market liberalisation, but that is no reason for complacency since there is a need for regulators not to fall behind the changes and developments in the marketplace.
- The basic structure and content of securities regulation in Asia looks increasingly similar to the model adopted in most other parts of the world, but there are notable deficiencies in some countries concerning enforcement. On the one hand, supervisors are often too bureaucratic. On the other, they often lack the ability or even the will to enforce basic standards.
- A key factor undermining the effectiveness of prudential regulation in some countries is the general weakness of the legal and accounting infrastructure, which is partly a function of the prevailing attitude towards common rights versus special interests.
- The two areas with the biggest weaknesses are issuer disclosure and the prevention of systemic risks. Disclosure standards for new issues are largely observed, but regular reporting is weak. Supervisors' understanding of market positions and related risks, with regard to both individual investors and intermediaries, is often not sufficient, largely due to resource issues.

In summary, there is clearly a need to strengthen prudential standards in most countries. However, this may be better achieved and have a greater impact on bond market

[1] The views expressed in this report are those of the author and not necessarily those of JPMorgan.

development if it takes the form of adoption and implementation of global best practices rather than attempts to harmonise bond market rules and regulations within the region.

Defining regulation

Any meaningful discussion of financial market regulation first requires a description of the basic regulatory framework. Not so long ago, financial market regulation in Asia consisted primarily of a set of rules and restrictions that were mostly aimed at ensuring market (and broader macroeconomic) stability and protecting onshore financial institutions from offshore competition. In the late 1980s and early 1990s, some of these rules and restrictions, especially capital controls, were eased. This led to a surge in offshore borrowing and what followed is well known history.

One of the key lessons of the Asian crisis is that financial liberalisation should not occur in isolation. Critical for success is the existence of adequate prudential regulation and supervision that protects investors, ensures that markets are fair and transparent and reduces systemic risks. Equally important is that the policy regime, especially the exchange rate regime, is sufficiently flexible to cope with increased capital mobility.

In the years since the Asian crisis, there has been sustained effort in every country to improve the prudential regulation and supervision of the financial sector and progress has been made everywhere, although to different degrees. Some countries have also adjusted their monetary policy frameworks to cope better with the rise in capital mobility, but the preference for tight monetary policy control, especially over the exchange rate, has remained strong. As a result, many countries have been slow to ease the foreign exchange and capital controls they imposed during the Asian crisis.

Another popular conclusion from the Asian crisis is that financial intermediation relied too much on traditional commercial banking and that most countries lacked strong local capital markets. In response, every country in the region has made efforts to promote its local bond market. These markets have grown substantially compared with the years before the Asian crisis (on average, more than tripling in size), but most people would still view them as underdeveloped. Much of the market growth has been driven by government issuance, which in turn was largely a legacy of the Asian crisis. Buy-and-hold investors, mostly commercial banks, still dominate markets and liquidity is low, while corporates still struggle to raise funds in the domestic bond market and rely on bank loans or offshore borrowing.

The recognition that local bond markets remain underdeveloped has more recently led to several regional efforts to promote their development, including the Asian Bond Fund (ABF) initiative by the 11 EMEAP central banks. A number of issues have been identified as hampering the development of local bond markets, including access barriers, especially for foreigners, lack of funding and hedging instruments, inadequate clearing, settlement and trading systems, lack of liquid benchmark curves, and last but not least insufficient prudential regulation and supervision.

This paper will focus on the regulatory aspects and compare the degree of financial liberalisation of local bond markets with the relevant prudential regulatory and supervisory conditions. The study focuses on eight local bond markets in non-Japan Asia which are in EMEAP economies, namely China, Hong Kong SAR, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand.

First, however, some more clarification of the term “regulation” is required. The usage of this term still creates some confusion and often has a negative connotation. On the one hand, people talk about regulatory restrictions that hamper market development and the need for deregulation and market liberalisation. On the other hand, there is growing demand for more sound regulation and supervision of market practices, especially following the Asian crisis

and the corporate governance scandals of recent years. To provide a framework, this paper differentiates between two types of regulation, namely economic regulation and prudential regulation.

Economic regulation

The motivation behind economic rules and restrictions often varies, but the end effect is that they undermine the free operation of market forces by prohibiting certain business activities or making them difficult. Good examples are market entry restrictions, capital controls, price controls and certain taxes. Often, economic regulations are used to support macroeconomic policy objectives, like financial market or foreign exchange stability. But while such regulations may help governments achieve their policy objectives, they are typically inefficient and lead to a misallocation of resources. Moreover, market participants often seek loopholes to circumvent these restrictions, which leads to a whole new set of problems. Another motive behind economic regulations, especially entry barriers, is to protect domestic financial institutions from foreign competition. However, such protection typically leads to inefficiencies and preserves poor market practices.

The aim of any developing economy should be to gradually reduce economic regulations and open up its markets. The only caveat is that such liberalisation should not run ahead of other economic, policy and market reforms, including the establishment of strong prudential regulation. Thus, when comparing the different degrees of financial liberalisation in the region, one needs to be mindful of the circumstances and the feasible extent of deregulation against the background of economic, policy and market conditions. In other words, the current degree of financial liberalisation in Hong Kong or Singapore is not a realistic near-term goal for countries like China or Indonesia.

Prudential regulation

Prudential regulation and supervision are meant to protect investors, ensure that financial markets are fair, transparent and efficient and reduce systemic risks. A strong prudential regulatory environment is the key to a successful financial centre. Contrary to popular wisdom, most financial institutions do not want lax regulation. The customers of financial firms need the assurance that the institutions with which they do business have high ethical standards, are prudently run, have high-quality staff, and adhere to the highest business standards. Unless they have confidence in these factors, they will simply take their business elsewhere.

Most financial institutions recognise that good regulation is a valuable asset which raises the value of their services in the eyes of their customers. It is no accident that the most successful financial centres, New York, London, Hong Kong and Singapore, all have rigorous supervision. Even so, detailed mechanical rules and ratios enforced by frequent checking are undoubtedly burdensome. When these rules constrain otherwise desirable transactions, they can contribute to driving business away.

Good prudential regulation works with the grain of market forces and should provide incentives to reinforce prudent instincts. This is why the trend of regulation and supervision is towards encouraging high-quality risk management processes, and away from detailed monitoring of balance sheet ratios. It stresses transparency, market discipline and self-regulation, and not just compliance with formal rules. In this spirit, the relationship between the regulatory agency and the regulated entity should not be adversarial.

The financial sector should regard the supervisor as a partner and counsellor, rather than as a policeman enforcing rules. The supervisor should be able to offer guidance to the financial institution when it falls short of best practice elsewhere in the industry, or when the business model being followed seems to have under-appreciated risks. Only when the institution

concerned has taken on unacceptable risks, misled investors or violated the law in any other way should the supervisor forcefully intervene in the public interest.

Having said that, it is also critical for effective regulation that the supervisory institutions are empowered to do their job, have the right people and resources, and are supported by sound legal and accounting standards. This means that objectives and responsibilities must be well defined, especially when there is more than one supervisory authority. Supervisors must have the training and background to deal with their private sector counterparts on equal terms and their compensation should not lag too far behind private sector standards. Legal, accounting and other financial infrastructure elements are often outside the scope of financial regulation, but supervisors need to impress on other public bodies the need to establish robust standards.

Economic regulation and local bond markets

There are many types of economic regulations in the region that have some restrictive impact on the development of local bond markets. This study focuses only on those that are the most common and have the most disruptive impact. In no particular order, these economic regulations are:

- Rules that limit foreign participation in the local bond market;
- Bond issuance restrictions;
- Price and interest rate controls;
- Rules that limit the use of hedging instruments;
- Taxation;
- Custody, settlement and clearing restrictions.

Foreign access

There are still substantial restrictions in several countries on access by foreign investors, issuers and intermediaries who want to participate in the local bond markets (Table 1). At one extreme, China is currently the most closed market. Investors can only enter the local bond market if they apply for a Qualified Foreign Institutional Investor (QFII) licence, which is a laborious process. On the issuance side, the government now seems willing to open the local market to multilateral agencies, but no bonds have been issued so far. And for intermediaries, access is currently only available through joint ventures. Even so, the schedule of China's WTO agreements and the current reform drive promise more opening of China's capital markets to foreign participation in the next few years. Only the move to full capital account convertibility probably remains many years (if not decades) away, given the poor health of many domestic financial institutions, especially the state-owned commercial banks.

At the other extreme, Hong Kong and Singapore are the most open financial centres in the region. The main difference between the two is the non-internationalisation policy of the Singapore dollar, which in practice only means that foreign bond issuers must swap the bond proceeds that are not used for domestic investment purposes into another foreign currency. Getting an intermediary licence is also a bit more difficult in Singapore compared to Hong Kong. In between these extremes, Korea, and to a slightly lesser extent Thailand, are more accessible, especially for investors. Indonesia, Malaysia and the Philippines are more on the closed side, in particular in terms of issuer access, which, as with China, is limited to multilateral agencies on a case by case approval basis.

Table 1

Foreign access

	China	Hong Kong SAR	Indonesia	Korea
Investor access	Very limited	Very open	Limited	Open
Issuer access	Very limited	Very open	Very limited	Limited
Intermediary access	Very limited	Very open	Limited	Limited
Foreign exchange/ capital controls	Heavy	None	Some	Some
	Malaysia	**Philippines**	**Singapore**	**Thailand**
Investor access	Limited	Limited	Very open	Open
Issuer access	Very limited	Very limited	Open	Very limited
Intermediary access	Limited	Limited	Open	Limited
Foreign exchange/ capital controls	Some	Some	None	Some

Issuance restrictions

Bond issuance restrictions not only affect foreign issuers, but domestic issuers as well. Protection of investor interests is often the motivation behind these rules, but this may come at the expense of unnecessarily constraining an issuer's ability to go to the market. There are two types of issuance models: disclosure-based and merit-based.

- In the disclosure-based model, which is increasingly becoming the global standard, the issuer is required to disclose all relevant information, but investors have to decide themselves whether the bond is fairly valued.
- In the merit-based model, a regulator decides whether an issuer is fit to launch a bond. The regulator's decision may be based on pure discretion, but more typically is based on a number of criteria, like the issuer's past financial performance, capitalisation, size of the issue, rating and so on.

In Asia, Hong Kong, Malaysia and Singapore have adopted the disclosure-based model (Table 2). For Malaysia, the main deviation is that issuers have to be rated before they can launch a bond. How restrictive the merit-based models in the rest of the region are depends largely on the regulatory requirements. The recently released new issuance rules in Thailand, for example, have become more issuer-friendly for large and frequent borrowers, but create a higher hurdle for small and infrequent borrowers.

Korea's issuance requirements have also become more liberal, but arrangers still have to commit to fully underwrite the bond. China has the most restrictive issuance requirements. Issuers must be rated at least AA and have to get approval from two or sometimes three regulators. In addition, the central bank sets or approves the interest rate level of the new bond.

Table 2

Issuance rules

	China	Hong Kong SAR	Indonesia	Korea
Issuance model	Merit	Disclosure	Merit	Merit
Mandatory rating	Yes	No	Yes	Yes
Number of domestic rating agencies	2	None	1	3
	Malaysia	**Philippines**	**Singapore**	**Thailand**
Issuance model	Disclosure	Merit	Disclosure	Merit
Mandatory rating	Yes	Yes	No	Yes
Number of domestic rating agencies	2	1	None	2

The mandatory rating requirement, which is standard in almost every economy except for Hong Kong and Singapore (note that both these economies are also the only ones without at least one domestic rating agency), is undoubtedly meant as a protection for investors. This may put pressure on issuers in the less developed markets to comply with the disclosure requirements. However, this benefit declines and the rating requirement becomes more of an additional cost as the market develops and disclosure standards are generally met. Furthermore, investors may become complacent and rely too much on the judgment of the rating agencies instead of making their own assessments.

Price and interest rate controls

Only China still has direct price and interest rate controls. The People's Bank of China (PBoC) effectively controls the cost of borrowing. For loans and bonds, the key rate is the central bank rate and the PBoC determines or approves the spread between this rate and the borrowing rates. The objective is to keep overall borrowing costs low, but also to leave enough margins for the banks between lending and borrowing rates. While interest rates are market-determined in the rest of the region, some countries still resort to moral suasion and other forms of indirect intervention to keep interest rates within desired ranges.

Hedging instruments

Lack of hedging instruments is repeatedly listed as one of the top obstacles to the development of local bond markets. At the moment, only Hong Kong permits the full range of hedging instruments. To be sure, derivatives are complex financial instruments and need to be used with care, but the reluctance to approve their use often has more to do with the fear that they may be used to destabilise markets than real prudential concerns. It must also be recognised that hedging instruments can be unavailable despite a neutral stance by the authorities, owing to a lack of liquidity in the market.

After Hong Kong, Korea, Singapore and Thailand have taken the most steps to liberalise the use of derivatives in the local fixed income markets (Table 3). In China, the use of derivatives is still the least developed, but a new series of guidelines is currently paving the way for the introduction of basic interest rate derivatives. In Indonesia, Malaysia and the Philippines, the use of derivatives is highly restricted and, unlike in China, there are no signs that this will change soon.

Table 3

Availability of hedging instruments

Risk type	China	Hong Kong SAR	Indonesia	Korea
Foreign exchange	Limited	Yes	Yes	Yes
Duration	No	Yes	No	Yes
Yield curve	No	Yes	No	Yes
Credit	No	Yes	No	No
Risk type	**Malaysia**	**Philippines**	**Singapore**	**Thailand**
Foreign exchange	Limited	Yes	Yes	Yes
Duration	Limited	No	Yes	Yes
Yield curve	No	No	Yes	Yes
Credit	No	No	No	No

Taxation

The issue as regards taxation is not so much one of principle (whether capital income and gains should be taxed), but one of distortion. There are legitimate reasons why governments want to tax capital income and capital gains. The problem is that it is difficult, if not impossible, to tax the different forms of capital income and capital gains equally. Moreover, there is a growing global trend not to tax foreign investors. So investors are likely to avoid those countries that still do so. Finally, even if there are tax treaties in place, the paperwork is often so laborious and refunding takes so long that many foreign investors stay out of the market.

In Asia, taxation is still a key factor that keeps many foreign investors away from local bond markets. Only Hong Kong and Singapore effectively do not tax foreign investors (Table 4). China has also done away with the withholding tax and only taxes capital gains if bonds are not held until maturity. Korea now has tax treaties with many countries, but the high amount of taxes initially withheld and the long time period until refunds are paid out still deter many foreign investors.

Table 4

Taxation

Tax type	China	Hong Kong SAR	Indonesia	Korea
Withholding tax	None	None	20%[1]	27.5%[1]
Capital gains tax	33%[2]	None	None	11% or 27.5%[3]
Tax type	**Malaysia**	**Philippines**	**Singapore**	**Thailand**
Withholding tax	15%[1]	20-32%[1]	None[4]	15%[1]
Capital gains tax	None	None	None	15%[1]

[1] Can be reduced or waived by tax treaty with certain other countries. [2] If bonds are not held until maturity (plus 5% profit tax). [3] The lower of 11% of gross sales proceeds or 27.5% tax on net capital gains. [4] Originally 10% but waived for all bonds issued after 1998. Singapore also has the most tax treaties of any country in the region.

Custody, settlement and clearing

Custody, settlement and clearing are the last areas one should highlight where restrictions are undermining local bond market activity and development. Settlement and clearing systems and conventions have substantially improved throughout the region (delivery versus payment and real-time gross settlement systems are standard in most countries), but they remain much localised.

Foreign investors that are active in local bonds have to use a local custodian and settle and clear their trades locally. Besides entailing extra effort and cost, the often short settlement periods in the local markets leave little time for foreign investors to process their trades (in Hong Kong, Korea, Malaysia, the Philippines and Singapore, local currency bonds settle either on the same day or the day after).

For the providers of custody services, another issue is the reluctance of local authorities to allow them to outsource part of their activities, especially to processing centres outside of the country. This also often applies to banks and securities firms that intend to move their back and middle offices to a central location outside the country. China currently prohibits the offshoring of any processing activities, while most other countries require approval. In some economies, for example Hong Kong, obtaining approval is primarily a matter of proving that the data and information are properly protected, while some other authorities tend to reject outsourcing requests simply to keep the business onshore.

Prudential regulation and local bond markets

The three broadly accepted objectives of prudential regulation and supervision for financial markets are the protection of investors, ensuring fair, transparent and efficient market practices and reducing systemic risks. Financial regulation and supervision is typically divided into three main sectors: banking, insurance and securities markets. Bond markets fall under the scope of securities market regulation and supervision, but there is typically some overlap with banking and insurance regulation. The regulatory structure varies from country to country, but basically evolves around one main law that contains most parts of the securities market regulation and one main agency that is responsible for supervision. In some countries, one agency supervises all financial sectors (banking, insurance and securities markets), but most countries have separate agencies overseeing each sector.

Securities regulation and supervision are broader in scope and more complicated than banking and insurance regulation and supervision. In banking and insurance, regulation and supervision deals almost entirely with the intermediary (ie banks and insurance companies), while securities regulation and supervision has a much broader scope, including securities intermediaries (eg brokers, dealers and investment advisers), exchanges, collective investment schemes and issuer disclosure.

The roots of securities market regulation and supervision in Asia go back to well before the Asian crisis, but have undergone substantial changes since then. Today, the basic framework of securities regulation and supervision in the region looks very similar to the standards in the rest of the world. In each country, there is typically one main law that governs securities regulation and one main authority that supervises the sector, although there are typically other relevant laws and supervisory authorities (Table 5).

Table 5

Securities regulation - laws and authorities

	China	Hong Kong SAR	Indonesia	Korea
Main securities laws	China Sec Law	Sec & Fut Comm Ord	BAPEPAM Rules, Cap Mkt Law[1]	Sec & Exch Law
Number of other laws relevant for securities	7	4	3	4
Main securities supervisor	China Sec Reg Comm	Sec & Fut Comm	BAPEPAM	Fin Supv Comm
Year established	1992	1989	1976	1998
Accountable to	State Council	Fin Secretary	MoF	MoFE
Staffing[2]	1,525	361	443	1,670
Funding	Gov & fees	Self-funded	Gov & fees	Gov & fees
Other relevant regulatory authorities	CBRC, PBoC, SAFE[3]	HKMA[4]	Bank Indonesia	FSS, SFC[5]
Structure of overall financial sector supervision[6]	Multiple	Multiple	Multiple	Single
	Malaysia	**Philippines**	**Singapore**	**Thailand**
Main securities laws	Sec Ind Act	Sec Reg Code	Sec Ind Act	Sec & Exch Act
Number of other laws relevant for securities	7	5	6	4
Main securities supervisor	Sec Comm	Sec & Exch Comm	MAS[7]	Sec & Exch Comm
Year established	1993	1936	1971	1992
Accountable to	MoF	MoF	MoF	MoF
Staffing[2]	549	361	987	391
Funding	Self-funded	Gov & fees	Self-funded	Self-funded
Other relevant regulatory authorities	BNM, CCM[8]	BSP[9]	None	Bank of Thailand
Structure of overall financial sector supervision[6]	Semi	Multiple	Single	Multiple

[1] BAPEPAM = Badan Pangawas Pasar Modal, the capital market supervisory agency. [2] See Central Banking Publications (2004). [3] CBRC = China Banking Regulatory Commission; PBoC = The People's Bank of China; SAFE = State Administration of Foreign Exchange. [4] HKMA = Hong Kong Monetary Authority. [5] FSS = Financial Supervisory Service; SFC = Securities and Futures Commission; the FSS and SFC are executive bodies of the Financial Supervisory Commission. [6] Integration/division in the supervision of the three main financial sectors (banking, insurance and securities): multiple = at least one supervisor for each sector; semi = one supervisor for two sectors; single = one supervisor for all sectors. [7] MAS = Monetary Authority of Singapore. [8] BNM = Bank Negara Malaysia (Central Bank of Malaysia); CCM = Commission Companies of Malaysia. [9] BSP = Bangko Sentral ng Pilipinas (Central Bank of the Philippines).

Legal and accounting standards

Securities regulation and supervision cannot be seen in isolation from the broader legal framework and accounting requirements. Appropriate and effective legal and accounting standards form the foundation for the regulatory and supervisory framework. In some places, it is a lack of sound legal and accounting standards that undermines what on paper looks like good regulation and supervision. In many parts of Asia, legal and accounting standards were poor before the 1997-98 crisis and, while reform is under way, six years is not a long time in which to make the types of structural and behavioural changes that typically require more than one generation.

Only Hong Kong, Singapore and to some extent Malaysia had robust legal standards before the Asian crisis. All three also practise *common* law. The legal code in the rest of the region is based on forms of European *civil* law, which is often complicated by the inclusion of other legal cultures, like socialist law in China, customary law in Indonesia, classical Chinese law in Korea, or Buddhist law in Thailand. In general, the quality of the law is improving in most parts of the region, but there are still some notable gaps, like private property law in China and Indonesia.

Table 6

Legal and accounting standards

	China	**Hong Kong SAR**	**Indonesia**	**Korea**
Type of law	Civil	Common	Civil	Civil
Legal opacity index[1]	100	55	86	79
Formal compliance with International Accounting Standards	Some material differences	Closely aligned	No material differences	No material differences
Accounting opacity index[1]	86	53	68	90
Corruption opacity index[1]	62	25	70	48
Corruption perceptions index[2]	3.4	...	1.9	4.3
	Malaysia	**Philippines**	**Singapore**	**Thailand**
Type of law	Common	Civil	Common	Civil
Legal opacity index[1]	...	...	32	65
Formal compliance with International Accounting Standards	No material differences	Some material differences	Closely aligned	No material differences
Accounting opacity index[1]	...	...	38	78
Corruption opacity index[1]	...	...	13	55
Corruption perceptions index[2]	5.2	2.5	9.4	3.3

[1] See PricewaterhouseCoopers (2001); the index ranges from 0 (least opaque) to 150 (most opaque). [2] See Transparency International (2003); the index ranges from 10 (highly clean) to 0 (highly corrupt).

As important as the quality of the law is the quality of the legal system (eg judges, lawyers, etc). Before the Asian crisis, the quality of the legal system was well behind the capital market development in most countries. The crisis revealed the inadequacy of most legal systems in the region, although one should be mindful that any existing legal system would have been severely challenged if faced with the kind of systemic insolvencies seen during and after the crisis.

Since the Asian crisis, there have been widespread efforts by all countries to improve their legal systems and progress is visible. However, one fundamental problem is that the prevailing political, social and economic power structures in some countries continue to work against efficient legal systems. Not coincidently, this bias to resist efficient legal systems correlates with the persistence of corrupt practices in several countries (Table 6).

On the accounting side, most countries in the region comply largely with International Accounting Standards (IAS) and/or US GAAP. Only China and the Philippines still have significant gaps, such as in the measurement of fair market value, but both are working to converge to international standards over the next few years. As with the legal standards, the problem lies less in the quality of the accounting rules than in their implementation. To some extent, this is a resource and training issue. But the more fundamental problem is whether there is the political will to change old habits.

IOSCO principles of securities regulation

All countries in this study are members of the International Organization of Securities Commissions (IOSCO) and subscribe to its principles of securities regulation. These 30 principles are grouped into eight categories (Table 7):

- Principles relating to the regulator;
- Principles for self-regulation;
- Principles for the enforcement of securities regulation;
- Principles for cooperation in regulation;
- Principles for issuers;
- Principles for collective investment schemes;
- Principles for market intermediaries;
- Principles for the secondary market.

The first four categories concern the regulatory and supervisory institutions directly, while the remaining categories outline the regulatory principles for the four main areas of securities regulation (ie issuers, collective investment schemes, market intermediaries and the secondary market). It is beyond the scope of this paper to assess in detail to what extent these principles have been implemented by each country - the IMF and the World Bank are currently leading a project to assess the observance of the principles - but some preliminary observations can be made.

Table 7

IOSCO principles of securities regulation

Principles relating to the regulator

1. The responsibilities of the regulator should be clear and objectively stated.
2. The regulator should be operationally independent and accountable in the exercise of its function and powers.
3. The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
4. The regulator should adopt clear and consistent regulatory processes.
5. The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.

Principles for self-regulation

6. The regulatory regime should make appropriate use of self-regulatory organisations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.
7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentially when exercising powers and delegated responsibilities.

Principles for the enforcement of securities regulation

8. The regulator should have comprehensive inspection, investigation and surveillance powers.
9. The regulator should have comprehensive enforcement powers.
10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance programme.

Principles for cooperation in regulation

11. The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
12. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.
13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

Principles for issuers

14. There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.
15. Holders of securities in a company should be treated in a fair and equitable manner.
16. Accounting and auditing standards should be of a high and internationally acceptable quality.

Principles for collective investment schemes

17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.
18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
19. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
20. Regulation should ensure that there is a proper and disclosed basis for asset valuation and pricing and the redemption of units in a collective investment scheme.

Table 7 (cont)

IOSCO principles of securities regulation

Principles for market intermediaries	
21.	Regulation should provide for minimum entry standards for market intermediaries.
22.	There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
23.	Market intermediaries should be required to comply with standards for internal organisation and operation conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.
24.	There should be procedures for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and to contain systemic risk.
Principles for the secondary market	
25.	The establishment of trading systems, including securities exchanges, should be subject to regulatory authorisation and oversight.
26.	There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
27.	Regulation should promote transparency of trading.
28.	Regulation should be designed to detect and deter manipulation and other unfair trading practices.
29.	Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
30.	Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

Source: IOSCO (2003).

Principles for the regulator, self-regulation, enforcement and cooperation

First, many of the principles relating directly to the regulatory and supervisory institutions have generally been implemented in the region. Nevertheless, there are some notable differences between countries. Second, implementation is often narrow and lacks effectiveness. A good example is the spread of regulatory responsibilities across several agencies or the lack of clarity of roles. To be clear, though, this is not to suggest that all countries should create a single regulator for the whole financial sector as adopted by Korea and Singapore. Whether there are multiple regulators or only one, most important is that responsibilities are clearly defined and standards and rules are consistent across sectors and institutions.

In that respect, the most confusion still exists in China. The patchwork of eight securities laws leaves gaps and is not entirely consistent, while overlapping responsibilities with the other three authorities involved in securities supervision often undermine the effectiveness of the China Securities Regulatory Commission. Korea, on the other hand, is a good example of the fact that even the single regulator model can have its problems. The trifurcated structure of the Financial Supervisory Commission appears cumbersome and in some cases gets in the way of regulatory effectiveness.

A different issue that is often raised by people familiar with securities regulation in Asia is that the supervisory authorities are often not sufficiently independent from the government or

other public authorities (like the central bank) to fulfil their roles. The desire for operational independence is understandable, and so is the desire to reduce the degree of political influence over regulatory decisions. In many countries, the government often interferes with the supervisory agency in respect of enforcing laws and regulations.

At the same time, it is only appropriate that a supervisory agency be accountable to a government body, typically the Ministry of Finance, and that it closely coordinate with other relevant government bodies, especially in times of crisis. More broadly, coordination and cooperation with other regulatory authorities and government institutions, both domestic and foreign, is an area where more progress is needed. This is even true for Hong Kong, whose regulatory framework is generally viewed as one of the best in the world. A case in point is the growing number of transactions and relationships between Hong Kong and the mainland. The supervision of the Hong Kong affiliates of mainland companies is no doubt strong, but little is typically known about the financial conditions of the parent companies.

Resources are another area where conditions differ. In terms of number of staff, supervisory agencies in the region have sufficient manpower to do their jobs. The problem is not quantity but quality, in terms of basic training as well as ongoing training to stay in touch with financial developments. Another issue in this regard is staff retention, which is not only a matter of pay but also motivation. In fact, even Hong Kong and Singapore, which have the highest quality of staff and the best pay, have difficulty retaining their top people.

Resource constraints are not limited to people. Another issue, especially for the less developed countries, is the technical ability to closely monitor markets and trading positions to detect manipulation and systemic risks. Interestingly, resource constraints occur everywhere, no matter what the type of funding. For those agencies that depend primarily on government funding, the message is that more is needed. For those agencies that are self-funded, the message may be that other sources may be needed, even if that may somewhat undermine the public image of independence.

Large differences in regulatory standards are also apparent in the area of enforcement. While most regulators have formally adequate powers of inspection, investigation and surveillance, they are often constrained in their ability to require compliance and impose penalties. Moreover, some regulators appear complacent and seem to deliberately overlook violations. Supervisors in Hong Kong and Singapore have the best reputation and there are few violations (if any) that go undetected and unpunished. Supervisors in Korea and Malaysia have sufficient regulatory authority and recent actions point to a growing commitment to enforcement, but there is still a sense that supervisors occasionally turn a blind eye to apparent regulatory violations.

In terms of style and procedures, Hong Kong and Singapore have the highest standards, but Hong Kong's securities supervisors are viewed as more user-friendly than their Singapore colleagues, who still have a reputation for being somewhat paternalistic. At the other end of the spectrum, China still struggles with many basics. In general, the rule in China remains that, if the law does not already approve a transaction, then it cannot be done. Another issue in China is poor documentation of new procedures and guidelines, which places demands on the experience of financial intermediaries, investors and issuers.

Korea's securities supervisors have made good progress in issuing appropriate and timely rules and procedures. Market perception, however, is that there are too many rules of sometimes mixed quality, while implementation is still very bureaucratic. Obtaining broader public comment would also help Korea's supervisors to dispel the sense that certain groups within the financial sector disproportionately influence some policies.

Use of self-regulatory organisations (SROs) in securities regulation is mostly limited to public exchanges, which usually have SRO status. In practice, exchanges focus primarily on stock market activity and less on bond markets, where secondary market trading takes place mostly over the counter. One exception is Thailand, where the Thai Bond Dealing Centre (an SRO) is responsible for monitoring activity in the bond market. The typical issue with an SRO

like a public exchange is that its own capability to regulate, monitor and discipline its members or market segments is often limited, while the relevant regulator does not always exercise full and consistent oversight over the SRO.

Principles for issuers

Disclosure standards, accounting and auditing practices and investor protection are issues that have received much attention around the world following the series of corporate governance scandals in recent years. In Asia, these concerns are compounded in many countries by prevailing legal uncertainties. Most countries in the region fulfil the basic disclosure requirements for new issues, but there are concerns regarding the timeliness and accuracy of reporting of new material information. Even in Hong Kong and Singapore, which have the soundest disclosure standards in the region, the release of non-periodic information is sometimes slow.

Issuer adherence to disclosure standards is often lax because of limited civil liability. Issuers in Malaysia, for example, face little or limited consequences if they are slow to disclose vital information or make false or misleading statements. The other main shortcoming in many countries relates to accounting and audit. The issues here concern both the quality of staff and the oversight of those staff by the professional associations and their respective official regulators. Only Hong Kong and Singapore are on a par with global best practices in this area.

In some cases, however, disclosure requirements are too stringent. In the new Thai issuer and disclosure guidelines, for example, the financial adviser, who is typically the underwriter, has the same responsibility and liability to ensure the correctness of all information provided in the prospectus as the issuer. The intention behind this is to make sure the underwriter undertakes proper due diligence. However, this does not conform to global best practices and may lead to higher transaction costs.

Principles for collective investment schemes

Regulation and supervision of collective investment schemes is mixed in the region, largely as a result of the recent development of this industry in many countries. In the least developed markets, proper product descriptions, clear definition of principal and agent, and risk warnings fall short of global standards. In some countries, retail investors are often not sufficiently advised about the differences between bond funds and regular bank deposits, which leads to an underestimation of the potential risks and an overestimation of the potential returns.

In contrast, some countries are clearly too strict in the way they regulate collective investment schemes, which undermines their growth potential. This is, for example, the case in Korea. Another issue concerns the growing internationalisation of fund management. Hong Kong, for example, currently has the largest fund management industry in the region, but many funds distributed in Hong Kong are managed offshore, which creates challenges for local supervisors.

Principles for market intermediaries and the secondary market

The licensing process for new market intermediaries appears sound from a prudential perspective. In fact, the issue is more that some countries are still too stringent in giving new licences, especially for foreign intermediaries. However, other aspects of the ongoing supervision of market intermediaries, such as the monitoring of capital requirements, risk management, governance, failure procedures and other prudential controls, still require strengthening in many countries.

Related to the regulation of market intermediaries is the supervision of secondary market activities. The regulation of public exchanges in the region is generally approaching global standards, but the detection and prosecution of manipulation and other unfair trading practices are not consistently enforced in all countries. Partly, this is a resource problem, with modern surveillance systems lacking. In addition, some countries need to step up enforcement of the self-regulatory responsibilities of their exchanges.

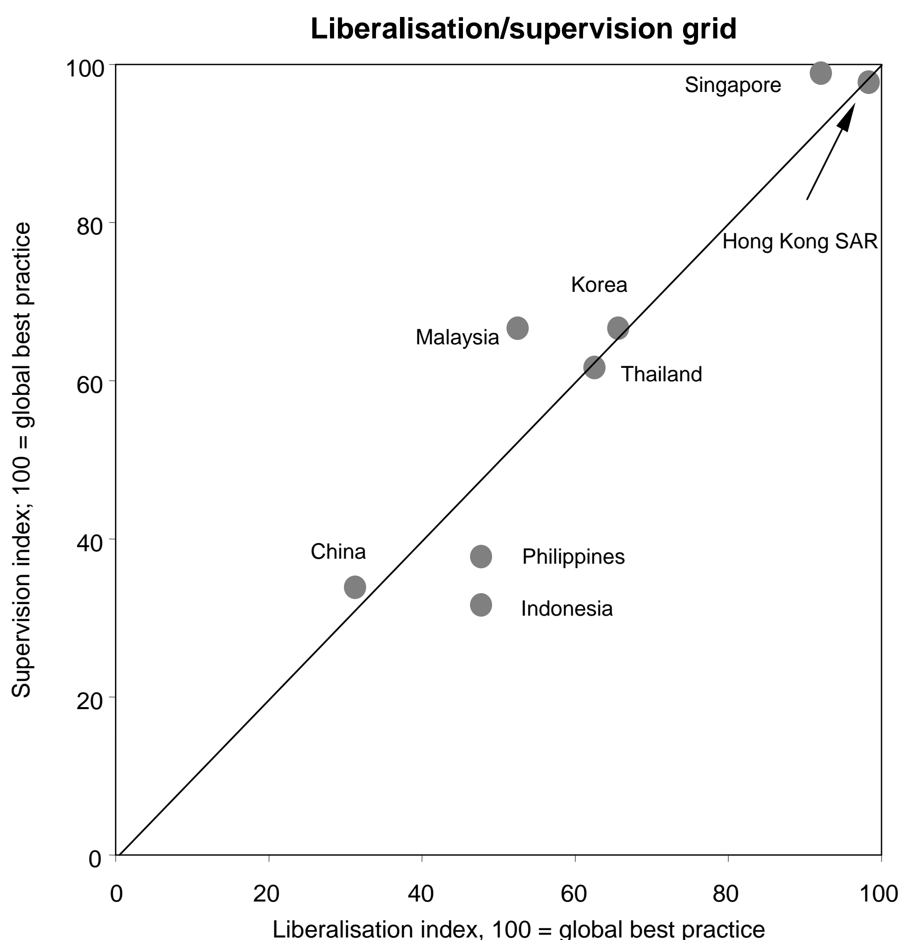
In the local bond markets, the large majority of secondary market trading is over the counter. Price transparency is low, given the low liquidity of most local bond markets. Not surprisingly, supervisors struggle in their efforts to monitor the markets and prosecute in the event of market manipulation. This is also true for many interest rate derivatives and, among other reasons, has made many regulators reluctant to approve new products.

Conclusion

Comparing the degree of local bond market liberalisation with prudential regulatory and supervisory standards reveals three clusters (Graph 1). Hong Kong SAR and Singapore are the most advanced economies in the region and essentially in line with best standards in the rest of the world. Both have superior prudential regulatory and supervisory systems, but Hong Kong is slightly more liberal in terms of market access and product innovation. The main challenge for Hong Kong is to improve cooperation with the mainland authorities in order to better understand the credit quality of the Chinese parent companies of Hong Kong affiliates.

Graph 1

Liberalisation/supervision grid



Note: The scatter chart above represents the author's judgment of the degree of market liberalisation and supervision based on the analytical framework outlined in this study and informal feedback from market participants.

The next cluster consists of Korea, Malaysia and Thailand. Of the three, Korea undoubtedly has the most developed bond market. In fact, the bond market probably plays a more important role in Korea's economy than in Hong Kong's or Singapore's. However, there is room to liberalise the market more and to strengthen supervision. Thailand's bond market is visibly smaller than Korea's, but not much behind in terms of deregulation and supervision. Malaysia's prudential regulatory and supervisory standards are largely on a par with Korea and Thailand, but the bond market is much more closed, in terms of both foreign access and product innovation. Given Malaysia's advanced supervision, liberalisation could accelerate bond market development without creating immediate prudential concerns.

China, Indonesia and the Philippines are at the low end of the scale. All three countries have improved prudential regulation and supervision, but China has come from further behind and has made the most progress. If this trend continues, China may leave behind Indonesia and the Philippines, which have fewer resources with which to improve prudential regulation and supervision. The main constraint for China is the low probability that it will achieve full capital account convertibility in the next few years.

Overall, it is probably fair to say that general prudential standards governing local bond markets in Asia are not grossly insufficient when set against the degree of market development and liberalisation. In fact, Malaysia and Singapore could immediately ease restrictions without creating any prudential concerns. However, there is no cause for complacency. First, given the development and sophistication of market practices and cross-border flows, regulation and supervision cannot stand still. Second, the current efforts in the region to promote local bond markets will probably lead to more liberalisation and market activity and, thus, require stronger prudential standards.

Whether this requires extensive harmonisation of bond market regulation and supervision within the region, as is often called for, is not clear. Different political, legal and economic structures make it very difficult to strive for a high degree of harmonisation. More important than efforts to harmonise all aspects of regulation and supervision within the region is that each country aims for global best practice and unbureaucratic rules and procedures.

Having said that, there are some areas of more practical concern where harmonisation and cooperation would undoubtedly be welcome.

- More cooperation around clearing, settlement and custody would greatly facilitate cross-border investment.
- Integration and linking of trading platforms would also help cross-border investment and boost price transparency.
- Concerning taxation, harmonisation towards the lowest common denominator (ie zero withholding and capital gains taxes) would be consistent with trends in most other parts of the world and help market development.

Finally, adopting common standards in line with global best practices could further enhance the value and credibility of local rating agencies.

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