Panel discussion: questions to be analysed

Yung Chul Park

It is my honour and privilege to serve as the moderator of this panel of distinguished experts on capital markets. Over the last two days, we have listened to presentations and discussions about 13 papers analysing many issues involved in developing regional bond markets in Asia. In order to summarise and better understand what we have learned in this conference, we have organised this panel discussion with the expectation that the panel members will help us chart a course of development that will establish deep and liquid regional bond markets in Asia. For this purpose, I would like to ask the panel members for their views on some issues that are crucial for Asian bond market development.

The first question I would like to raise is: does Asia need regional bond markets?

- Would it be easier and cheaper to issue local currency bonds in regional bond markets than in global bond markets?
- Would these regional markets help diversify the foreign exchange reserve portfolios of Asian countries?
- Would regional bond markets improve resource allocation and stimulate investment in the region?

The second question refers to the ideal structure of Asian bond markets: what types of regional bond markets would best serve the bond financing needs of Asian governments and corporations? Possible approaches are:

- Improving and expanding existing regional bond markets such as the samurai market in Japan
- Creating an offshore bond market (replication of the old eurobond market)
- Promoting regional financial centres through competition

Finally, I would like to ask the panel members: what could ASEAN+3 do to develop deep and regional bond markets in Asia? Aspects to consider:

- Develop and open local bond markets - a prerequisite to the promotion of regional bond markets in Asia
- Facilitate regulatory, tax, and other institutional harmonisation and policy coordination
- Construct regional capital market infrastructure, including clearing and settlement, regional rating and credit enhancement institutions

Panel discussion

Tom Byrne

This conference addressed issues concerning the development of an Asian bond market. Moody's view is that governments and corporations in Asia will continue to seek access to the global capital market, but that national markets in the region will develop and mature, allowing firms to increase their funding in domestic debt markets. As in other regions, Moody's has in recent years expanded in Asia, by building up its offices in Tokyo, Hong Kong and Singapore, as well as by buying into local rating agencies. For example, Moody's has majority ownership in KIS, one of the national rating agencies in the Korean market. The use of a national rating scale in Korea - although not integrated into Moody's global rating scale's default and expected loss probabilities - provides local investors with valuable distinctions of relative creditworthiness in a credit rating convention they are more familiar with.

I think it is important to consider the role of a rating agency, which is valid in any market, regional or global. In Moody's view, the main and proper role of credit ratings is to enhance transparency and efficiency in debt capital markets, by providing an independent opinion of relative credit risk, reducing the information asymmetry between borrowers and lenders. This function enhances investor confidence and allows creditworthy borrowers broader marketability of their debt securities.

Moody's believes that there is room to enhance the disclosure of its own rating processes. Moody's does not believe the accusation that it is a "black box" to be fair or accurate. Moody's rating methodologies and practices have been published periodically, and senior officers of the firm have made speeches to professional forums and made presentations to government regulators concerning this issue. Moody's has codified core principles of good rating practices; they are:

- Ratings must be independent of commercial relationships with an issuer.
- No forbearance: Moody's shall not refrain from taking a rating action out of concern for the potential effect it may have on the issuer or the market.
- Controlling conflicts of interest: Moody's does not give investment advice.
- Confidential information is not disclosed, and used only internally for rating decisions.
- Judicious consideration will be taken in assessing all the circumstances relevant to an issuer's creditworthiness.
- Rating committees make rating decisions that reflect the collective experience of judgment of the organisation, not the opinion of any single person.

Furthermore, Moody's believes that independence, objectivity and reliability have been the heart of the rating agency's role in credit markets for nearly a century. Moody's would be concerned if additional regulatory oversight were to reach into the underlying methodology and practices of the credit rating practice - particularly if regulation were to change the nature of the product offered by the rating agency from one based on credibility with the investor community to one of a licensing function for the government.

Moody's believes that innovation and competition between rating agencies better serve the market than harmonisation or cooperation with the industry. Well functioning rating agencies, in the manner described above, will help improve market transparency and efficiency in allocating capital.

Panel discussion

Aaron Low

1. Does Asia need regional bond markets?

There is no disputing the need for Asian bond markets to provide sources of financing for Asia's capital needs and instruments for investing Asia's savings. The economic concept of "market completeness" comes to mind. A more critical question is whether issuance should be through local or hard currency. Asia's situation is somewhat similar to some emerging markets, where sovereigns prefer to issue in hard currency, in contrast to the G5 economies, where sovereigns typically issue in local currency to the natural, local investors. Valuations that influence the choice between local and hard currency issuance tend to vary across the region, depending on domestic monetary policy as well as on demand and supply conditions. For example, it is currently cheaper for Korean corporations to issue long-dated bonds in dollars due to US-Korea yield curve spreads and currency swap spreads. Another important consideration is that global demand is generally better for longer-term maturities while local investor demand tends to be concentrated on the shorter end.

Naturally, increasing the opportunity set with Asian bonds will help diversify foreign exchange reserve portfolios. My view is that additional return/risk benefits would accrue from credit risk diversification rather than from currency/interest rate diversification. As long as Asian exchange rate policy targets the US dollar with full capital account convertibility, local yields will be highly correlated with US interest rates in terms of systematic movements. Diversification benefits will then arise from sovereign or credit risks.

2. What types of regional bond markets will best serve the bond financing needs of Asian governments and corporations?

Absent a common regional currency, the Asian dollar bond market is perhaps the most attractive alternative to a regional bond market. This approach does imply an additional set of costs that includes issues of corporate governance, disclosure, rating fees, etc. As long as developed Asia relies on the external sector and hard currency earnings for its growth, it would be natural to finance that growth with hard currency debt. Corporations and governments also look closely at the cheapest form of financing. Local currency and even offshore issuance increases the financing opportunity set and should be an important priority, especially for firms that do not have foreign revenues or operations. Regulatory bodies can facilitate and improve market infrastructure, but markets will gravitate to the cheapest and most efficient alternative.

3. What could ASEAN+3 do to develop deep and regional bond markets in Asia?

Building acceptance for regional benchmarks would be a good start. We have seen the introduction of two recent local currency benchmarks in the region that include issues with acceptable liquidity and size. These are in addition to a couple of dollar issue regional benchmarks that were more in demand when the dollar was strong. If the recent weak dollar outlook continues, local currencies will probably face more demand.

An important yardstick of success would have to be the depth of liquidity in Asian bonds, both for local and for hard currencies. The current lack of liquidity in secondary issues poses problems for active managers, pricing vendors, market-makers and traders. There are naturally some exceptions, but illiquidity is the rule. The need to boost liquidity and trading is a paramount concern, and any bond market cannot be considered a success if most bonds are held to maturity. Fortunately, there are options available to address this matter.

Using active external fund managers, traditional or hedge fund types, would be a big boost. Conventional fears of market volatility are overblown, in my view. First, fundamentals look positive with the excess pool of Asian savings and improving regional fiscal discipline providing strong support against trading volatility. The real sources of volatility will more likely prove to be G3 interest rates and spreads. Second, the real source of volatility in Asia is equities rather than bonds, and with excessive pools of savings channelled into real estate and stocks, the lack of a bond market increases systematic risk.

Asian investors are also heavily invested in global bonds, using global benchmarks. These do provide both interest rate and currency diversification, but there is also a need for a meaningful regional component, especially if local investors are to internalise asset and liability management practices.

Panel discussion

Robert N McCauley[1]

In his remarks, Sang Yong Park offered a counsel of despair. Only an offshore regional market, he argued, could break the vested interests that are preventing the development of domestic bond markets. The flaw in this prescription, however, is that governments have to allow their currencies to be used offshore, and the same vested interests that block domestic market development will prevent offshore market development. The US dollar was already internationalised when the US government made the policy errors that encouraged the development of the offshore eurodollar bond market. Offshore markets in the Deutsche mark or Swiss franc were limited by restrictions imposed by the German and Swiss authorities, with the effect of protecting vested interests. Offshore regional markets do not, in my view, offer the way forward.

The real choice is between the global bond market and domestic bond markets. As debt managers, governments need to recognise that global securities firms naturally argue for global markets. They cannot be expected to give full weight to the direct costs, and perhaps more importantly, the indirect costs, of going global. Debt managers need to exercise discipline in choosing between global and national markets. Consider the example of the last Korean sovereign issue.

Last June, the Republic of Korea sold a $1 billion dollar bond due in 2013 in the global market. Underwriters Barclays, Citigroup and Goldman Sachs were paid to distribute the bond to global investors. The trade press, in particular *FinanceAsia* (June 2003, page 8), reported that about 75% of the bonds were placed in Asia, with less than 10% in Korea, 15% in Europe and 10% in the United States.

It is widely believed that, owing to secondary market purchases, Samsung Insurance has become the largest holder of this dollar bond. Since the insurer has Korean won liabilities to its policyholders, it has reportedly converted the dollar cash flows from this bond into won with a cross-currency swap.

Consider the Rube Goldberg contraption that this circuit of transactions represents. The Republic of Korea pays underwriters a fee to place the bond with global investors. Samsung Insurance pays half the bid-ask spread to the bond's market-maker and half the bid-ask spread to the derivatives dealer who arranged the cross-currency swap. Would it not have been easier and cheaper to sell a 10-year Korean won government bond in the Seoul bond market?

Look at the transaction from another perspective. The Republic of Korea paid 92 basis points over the yield on a 10-year US Treasury note on its bond. This was a vast improvement on the 355 basis points paid in April 1998 on a 10-year bond. Following the money, the $1 billion is added to Korean foreign exchange reserves. There, Korea's reserve managers will try to earn returns over US Treasury yields by investing the $1 billion proceeds. If they are able to obtain a return of 40 basis points over US Treasury yields by buying agency paper or bonds backed by credit cards or mortgages, they would be doing well. But this would imply a net cost of something like 50 basis points per year, or around $50 million over the life of the

[1] Views expressed are those of the author and not necessarily those of the Bank for International Settlements.

10-year bond. The good news is that, in buying the bond, Samsung Insurance recaptures some of this sum for Korea as a country.

Again, would it have made more sense for the Korean government to have added another $1 billion to the domestic bond market? There, could these bonds have satisfied pension funds' and the insurers' need for long-duration, won-denominated assets? Could they have added to the mass of bonds available for trading and repoing? Could they have helped lengthen and deepen the won benchmark yield curve?

Global securities firms highlight the externality of having the sovereign bond set a benchmark in the dollar (or euro) market for other issuers. Why? With a sovereign benchmark, Korea Development Bank or Korea Export Import Bank bonds can be properly priced by international investors. Indeed, *FinanceAsia* reported that the success of the sovereign deal led to a repricing of the Korea Development Bank from US Treasury plus 120 to US Treasury plus 107 basis points. Why? With a well developed agency dollar yield curve, bonds for Korean corporations and banks can be properly priced by international investors. As *FinanceAsia* noted, "the sovereign does not need the money, but was merely keen to create a new tighter benchmark from which corporate Korea could benefit". Such externalities come at a price, however, which can be measured not only in terms of the direct cost, but also in terms of the opportunity cost.

That is, the benefits of setting such benchmarks come at the missed opportunity of more issuance in domestic currency in the domestic market. In late 2002, the Kingdom of Thailand came close to issuing a $1 billion bond in the global market. At the last minute, the deal was cancelled, although the Kingdom has done a pair of floating rate dollar deals. Consistent with Fernandez and Klassen's result that the sovereign and corporate choice of currency is similar, Thai bond issuance in foreign currency since the crisis has been more limited than Korean bond issuance in foreign currency. Ultimately, there are positive externalities to corporate issuance from government issuance within limits in dollar or domestic currency. Given limited amounts of government debt and a policy preference for domestic bond issuance, debt managers should think twice before selling dollar bonds.