



Key issues in building deep, liquid and integrated capital markets in APEC

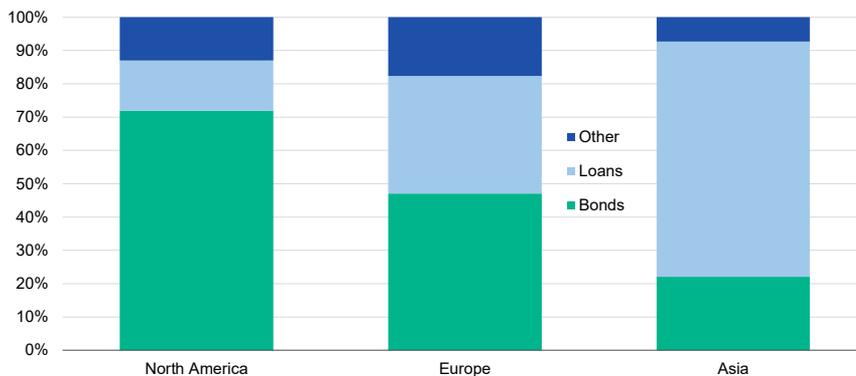
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Financial Intermediation: The Basics

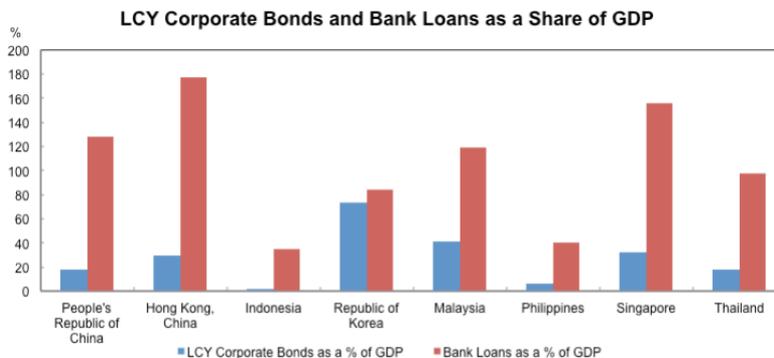
- » Channels funds from savings to borrowers, playing a critical role in household wealth formation, economic activity, economic growth, and the functioning of government
- » Transforms savings instruments into different borrowing instruments to satisfy the different desires of savers and borrowers w.r.t. maturity, risk, and liquidity
- » Funding can take place solely within the banking system or can be supplemented by funding through the capital markets
- » Bank intermediation places one party, the bank, at the center of the intermediation process; whereas, capital markets funding requires a much richer financial ecosystem

Asian Corporates Are Funded More by Bank Loans Than Are North American and European Corporates



Source: "Insolvency Resolution and the Missing High-Yield Bond Markets," Bo Becker and Jens Josephson, *The Review of Financial Studies*, 2016. Data as of 2010.

Dependence on Bank Loans Widely Observed for Asia



Note: Data as of end-2014.
Source: Local market sources and AsianBondsOnline.



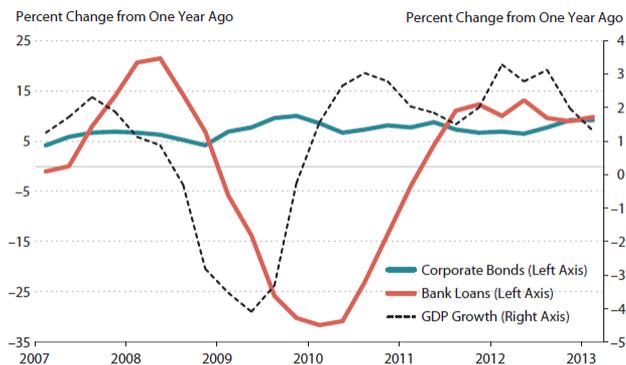
Source: "Domestic Bond Market in Asia," presentation by Thiam Hee Ng, ADB, 2015.

Why Grow Asia's Domestic Bond Markets?

- » While domestic banks are often successful at leveraging local expertise and offering client confidentiality, they can also be opaque and face limited competition, giving rise to cronyism and inefficiency
- » Their “essentiality” can put the government on the hook for bailouts to avoid the risk of economic meltdown
- » Foreign funding can substitute in good times, but can also induce volatility when foreign investors retreat
- » In a downturn, bank capital constraints can lead to a sudden stop in lending

US Corporate Bond Finance Remained Resilient during the Financial Crisis as Banking Lending Collapsed

Real Growth Rate of Bonds, Loans, and Gross Domestic Product for Nonfinancial Corporations (2007:Q1–2013:Q1)



SOURCE: Financial Accounts of the United States (Table B102) and Bureau of Economic Analysis.

Source: "Bank versus Bond Financing over the Business Cycle, Federal Reserve Bank of San Francisco, *Economic Synopses*, 2013.

What Is Needed to Grow Asia's Bond Markets?

- » Moody's has been closely involved in an APFF work stream that has created self-assessment tools that help economies evaluate the type and amount of information investors have access to in any market
- » Trust is an important foundation of any functioning market
 - Investors have to trust the information they use to evaluate risk
 - » Reliable information (e.g., disclosure regimes)
 - Investors and Issuers need to trust that the system is functioning well with risks properly identified and disclosed
 - » Operational resilience (e.g., clearing and settlement systems)
 - Investors and issuers must understand their rights and trust the government will protect and enforce them
 - » Predictable outcomes (legal infrastructure/insolvency regime)

Our Panelists Will Discuss Other APFF Efforts Focused on Capital Markets

- » Asia Region Funds Passport
 - Supporting the growth of institutional investors that might by domestic bonds
- » Development of repo markets
 - Facilitating the short-term financing of long-term bonds
- » Legal frameworks for over-the-counter derivatives
 - Providing certainty with regard to legal standing
- » Financial market infrastructure
 - Providing confidence around operational resiliency

Conclusion

- » When domestic markets are built upon sound foundations that meet international best practice standards, it is much easier to connect them to global markets
- » Public-private sector dialogue, like we have here in ABAC, is invaluable to this process

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