

Domestic financial markets are interconnected and help each other to function optimally



Infrastructure, projects and debt capital markets

Infrastructure and corporate projects with local currency inflows need local currency denominated debt placed with both domestic and international investors.

- Provides long-term debt to match tenor and currency of projects.
- Funding exclusively by equity won't be economical.
- Financing of projects with tenor longer than 5-7 year by banks is generally not advisable
- Insufficient long term debt capital from domestic sources.
- Regional infrastructure financing needs far exceed funding available from multilateral agencies (ADB, World Bank, etc.)
- PPP will help but will also need domestic debt capital.

Therefore emerging economies' developmental needs require international private debt capital invested in domestic currency bonds.

Domestic Government Bond Markets are Important

A liquid, traded, government bond market is key to developing a domestic currency bond market and attracting long-term international capital.

- Establishes “risk free” domestic currency yield curve.
- Provides reference rate for all domestic currency debt
- Provides a pricing curve for all local currency swaps (e.g. IRS and FX swaps) needed for projects.
- New international investors will typically start by buying government bonds (the most liquid) before buying local currency project/corporate bonds.

Managing the reference yield curve

As all domestic currency debt capital and swaps are priced off government bond yields it is important to lower the nominal (pre-tax) yield paid on government debt by:

- Reducing the illiquidity premium by improving market liquidity.
- Eliminating the withholding tax “gross up” by eliminating this tax.
- Reducing the FX risk premium by reducing FX rate uncertainty.
- Reducing other cost of investing in government bonds e.g, by
 - Reducing the complexity of FX rules, integrating onshore and offshore FX and FX hedging markets.
 - Enabling bonds to be held at ICSDs
 - Continuously improving electronic platforms.
- Ensure bonds are included in many indices.

14 Requirements for Secondary Market Liquidity

1. Sound economic and monetary policies.
2. Sound issuance program/primary market.
3. Primary dealers that make markets.*
4. A liquid “title transfer” repo market. *
5. Sound money markets.
6. Sound swap and derivative markets.
7. In time, a government bond future’s market.
8. Continuously improved electronic platforms.*
9. Active domestic institutional investors.*
10. A broad international investor base. *
11. Suitable laws (e.g. creditors’ rights, closeout netting).
12. Suitable taxes (e.g. on repos and cross-border investments).
13. Suitable market practices.
14. Continuous education of domestic investors, regulators, judiciary

14 Requirements for Secondary Market Liquidity

3. Primary dealer (PD) that make markets

- Bonds trade over-the-counter.
- Investors need firm two way quotes from market makers.
- The market needs PD who trade (not brokers).
- If PDs have a useful quoting obligation (firm, in size) and a useful obligation to bid at auctions, they need profit making privileges.
- To hedge their risk and fund their positions PDs need liquid repo and money markets (and, in time, a bond futures market).
- To avoid being squeezed PDs need a securities lending facility.

Note: Post-GFC regs. may result in international banks reducing their market making activity in emerging markets.

14 Requirements for Secondary Market Liquidity

4. A liquid “title transfer” repo market

- Supports the primary market
 - Facilitates the funding of PDs’ bond portfolios.
 - Allows PDs to hedge
 - Enables a more liquid secondary market.
- Supports market making and the secondary market.
 - Market makers can quote for bonds they don’t own (but can borrow).
 - Market makers can trade rather than broke a sale.
 - Provides cheaper funding of bond portfolios because secure.
 - Enables shorting, hedging and relative value trading.
 - Promotes trading across the yield curve.

14 Requirements for Secondary Market Liquidity

4. A liquid “title transfer” repo market

- Supports the money markets and monetary policy implementation
 - Facilitates central bank repos and reverse repos.
 - Enables secured lending between money market participants.
- Supports the development of OTC derivatives and bond futures markets.
 - Enables hedging of transactions in these markets.
- Lending bonds through repos enables long-term investors to enhance their returns.

14 Requirements for Secondary Market Liquidity

4. A liquid “title transfer” repo market

- Needs a standard agreement. The best is the GMRA under UK law.
- Appropriate reporting to regulators and monitoring of market activity.
- Appropriate market conventions (e.g. fails, GC).
- Appropriate accounting and tax treatment (similar to a secured loan).
- Closeout netting and suitable treatment in bankruptcy.
- Suitable risk management by market participants.
- Suitable electronic platforms.
- Domestic and international end-investors must be encouraged to lend securities through the repo market.

6. Onshore legal framework: ISDA opinions

| | Netting | Collateral |
|---------------------------|----------------|-------------------|
| | | |
| Indonesia | Fairy Clean | Unclean |
| Korea, Rep. of | Fairly Clean | Unclean |
| Malaysia (being reviewed) | Fairly Clean | Unclean |
| The Philippines | Fairly Clean | Clean |
| Thailand | Clean | Unclean |

14 Requirements for Secondary Market Liquidity

8. Continuously improved electronic platforms.

1. Price discovery
2. Trading
3. Confirmation
4. Payment and settlement
5. Valuation (end of day pricing)
6. Transaction and portfolio reporting to regulators
7. Appropriate transaction and portfolio reporting to the market.
8. Messaging.

As much as possible should be connected for straight through processing.

14 Requirements for Secondary Market Liquidity

10. An active domestic investors base

1. Institutional not retail (retail is less than 3% globally).
2. Institutions with a trading desk not only buy-and hold.
3. Institutions that are able to do repos.
4. Minimum prudential requirement to hold government bonds either through risk based capital requirements or other regulations.
5. The investor base will build up only over time as contribution accumulate.

14 Requirements for Secondary Market Liquidity

10. A broad international investors base

1. Bond, repo and FX price discovery platforms that are fair to all.
2. FX and interest rate fixing that is fair and transparent to all.
3. FX and capital control rules that are easy to understand and comply with.
4. Liquid spot and forward FX markets (including offshore FX markets).
5. No withholding tax on income from government bonds.
6. Able to do repos and derivatives (offshore and onshore).
7. Domestic currency bonds can be held at International Central Securities Depositories (e.g. Euroclear and Clearstream).
8. Inclusion in one or more index is useful.
9. Continuously develop the domestic investor base.