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A Public-Private Sector Initiative

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Report on the Public-Private Sector Forum on Bond Market Development in the APEC Region, Melbourne, 8 May 2007

First Draft

REPORT ON PUBLIC-PRIVATE SECTOR FORUM ON BOND MARKET DEVELOPMENTS IN THE APEC REGION – MELBOURNE, 8TH MAY 2007

INTRODUCTION

In recent years, various public-private sector dialogues on the development of local currency bond markets in the region have been conducted.[1] Aside from producing important insights and a compendium of key recommendations, these exercises have proven very useful to both public and private sectors by providing advice on measures likely to successfully encourage private sector activity to deepen and increase the liquidity of bond markets, and an understanding of how markets are likely to develop in response to measures being planned and undertaken by policy agencies.

At their meeting in Hanoi on 7 September 2006, APEC Finance Ministers welcomed a proposal submitted by ABAC that the Advisory Group of APEC Financial System Capacity Building facilitate in-depth discussions with individual economies on how the public and private sectors can collaborate to develop their respective bond markets (with special attention to corporate bond markets). The timing for such a dialogue was deemed appropriate as many APEC economies are moving away from goal setting phase and into critical issues phase and implementation. It was decided that these dialogues would take the form of a series of one-day sessions, each focused on three or four developing member economies' bond markets.

The first Forum was convened on 8 May 2007, back-to-back with the Second Senior Finance Officials Meeting (SFOM-II). The forum was organised by the APEC Business Advisory Council (ABAC) and the Advisory Group on APEC Financial System Capacity Building, supported by the Australian Treasury and generously sponsored by the ANZ Group. A reception was held the evening before hosted by State Government of Victoria.

The focus of the first forum was on the bond markets of Indonesia, the Philippines and Vietnam.

The aim was to facilitate a dialogue between representatives from APEC economies, private sector market players, and experts from international public and private organisations, with the following objectives:

- To promote public-private sector collaboration in the development of bond markets.

[1] Notable among these were the bond market conferences organised by ABAC and PECC in Taipei in May 2004 and in cooperation with the Asian Development Bank Institute (ADBI) in Tokyo in June 2005.

- To identify aspects in the policy and regulatory areas that could be addressed by authorities to enhance the environment for bond market development, and in particular, corporate bond issuance.
- To identify capacity building initiatives to build the environment conducive to bond market development. These might include public-private partnerships (PPP) and regional cooperation initiatives.

The event attracted around 75 high-level participants representing participants from the focus economies (Indonesia, the Philippines and Vietnam), participants from other interested APEC economies, including, importantly, members of the Senior Finance Officials' Meeting, participants from the Advisory Group, key experts and representatives from investment banks, institutional investors, fund managers, rating agencies, and experts from international public and private organisations and multilateral institutions.

Expert presentations and discussions provided insights into key challenges facing bond market developments in the region, including market depth and liquidity, the legal, operational and market infrastructure, the regulatory and supervisory environment, the role of credit rating agencies, and information necessary to support markets. The forum highlighted capacity building initiatives that would assist the development of markets. This report contains the essential elements of these presentations and discussions.

Reflecting the structure of the conference, this report is divided into five parts:

- *Part 1 provides a broad overview and key characteristics of the region's bond markets*
- *Part 2 outlines key issues relating to bond market developments identified in the dialogue*
- *Part 3 describes key developments in the three focus economies, Indonesia, Philippines and Vietnam*
- *Part 4 highlights key factors relating to capacity building initiatives, and*

Part 5 provides some concluding comments. .

PART 1 – BROAD OVERVIEW AND KEY CHARACTERISTICS OF THE REGION'S BOND MARKETS

Broad Overview

- The rationale for bond markets and particularly corporate bond markets

Well functioning capital markets are fundamental for sustainable growth. In particular deep and liquid local currency bond markets have a key role to play in financial stability and economic development in APEC economies. They ensure greater access to capital across an economy, provide stability and diversification of savings and investment and reduce an economies' susceptibility to external shocks. The Asian financial crisis underscored the importance of long-term local currency funding for financial stability.

- Developments in the region

The total amount of outstanding local currency bonds is valued at US$10,754 billion, with Japan accounting for nearly 85%, followed by Korea 6% and China 5.5%.

Of the three focus economies, the Indonesian bond market is currently valued at US$47.3 billion in outstanding issues. It is growing steadily and is relatively developed in terms of capitalisation. The government is the major issuer in the market with conventional bond offerings, accelerating significantly since 2003. The share of local foreign currency is 9.5% of total bonds.

The Philippines bond market (US$38 billion) is relatively underdeveloped and the economy is heavily reliant on financing from the banking and equities markets. The bond market is primarily composed of governments bonds (98%). The corporate bond sector is less developed in terms of product range, profile of issuers and investor base.

Vietnam is a small but evolving bond market with the equivalent of only 9.4% of GDP currently in local currency bonds. The sector is primarily still a government bond market, with a 19.2% share in foreign currency.

Singapore, Korea and Malaysia have developed a healthy spread of issuers across categories of government, financial institutions and corporate issuers.

Singapore (US$82.5 billion) is an important open capital market and over the last decade has grown considerably in size, depth, and liquidity, with sovereign bonds and statutory board bonds as a vital feature. Government securities are issued primarily to stimulate market activity and to provide a benchmark for corporate issues. Statutory Board fixed income securities, issued by autonomous government agencies are considered the most liquid among debt instruments in the corporate bond market. Foreign entities can issue debt in Singapore dollars and this has become an importance source of both local and foreign financing.

The Malaysia bond market with outstanding issues of US$116.1 billion is increasing in market size with active issuance and trading of both corporate and government issues. Improvements to regulatory structures and diversification of instruments being exchanged through the exchange and over-the-counter (OTC) markets are developments that have significantly contributed to growth in that market.

In the intermediary Thai market (US$77.3 billion), active local trading and increased issuance has driven growth. There is a healthy mix of public and private sector participation, with the government initially stepping up issuance for its financing requirements and to build a reliable benchmark yield curve to develop the market. Regulatory reform has transformed corporate bond issuance, with a variety of issuers have entered the market. Both government and corporate bonds are available to foreigners.

- **Macro-economic conditions are favourable, though lack of openness and fixed exchange rate policies pose significant challenges in some economies**

Market perspectives on the development of corporate bond markets in the Asia Pacific point to both favourable macro-economic environments, but also to some key macro challenges. A decline in volatility against a backdrop of strong growth is an important condition for reducing risk in investing in fixed income interest securities. While low interest rates may mean higher returns for investors in other assets, it is an important condition to attract local issuers and increase the supply, depth, and liquidity of corporate bond markets. The prospect of long-term currency appreciation and growth in a number of member economies is attracting foreign participation. Local currency issues are increasingly popular internationally, thus increasing the investor base. However, for some economies with fixed exchange rate policies and concerns about near-term foreign exchange appreciation, capital inflows are seen as a problem. As such, some markets are largely closed to foreign investors.

Finally, there is a sense from international investors of the continuing need for corporate reforms in the region, despite the legacy of 1997-98 bankruptcies prompting better legal structures, better disclosure and reporting and better enforcement of outside investor protections. Outside investor rights protection is crucial to credit markets. There is real concern over creditor rights in times of default by bond issuers. Without good information and enforcement, the ability of bond market participants to exercise choice limited.

Key characteristics

- Bond markets remain relatively small and under-developed.

Since the Asian financial crisis a number of significant initiatives have been developed to promote local bond markets in several Asian economies, primarily driven by the need for greater financial stability and funding diversification. Bond issuance in 2006 were nine times greater than a decade ago. Even so, regional domestic bond markets are generally relatively small and under-developed.

- There is great diversity in bond market development in the region.

The Asia Pacific is a diverse and heterogenous region with some of the world's largest and most sophisticated financial systems (Japan and USA) co-existing with small, under-developed systems such as Laos, Bhutan, Vietnam, and Cambodia. There are many disparities that impact on the diversity and development of bond markets between APEC member economies.

Disparities include whether or not the policy environment is favourable to private sector participation, the size of local currency bond markets among the relative to GDP and to the banking sectors. A number of emerging markets have made significant advances in developing relatively robust policy and regulatory frameworks, market infrastructure, and key components of deep and liquid bond markets. However the majority of the region's emerging markets remain underdeveloped and some are yet to address fundamental market and infrastructure issues.

- Supply Constraints are the key hindrances of bond market development.

The dialogue noted a consensus that there is strong demand for bonds in the region both domestically and internationally and, further, that there is a strong demand for higher risk returns globally. Further there is demand for issuance, as firms seek out alternative longer-time debt financing opportunities. These factors lead to the conclusion that the relatively low volume of bonds being created and traded in the Asia Pacific region is overwhelming to do with supply constraints. These supply constraints fall broadly into the following categories:

- Depth and liquidity of bond markets
- Market infrastructure and architecture
- Operational issues and transaction costs
- The regulatory, supervisory, legal and taxation framework
- The investment environment broadly.

- Trends in favour of bond market developments in the region were identified, as follows:

- The incidence of poverty has continued to drop.
- The global and regional economic landscapes have changed extensively since 1995 with the advent of the IT revolution, increasing economic openness, the expansion of multinational global reach, and the rise of the growth economies of India and China.
- Free Trade Agreements are increasing in East Asia and many other parts of Asia Pacific.
- The Asian financial crisis revealed a high degree of contagion across the region, illustrating the need for greater monetary and financial cooperation – forms of which are now occurring.

- Specific trends identified by market participants were:

- The global sovereign bond supply is shrinking
- Generally , domestic bond markets in the Asia Pacific region are small in comparison to the banking and equity sectors

- Generally corporate bond markets are small relative to government bonds.
- Corporate bonds in domestic economies are traded infrequently (excluding Japan)
- Long-term Asia bond yields are low

- Convergence in the role of the public/private sectors

Participants identified key elements in the role of the private sector in bond market development with particular emphasis on the insights from the work of ABAC and PECC. A healthy market economy is one where the private sector engages in robust innovation and competition, while the public sector provides sound legal and policy frameworks, regulation and supervision. There is much scope for the private sector to help enhance the public sector's effectiveness and for direct collaboration with public sector. Ultimately through close partnership and collaboration through dialogue, public sector priorities converge with private sector needs.

- Regional cooperation

There are a number of ongoing regional cooperation capacity-building initiatives supporting the development of bond markets. Regional cooperation and integration plays a vital role in offering opportunities to unlock the region's economic potential, contributing to economic growth, inclusive development, and poverty reduction. Cooperation and integration are deeply inter-dependent. Market-driven economic "integration" requires cooperation to manage the externality/spill-over issues that integration implies. Regional cooperation can accelerate regional integration

PART 2: **KEY ISSUE IDENTIFIED IN THE DIALOGUE RELATING TO THE FURTHE DEVELOPMENT OF BOND MARKETS**

Liquidity and depth

Liquidity and depth were two key market characteristics identified as critical for bond market development. The flexibility that comes from liquidity and depth is important to promoting choice.

Liquidity

The main factors identified to develop the liquidity of corporate bond markets in the region included:

- Diversification of financial instruments and maturities

- The development of secondary trading markets – generally corporate bonds deals were being done through private placement with little secondary trading.

- Challenges to secondary trading

The key hindrances to the development of secondary trading markets include:

- the current size of issuance is generally small, reducing the possibility of secondary markets. Increasing market liquidity will increase the size of issuance of bonds.

- Buy-and-hold attitude of investors

- Lack of price signals in the market**:** Corporate bond deals are generally being done through private placement so accurate pricing information is not available to potential investors. As such it is difficult for markets to work effectively in assessing quality and pricing.

- Repo markets need to be developed to provide liquidity (and depth).

Depth

The main factors identified to enhance depth in corporate bond markets involve addressing issues of concentration both in the investor base and the issuers.

- Limited diversity of issuers

While some economies are developing a healthy mix of government, finance institutional and corporate issuance, in most economies diversity is limited, and highly concentrated in the public sector. Some key hindrances identified included:

- Under-developed market infrastructure

- Lack of corporate governance and hesitancy by firms to provide disclosure and information requirements

- High costs of issuance through charges and taxation

- Uncoordinated regulatory and supervisory frameworks

- Concentrated investor base

In most bond markets in Asia the investor base is concentrated, with the majority of bonds were being held by banks with similar risk profiles. The second largest proportion of bonds is held by foreigners and in particular by hedge funds, also with similar risk profiles. This concentration greatly limits the resilience of a market. The key hindrance to greater diversity in the investor base include:

- the lack of insurance companies and pension funds, which should be natural holders of long-term fixed income instruments. In developed economies, pension funds and insurance companies tend to be large-scale buyers of government bonds. By comparison, in Indonesia, for example, these industries are small and conservative in their asset structure

.

- secondly, restrictions on capital flows and a lack of openness in a number of markets limits foreign investor participation. International fixed income investors are increasingly interested in becoming a part of local markets. Further, with expectations of exchange rate appreciation in some Asian economies, there is strong foreign demand for local currency bonds

- underlying monetary policy objectives of some economies needs greater clarity

- there is a need to address regulatory disparities resulting in different rules for different market participants

Market infrastructure

- Market making and price discovery

Constraints on market making and price discovery are the two primary impediment of market infrastructure in corporate bond markets in the region. There is broad consensus that developing government bond markets is a fundamental first step to developing corporate bond markets, to provide the market infrastructure, pricing and bench-marking. The key challenges identified include:

- Information and pricing

- building benchmark treasury yield curves across a broad range of maturities, and the importance of sovereign bond yield issues to get the yield curve right

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- the need for information and transparency for better price discovery, requiring strong disclosure laws, listing requirements, and accounting standards

- transparency is fundamental in maintaining and attracting larger pools of investors

- post-trading information structures need to be established such that all transactions should be reported to a central reporting arbitrator to disseminate information to markets as early as time permits

- clearance and settlement infrastructure that is free and transparent and with minimum administration costs.

- The role of credit rating agencies

The role of credit rating agencies (CRAs) is vital as is the need for to develop these institutions to support the region's bond markets Credit rating is an effective and objective tool in evaluating risk, benchmarking, in helping management in effective valuation and pricing. Capacity building priorities and initiatives were noted to develop CRAs – see Section 1V.

Emphasis was placed on the need for independence of CRAs and for accountability and transparency of all regulators. Investors and issuers need independent and transparent valuations. Effective comparison of ratings across economies requires consistency in application of methodologies.

Discussion pointed to the desirability of the development of a large number of rating agencies and the benefits of competition. This is associated with the Basel Capital Accord and the linkage of bank risk weights on assets with external risk rating agencies.   The need for international versus national rating systems was raised. While international rating systems provide comparable signals across markets, national rating scales are required for local bond markets, in particular when the sovereign ceiling is below the investment grade. Rankings are compared to the best credit rating in a particular economy.

There was also discussion on whether credit rating agencies lead or lag markets. While bond prices reflect perceptions of risk, they are not the only indicator taken into account in a credit rating exercise, which are only a point-in-time rating value.

- Risk Management

Bond markets contribute to better perceptions of risk and in doing that they help reduce risk. However there are a number of associated derivative markets that remain under-developed in some regional economies. In the absence of those markets, the investors ability to reduce risk is diminished. Further, market participants are limited in their capacity to both to warehouse and to distribute risk, and as a consequence this limits the development of bond markets. In summary:

- without a repo market it is impossible to short bonds or to easily access liquidity by repo-ing bonds, thereby limiting both trading and risk management

- increasing the availability of hedging products such as interest rate swaps and foreign exchange swaps allow for the separation of credit and interest rate risk and better risk management

- the development of bond futures markets would be a useful market risk instrument

- Issuance modes

A desirable development would be for bond markets to move away from private placement as an issuance mode, especially to increase information to facilitate trading and for secondary markets. Auctioning and over-the-counter markets for bond issuing, trading and active inventory management were noted by participants as useful in market deepening, as was the emphasis on primary issuance markets at this stage of development in the region. A strategic question is whether policy makers should give priority to the development of secondary markets to encourage primary issuance or to reducing impediments to primary issuance.

Creating a level playing field – rules and obligations are set forth and clear and applied in a non-discriminatory manner

Private sector participants pointed to a number of key concerns over the regulatory, supervisory, legal, and taxation environment that both investors and issuers confront in the region. These also link to those concerns discussed above about the lack of participation, the depth in markets, and concentration in both the investors and the issuers.

Related major concerns include the lack of a level playing-field and the discriminatory manner in which rules and regulation are applied to different types of participants. Some noted problems in dealing with competing regulatory bodies and taxation authorities in economies. Others observed that private bond market development is constrained by a lack of issuers who are inhibited from entering a market because of different regulatory requirements and taxes that are applied and which do not apply to public issues. There was extensive comment about the need for coordination and collaboration of regulatory agencies, and the eventual harmonisation of rules, to avoid duplication and confusion, the need for rules and obligations to be set-forth clearly and transparently and the need for proper enforcement. Market participants proposed regulatory and supervisory approaches which encourage markets, innovation in product design and marketing.

- Legal protection and legal infrastructure

The value of legal structures to support issuance and investment is a key determinant for market participation. Inconsistency and arbitrary decision making in the interpretation of rules by authorities is detrimental to confidence and to the willingness of firms to enter markets. Government bonds and corporate bonds ought to be regulated and have similar legal security if corporate bond issuance is to develop more strongly in some of the region's emerging markets. To support investor and issuer participation the following legal infrastructure are necessary:

- enforcement of contract
- creditor rights protection and enforcement
- effective and efficient settlement systems
- insolvency and bankruptcy laws supported by informal work-outs arrangements across borders
- custodian relationships

Greater access to guarantees could facilitate greater access to corporate bond markets, particularly by small and medium enterprises.

- Taxation

There is a great diversity of taxation arrangements in the region. The need to eliminate with-holding tax and its particular application to corporate sector issuance is an important matter in promoting the corporate bond market. Investors in some of the region's economies now use credit derivatives provided offshore since these can avoid tax and access limitations. Eliminating tax and other barriers would contribute to bringing liquidity into domestic markets.

- Regulatory coordination

The need for coordination and collaboration amongst domestic regulatory agencies is important in avoiding confusion in market supervisory arrangements and in the arbitrary application of rules, and in reducing excessive and burdensome compliance costs such as multiple reporting requirements. There was an inconclusive discussion on the value of a single supervisory authority, with experiences drawn from a number of OECD economies. Capital market reform involves many stakeholders. Some point to the value of a single authority in providing strong supervisory leadership. However, among OECD members there is no uniformity in the form of regulatory structures – some involve single authorities while others rely on more fragmented structures. There is also a tendency in the OECD group for regulators to be independent of government. There are different forms of funding of regulators.

While there is no one-size-fits-all model, coordination between regulators is highly desirable in a mixed regulatory jurisdiction to ensure a coherent regulatory approach.

- SME Financing

SME is a potential activity for corporate bond markets. In ABAC and Vietnam agencies reviewed access to formal finance by SMEs in the region. That report noted inter alia that access is not easy and discussed the potential for pooling of SME financing requirements into an instrument that could allow for long term bond market issuance.

Participants discussed the desirability in relatively immature bond markets for bond issuance of this type. It was noted that in Singapore and Korea SME financing has been successfully achieved through securitisation and this could be a model of financing relevant to Vietnam and other emerging markets. It Securitisation could be viewed as valuable component of corporate bond issuance, particular as in Vietnam for example, where in the absence of collateral security, the banking system is not fully meeting SME financing needs.

Liberalisation – markets act rationally

Liberalisation of capital markets and the development of derivative markets are significant to bond market development in a number of economies in the region. Restrictions on capital flows, inability to manage foreign exchange and interest rate risks, and barriers to entry to both issuance and investment are key impediments identified by the private sector participants, limiting the investor base. The basis of these concerns is the principle that markets do act rationally and that where there are flexible capital and exchange rate regimes, markets will act rationally thereby reducing adjustment costs (that could otherwise be more acute in inflexible regimes) and facilitate better risk management.

- Foreign exchange policies

Exchange rate policy has a significant impact on the development of bond markets. Fixed rates impede market diversity and limit the ability of taking FX positions on-shore, usually resulting in investors having to hold underlying assets to protect against currency moves. As such foreign investor participation tends to be limited. In an environment of exchange rate flexibility, investors see more investible opportunities on a regional basis. For domestic investors, their first foray out of their own currency is predominately into the US market. If there is more exchange rate flexibility, their first step may instead be into regional markets.

- Impact of limits on foreign investor participation

Inviting offshore investors that are attracted by the long-term perspective of currency appreciation into local currency markets is considered important to increase liquidity. At the same time, a fundamental objective of developing bond markets in Asia is to cause a shift growth in the growth of capital markets at the expense of banking sector growth. As such a question for consideration is whether for this objective is better served by developing local currency markets or whether acceleration would come by an increase of non-foreign investors. Institutional development and access is important, especially for private sector institutions, and having a wide range of participants and a largely free entry position would increase the investor base and market depth. .

- *Derivative markets and hedging*

Derivative and repo markets and the of investors to hedge through interest rate and FX swaps are important developments yet to take place in some markets. They are necessary so as allow investors to manage underlying risks in their portfolios.

PART 3: KEY DEVELOPMENTS IN THE THREE FOCUS ECONOMIES

- INDONESIA

The Indonesian government began developing the bond market in 1999, as part of the post Asian Financial Crisis deficit financing program. While the market is small both in absolute terms and relative to GDP compared to other Asian economies, significant developments have taken place. With 40% default rates in corporate bonds in 1998, there have been challenges in building a corporate bond markets but significant progress has been achieved. Investors are bullish, encouraged by the fiscal and monetary policy environment, an improving and stable policy backdrop, underpinned by ratings upgrades, and improved medium term economic prospects with growth expected to be 6 – 6.5%. Recent developments are having positive impacts on liquidity, with improvements to previously wide bid-off of spreads and volatility, an improved trading system and price transparency, the introduction of a market-maker system, and other structural changes.

Factors which should lead to further growth include:

- plans to launch treasury bills and municipal bonds, and potentially, Islamic bonds
- good growth in private sector investor base
- mutual funds, insurance and pension funds, while they currently hold less than 20% of bonds on issue, there are signs that these natural consumers of fixed income assets are growing

- continuing reforms in the banking sector – bringing about mergers and acquisitions – and a reduction in the amount of debt available from the banking sector
- capacity constraints in the real sectors, and massive infrastructure financing needs which must be funded by further bond issuance.
- inflation targeting monetary policy should see some decline in interest rates and in volatility.

- Key impediments to bond market development

Volatility in the Indonesian bond market arises from the level of concentration of the investor base, lack of market making and lack of information transparency. There has been solid in 2007 with new mandatory reporting requirements of all transactions to make this information available to investors to benchmark their decisions. Even so some challenges remain:

- there is a need for greater development of the government bond sector to establish the benchmark yield curve

- limitations of the investor base: There is concentration of ownership, limited investor diversity, and a similar risk profile of these investors. Banks currently hold over 60% of total tradable securities. Foreign investors own a further 13% and local pension funds, mutual funds and insurance companies own less than 20%. Non-bank intermediaries such as securities firms hold small inventories that limit their ability for market making and to act as dealers. This also impacts on price volatility of securities. Further, there is no maximum limit for a single bidder to take issuance in a primary market. Often big bidders can offer lower yields or better prices for government paper. This is creating concentration of bonds to certain players. However, with the introduction of primary dealers there are expectations that ownership will spread and greater participants in the primary market will lead to secondary market development.

- liquidity is limited due to supply side imbalances such as lack of diversity of bond maturities, limited availability of instruments consistently in the market, and to too many series of small size of issuances

- public demand for bonds is limited by restrictions imposed on the Central Bank not to use government bonds as instruments of monetary operations.

- Impediments to corporate bond market development

Impediments identified include the need for greater stability in the government bond-segment, liquidity and benchmark securities; the lack of development of the investor base; the need for improvements in information infrastructure; the need for incentives to issuers and investors; the need for improvements in transaction efficiency; and the need for better coordination among regulatory agencies. .

- issuance is dominated by financial and banking sector (43% of total outstanding volume) resulting in a lack of diversity of issuer profile. There is growing issuance from other segments, which will lead to better balance as the private sector increasingly views the corporate bond market as a major avenue for long-term fund rasing activities

- corporate governance and information infrastructure needs to be addressed. Corporate issuers are limited in number due to the perceived costs of transparency that can be avoided when seeking capital elsewhere. This requires improvements and more stringency in disclosure standards. There are systematic loop-holes that allow issuers to refuse to be rated. A policy response would be to enforce rules that all issuers of corporate bonds be rated once a year for the duration of the bond maturity. Public-private partnerships could play an important role in enhancing the raging agencies function via BAPEPAM Regulation. The Regulatory Framework for Bond Pricing Agency is in final stages of development, and this should give investors better benchmarks on which to base investment decisions

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- lack of investor diversity is restricting liquidity and depth in the corporate bond markets. However, the limited recovery of mutual funds investing in corporate bonds after the 2005 mutual fund crisis has restricted an investor base that tends to trade more actively. End-investors tend to be insurance companies and pension funds with buy-and-hold investment strategies, also limiting demand in secondary markets

.

- foreign banks (and other foreign institutions) have limited investment in the corporate bond market in Indonesia due to the Country Level Risk set by global investment limits falling below minimum investment guidelines

- there is a need for greater incentives to issuers and investors, and the ongoing comprehensive re-evaluation of current taxation structures in capital markets is fundamental in this regard. Reducing the costs and operational risks for market intermediaries is also important

- improving transaction efficiency through, employing low cost and low risk electronic trading platforms and increasing the role in clearing activities in OCT markets

- regulatory concerns relate to a lack of coordination and collaboration between different regulators. Further, there are limits of functional independence of BAPEPAM, the capital markets regulator. Generally it is felt that the capital markets legislation is not aggressive enough

- derivative markets are yet to be developed. Currently there are no future or options markets for Indonesian government securities, reflecting in part the conservatism of local market players. The lack of derivative markets excludes investors who prefer derivatives, limits hedging possibilities and constricts the ability of market players to both warehouse and distribute risk, thereby limiting the development of the bond market

- absence of a repo market: Although there is a Master Repo Agreement, so far few banks have joined the agreement. There are still credit concerns among market participants that hinder activity. Some banks treat repo lines just as they would any other line of credit to a counter-party despite the fact that there is collateral on offer. This is due to a lack of confidence that contracts will be enforced consistently in the event of a problem. Without a repo market it is impossible to short bonds or to easily access liquidity by repo-ing bonds, thereby limiting both trading and risk management possibilities

- lack of legal and institutional support means that there is insufficient protection to holders of corporate debt. The lack of specific legal support, as offered to the government bond market by the Government Bond Law for example, is a major limiting and skewing factor.

- Strategies for bond market development

A series of strategic priorities are identified and which are being pursued in the development of bond markets in Indonesia.

The short-term priorities include:

- strengthening intermediary infrastructure involving addressing market organisation, market access, reducing transaction costs and developing intermediary mechanisms

- improving information infrastructure through focusing on information transparency, valuation and pricing, strengthening the credit function, and improving information access.

The medium-term strategy involves:

- improving transaction efficiency through facilitating active inventory, promoting management tools and improving straight through processing

- improving intermediary and regulatory capacity by improving matching activities and promoting information driven market supervision

The long-term strategy involves:

- developing a new market segment such as the development of the Sukuk market, a securitisation market, and developing a corporate bond segment.

- PHILIPPINES

The bond market is valued at US$38 billion and is relatively underdeveloped with still heavy reliance on bank and equity financing. However there has also been significant progress since the Asian financial crisis, which highlighted the need for comprehensive reforms to the regulatory framework, market infrastructure, and expansion of issuer and investor base. Further, the crisis highlighted the need for the development of a domestic bond market, private bond market, and local currency markets.

Significant reforms have taken place focused on fiscal consolidation, strengthening the regulatory framework and moving to a disclosure based system, building strong partnerships with the private sector through the fixed income exchange and the Capital Market Development Council, and advocating good corporate governance and transparency and adopting international best practice standards. The government benchmark yield has flattened and sustained a downward trend, signalling improvements to market confidence and liquidity. Further the regulatory framework has strengthened with greater coordination amongst agencies including the Department of Finance, Securities and Exchange Commission, Insurance Commission (PDIC), and Bangko Sentral ng Pilipinas. The development of the Financial Sector Forum has been important in levelling the regulatory playing field, enhancing regulatory coordination, information exchange, and strengthening education and protection of consumers.

The Pilipino fixed income exchange system for trading, clearing and registry was a contentions development option amongst participants at the forum. The exchange was set up with the aim of better price discovery and transparency to attract more investor participation and liquidity. However private sector participants stated a preference for market structures.

- Key impediments to bond market development

There are a number of key impediments to bond market development. There is stronger emphasis on government bond issuance over corporate bond issuance. The key challenges include:

- the development of securities borrowing/lending and repo facilities and the introduction of organised derivative markets, important for liquidity and risk management

- the development of a national securities settlements highway to expand settlement coverage beyond government securities.

- information infrastructure should be developed to enhance listing of corporate bonds. This is a priority that is planned to be achieved by the end of 2007. It is hoped that with the sovereign benchmark established and better pricing discovery mechanism, corporates will be encouraged to list their bonds

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- taxation structures are of major concern and in particular excessive with-holding taxes

- expansion of investor base, in particular by encouraging contractual savings institutions and foreign investors to participate in the bond market

- the Regulatory framework has involved continued reform including moves towards rationalisation of financial sector taxation, implementation of securitization and PERA laws, the development of retirement laws, the Corporate Recovery Act, strengthening creditor rights and strengthening information disclosure requirements

- high costs of issuing and trading bonds including taxation on long-term securities and the cost to register a bond

- fiscal consolidation: efforts to achieve fiscal consolidation, require any reduction in taxes in one activity require off-setting tax revenues to be raised in another. In terms of sequencing, the authorities are giving priority to fiscal improvements over capital market developments
- the tendency for regulatory arbitrage

.

- limited coordination and collaboration between authorities results in burdensome regulatory compliance requirements

- diversification of the investor base is an impediment not only to the bond markets but across the whole financial sector. The insurance sector is scattered, with different regulatory frameworks. Concentration in the insurance market and harmonised rules would allow greater bond market activities. The development of mutual funds and trusts could expand the investor base.

- Strategies for bond market development

The Capital Market Development Blueprint targets specific goals in a phased approach.

In the short-term there will be a focus on:

- improvements in market infrastructure to promote efficiency and transparency in securities trading

- strengthening surveillance capacity

- improving liquidity by adopting rules on margin lending, short selling of securities, repurchase and securities lending transactions of debt securities

In the medium the objectives are:

- streamlining registration process for public offerings of corporate debt that should lead to a reduction in origination costs

- expanding the range of traded products, including asset-backed securities

- the establishment of inter-professional market through the fixed income exchange

- strengthening the payments system

- migrate to a scriptless environment

The long-term objectives strategies include:

- development of private pension fund accounts
- exchange participation in regional initiatives to promote capital market integration

- promotion of competitive parity, including tax parity

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- VIETNAM

The Vietnamese bond market is new, and less developed compared to other regional markets. Currently there are 450 bonds outstanding in total with a market value of 130 trillion Viet Dong, equivalent to 13% of GDP. The first international bond was issued in October 2005;Vietnam has a BB minus international rating.

Investor interest in Vietnam is strong, in particular by hedge funds, due to the economy's strong economic performance and accession to the WTO. Reforms, including to capital markets, have high priority, in part to support Vietnam's infrastructure capital needs.

Currently the government dominates the total issuance of bonds (86%) with municipality bond issuance making up 7% and the remaining 7% issued by the corporate sector.

- Key challenges and impediments to the development of the bond market

- the lack of legal and regulatory harmonisation – there is no single comprehensive law for bond markets, with each aspect of the market subject to a wide range of decrees and regulation

- while international accounting standards have been introduced, the exception of IAS 32 and 39 limits the requirements for disclosure. Further, there are no clear guidelines in respect to enforcement and monitoring

- risk management and information: enterprises have only recently been required to prepare audited financial statements, and financial exposures are not being measured or reflected in accounts due to the exceptions of IAS 32 and 39. That noted, risk management practices are steadily improving in the domestic banking sector

- interest rate ceilings do not reflecting true demand/supply market relationships

- secondary markets are yet to be developed. Investors tend to have a buy-and-hold investment attitude, in part as a consequence of a concentration in the investor base of banks and the lack of financial intermediaries playing the role of market maker

- there is a tendency for too many issuances of small volume, which significantly limits liquidity and trading

- government bond interest rates have yet to develop as benchmark rates

- plans and schedules for bond issuance are inadequate and and disclosure of intentions is limited

- an OTC market for bond issuing and trading not yet established

- Specific issues for the development of corporate bond markets were noted. . Predominately they relate to the small size of the corporate market relative to the government market, the very small number of issuers, weak corporate governance, lack of issuing plans and disclosure, limited trading in the secondary market, and finally the lack of a credit rating capacity. Specifically, the dialogue noted that:

- currently there are corporate bonds Issued by four companies (Vinashin, Song Da Corporation, Electronic Vietnam, and Lilama) – these are essentially state owned enterprises

- issuance is usually undertaken through private placement, limiting information and price discovery for potential investors. While there are auctioning and underwriting issuance modes, these have not so far been used because of more thorough and complicated requirements for public offering (compared with bank financing)

- the long-term fixed interest investor base is under-developed, due to bank-dominated investment, the boom in the equities market and the preference of shares.. Liquidity in the bond market will arise with the growth of a pension industry and mutual funds

- in the secondary market underwriters for corporate bond are active in selling bonds to investors, both local and foreign. However, trading is limited. Bond issuance are not standard in terms of sizes/maturities and characteristics due to the specific features of each corporate. Further corporate bonds are not listed.

- the lack of specific exchange market for bond trading was discussed (but the value of a specific exchange was questioned and based on experiences in Chinese Taipei)

- Vietnam does not yet have a credit rating agency and there is no post-trading information dissemination system and an absence of public information available about activities in the secondary market

- Strategies for bond market development

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- increase bond issuance volumes by increasing the issue of government bonds through auctioning and underwriting

- stabilise the frequency and volumes of government bond issuances

- enhancing issuance techniques such as issuing bonds in larger lots to standardise bonds and increase the liquidity

- establishing a benchmark yield curve

- improve monitoring and information disclosure to ensure safe and efficient markets

- greater Vietnam participation in regional international integration, such as ABMI

- consolidation of the legal and regulatory framework for bond market development, and review regulations on tax regime and fee structures

- introducing new financial services such as private pension funds, and bond issuances of corporates to overseas markets

- develop an independent domestic credit rating agency possibly through a joint venture. Shareholders could be various financial institutions from banks, credit institutions, corporates, the World Bank, the Asian Development Bank and international rating firms

- develop a primary dealers system to promote and maintain government bond trading in secondary markets

- strengthen corporate governance (especially of SOEs after corporatisation) and enhance transparency and information reporting

- step-by-step moves to flexible and market based interest rates management, and the phase-out administered ceiling rates

- commit processes which would allow a minimum volume of bonds to distribute to investors

- develop two-way-quotation for bonds to ensure secondary market trading

PART 4 : CAPACITY BUILDING INITIATIVES

One of the primary objectives of the dialogue was to review capacity building initiatives in the region in support of corporate bond markets, and to consider further initiatives that might be appropriate, particularly those that may of relevance to the focus economies. Public-private partnerships can play a fundamental role. Key capacity building needs identified at the forum include:

- measures to expand the institutional investor base through the development of pensions, insurance and mutual funds

- the need to develop a strong credit rating industry in the region involving many and varied public and private participants such as ACRAA, private international rating agencies and to draw on the experiences of regional economies

- the promotion of effective domestic and region-wide insolvency and creditor rights systems

- promoting region-wide convergence towards robust global accounting standards.

APEC and other regional forums and international agencies and the private sector are providing important support to the efforts of national authorities and, as demonstrated at this dialogue, cooperation between these public/private groupings complements the efforts of individual groups and agencies. The primary role of capacity building is to help improve the confidence of national authorities which are considering reforms to capital markets. That entails the understanding of tradeoffs between policy options, the implications of reforms being considered and in improving the ability of economies in monitoring and evaluating prospective reforms.

The dialogue considered whether there is sufficient transparency in various capacity building initiatives, whether there is duplication of effort and whether some capacity building needs are not being effectively met.

The discussions reported earlier in this note point to the richness of the dialogue on a variety of issues surrounding the development of corporate bond markets and on capital market and financial system strengthening more broadly. Developments include importantly regional cooperation.

- *Regional Initiatives*

There are a number of important advances in support of the development of regional architecture to facilitate economic and financial integration. Many of these were inspired after the Asian financial crisis including the Chiang Mai Initiative and more recently developments under the Asian Bond Market Initiative. These are important components of regional capacity building, to be encouraged and further developed by relevant forums. APEC has a significant role to play in this work as have international and regional agencies such as the World Bank, the IMF, and the ADB and other regional groupings such as ABA, ACCRA, and SEACEN.

One of the pillar priorities of the ADB's Regional Cooperation and Integration Strategy is monetary and financial cooperation and integration. The key priority activities include:

- development and liberalisation of domestic financial markets as the building bloc for a larger regional bond market

- liberalisation of contractual savings institutions as the bedrock of bond markets

- the development and harmonisation of domestic laws, regulation, financial standards and access rules for foreign financial institutions and products

- developing financial infrastructure necessary to support regional markets

- ***Capacity Building – initiators***

The ADB and in particular the Asian Bond Market Initiative (ABMI) is supporting capacity building activities through the provision of technical and research assistance in a number of focal areas. These include facilitating access to markets via a wider variety of bond issues in Asia, enhancing market infrastructure for bonds, including developing guarantee mechanisms, new bond products, credit rating systems, information dissemination, and policy dialogues and legal and institutional infrastructure. The Asian Bonds Online website (http://asianbondsonline.adb.org) and the Asia Bond Monitor are important new tools for improving transparency and information dissemination.

Private commercial groups are similarly playing an important part in the developing capital markets. Private groups made major inputs to the dialogue, not just about the impediments to market developments as they perceive them, but on the types of tools that are being developed to improve management and technical advice to authorities and to potential market makers. They provided most significant contributions about the perceptions of the investment community and how to broaden investor participation in markets both as investors and issuers.

The OECD also plays an important capacity building role in bond market development in the region, and also actively promotes cooperation with non-OECD economies. The OECD provides a platform to conduct policy discussions for the Asia region in areas of public debt management, corporate governance, insolvency systems, capital markets developments more generally, and in supporting the development of private pension guidelines.

Capacity building initiatives are varied and imaginative, whether through high-level dialogues, specific operational training as provided by a number of major international and bilateral agencies. The effectiveness of building capacity through sustained long-term engagement such as through technical field presence in institutions or though exchanges between institutions in developed and emerging markets were also matters raised in the dialogue. Possible sensitivities of involving outside expertise in policy areas within economies was noted as was the need to ensure effective diagnostic work in identifying capacity building needs and in ensuring that initiatives address the needs of recipient economies.

- *Credit Rating Agencies*

Capacity building initiatives to support the development of local credit rating agencies are provided by IFIs and private credit rating agencies, regional organisations such ACCRA and by some economies themselves.

Experience points to the importance of independent private sector agencies but that government initiatives may be necessary to encourage the growth of private groups through the provision of a legal and regulatory framework and disclosure and accounting standards.

ACRAA plays a fundamental role in the region supporting the development of local agencies, facilitating coordination amongst them, and promoting the adoption of best practice and international standards, the development of regional bond markets and cross-border investment.

Chinese Taipei advised that the first agency in that economy was developed out of a joint-venture partnership with SNP fifteen years ago. Independence from official involvement in agencies was emphasised. The ADB noted that it could extend support for capacity building of CRAs or be a shareholder in the formation of an agency. A mandatory credit rating system could follow the development of an effective credit rating agency.

- ***Creditor rights and enforcing an issuer's obligations***

Enforcing an issuer's obligations was identified as an important matter requiring both capacity building initiatives and regional cooperation in integrating effective measures. Laws in most Asian economies are generally deficient in providing for cross-border insolvencies. Reference was made to the AP & P case to demonstrate impediments that exist in APEC economies in matters of recourse when companies operating across borders become insolvent. In the absence of legal remedy, there are potentially a number of response mechanisms and they include a possible regional treaty, the use of UNCITRAL model of cross-border insolvency law, or informal workouts as an alternative to formal procedures. Other measures include the adoption by banks – as agreed by the Hong Kong Bankers Association - of a set of guidelines that banks might follow in the event of a major default.

Under a technical assistance program the ADB has received advice on the set of informal workout principles that could apply to overcome the absence of legal processes. The Asian Bankers Associations has agreed a Model Agreement to Promote Company Restructuring. Such collaboration reflects a private sector initiative to address a public sector problem of deficiency in economic legal infrastructure. Other initiatives that could be pursued by the private sector to enhance cross-border cooperation include developing:

- a regional Centre for Arbitration as an alternative to courts
- fast Track Formal Workout Regime
- arrangements for creditors' voluntary Liquidation or for voluntary administration

Further the private sector could play a vital role in addressing the lack of institutional capacity and skills such as
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- advising judges on modern business transactions,
- providing funding to alleviate general delays in courts,
- encourage improved court procedures to provide for more transparent processes and advocating more publicly accountability and regulatory

systems which underpins the operation of a country's insolvency laws,

- supporting the development of a body of suitably qualified insolvency practitioners

While the issues are essentially public sector problems, the private sector can take actions to support reform and promote ways to find resolutions.

PART 5: CONCLUSIONS

This dialogue marks an important development in APEC as a public-private initiative to support the efforts of three APEC economies in enhancing the development of their respective corporate bond markets. Comments made by senior officials from the three focus economies were frank, open and highly informative and constructive. They each outlined important challenges now being confronted and they highlighted in a systematic way, processes now going on in developing institutional frameworks to address those challenges.

While the challenges should not be underestimated – particularly given the enormous long-term infrastructure financing needs of the regional economies over the next decade or so - important reforms are underway or are being contemplated which should add to the capacity of local currency corporate bond markets. That said, the challenges as discussed in this report are major if economies are to attract and diversify the investor and issuer base necessary if local bond markets are to seriously increase their role in capital formation in the three economies.

The dialogue outlined major regional cooperation and capacity building initiatives, and public-private partnerships that are developed and being developed and which can play a fundamental role in meeting the challenges confronting the three focus economies.

ABAC will further identify particular issues that could be discussed with each of the three focus economies and coordinate with those economies and regional and international agencies and with other regional bodies in offering advice on specific capacity building initiatives. There are major aspects of work on the APEC Finance Ministers agenda and on the agenda of the APEC Economic Committee that are presently addressing a number of the key points that arose in the dialogue, including how to deepen and strengthen the region's capital markets, how to improve governance, and problems associated with deficiencies in aspects of the region's legal systems. There is one simple message: APEC and ABAC are well focused on assisting member economies in meeting the major challenges that do lie ahead in developing local corporate bond markets the focus economies. There are compelling reasons to continue this series of dialogue with other emerging economies in the period ahead.