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A Public-Private Sector Initiative

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CONFERENCE REPORT OF THE THE 2ND APEC PUBLIC-PRIVATE SECTOR FORUM ON BOND MARKET DEVELOPMENT

*DEVELOPMENTS IN CHILE, MEXICO AND PERU AND
PUBLIC-PRIVATE PARTNERSHIP IN REGIONAL CAPACITY-
BUILDING*

Office of the Advisory Group Chair

**THE 2ND APEC PUBLIC-PRIVATE SECTOR
FORUM ON BOND MARKET
DEVELOPMENT**
*DEVELOPMENTS IN CHILE, MEXICO AND PERU AND
PUBLIC-PRIVATE PARTNERSHIP IN REGIONAL
CAPACITY-BUILDING*

CONFERENCE REPORT

A FORUM JOINTLY ORGANIZED BY
**THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY BUILDING
THE APEC BUSINESS ADVISORY COUNCIL**
*IN COOPERATION WITH THE PERUVIAN MINISTRY OF ECONOMY AND FINANCE AND
PROCAPITALES*

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BOND MARKET DEVELOPMENT
DEVELOPMENTS IN CHILE, MEXICO AND PERU AND PUBLIC-PRIVATE
PARTNERSHIP IN REGIONAL CAPACITY-BUILDING**

CONFERENCE REPORT

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CONFERENCE REPORT

INTRODUCTION

Local currency bond markets play an important role in economic development, not just by supporting economic growth but also by helping to promote equity.

The development of local currency bond markets helps promote financial stability and avert financial crises that often create widespread economic dislocations. The Asian financial crisis demonstrated the importance of having deep and liquid bond markets that can provide long-term financing in local currency for domestic projects. Diverse financial markets are also stronger and more stable, and bond markets would bring greater diversity for many developing economies that depend mostly on banks and equity markets for financing.¹

Bond markets are needed for the development of infrastructure, especially in regions that have been left behind in the competition for investment. The need for infrastructure is great. Combined together, emerging economies are expected to spend over US\$20 trillion on infrastructure over the next ten years. The vast scale of investment will require private sector funding, and in developing economies, bond markets need to be developed to play a central role in that process.

The development of bond markets can help promote the growth of medium, small and micro-enterprises. Access to bank loans has been a major problem for them in many developing economies. New financing opportunities have now begun to emerge with asset-backed securities markets and microfinance investment vehicles. Sound and robust bond market infrastructure is needed for these new opportunities to grow.

Bond markets help ordinary people grow their own savings, acquire homes and provide for contingencies. Bond markets offer opportunities to promote the growth of pension and mutual funds and the mortgage and insurance industries. They provide attractive products for ordinary retail investors who need an alternative to low-yielding bank accounts and highly volatile equity markets.

In the age of globalization, the development of bond markets can be accelerated through the facilitation of cross-border investment and issuance. APEC has tremendous potential to bring this process forward, especially by promoting region-wide convergence of regulatory standards and market practices, which should occupy an important place in the present and future agenda of APEC.

¹ Juan Francisco Raffo, *Welcome Remarks at the 2nd APEC Public-Private Sector Forum on Bond Market Development*, 9 July 2008, Cusco, Peru.

Recent years have seen various initiatives and public-private sector dialogues on the development of local currency bond markets in the region.² Many of these have produced important insights and recommendations. Public-private sector dialogues have proven very useful to both 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 the public sector.

At their meeting in Hanoi on 7 September 2006, APEC Finance Ministers welcomed a proposal submitted by ABAC that the Advisory Group, together with ABAC, 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). These will take the form of a series of one-day sessions, each focused on three or four developing member economies' bond markets.

The central objective is to hold a dialogue among interested economies, private sector market players and experts from international public and private sector organizations, aimed at identifying aspects in the policy and regulatory areas which could be addressed by authorities to enhance the environment for bond market development, and in particular, corporate bond issuance. The dialogues also aim to identify capacity building initiatives, including public/private partnerships to build the environment conducive to bond market development.

The Advisory Group and ABAC, in cooperation with the Australian Treasury and the Australian APEC Study Centre, organized the First Forum on 8 May 2007 in Melbourne, back-to-back with the Second APEC Senior Finance Officials Meeting (SFOM II). This first forum, which focused on the bond markets of Indonesia, the Philippines and Vietnam, was successfully concluded.

Following a review of these results, the Advisory Group and ABAC endorsed the holding of subsequent forums. On 9 July 2008, the 2nd APEC Public-Private Sector Forum on Bond Market Development was held in Cusco, Peru, in conjunction with the 4th APEC Senior Finance Officials' Meeting. It was co-organized by ABAC and the Advisory Group in collaboration with the Peruvian Ministry of Economy and Finance and Peru's capital market association, Procapitales.

The event attracted over 60 high-level participants representing participants from the focus economies (Chile, Mexico and Peru), and representatives from APEC finance ministries, private sector financial institutions, as well as the Asian Development Bank (ADB), the Inter-American Development Bank (IDB), the International Monetary Fund (IMF) and the World Bank (WB).

The presentations and discussions focused on key challenges facing bond market development in the region, and in particular in Chile, Mexico and Peru. The forum also discussed how to promote capacity building initiatives involving the private

² 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. The conference reports have been published; see "Developing Bond Markets in APEC: Moving Forward through Public-Private Sector Partnership (Report of a Joint Conference Organized by the APEC Business Advisory Council and the Pacific Economic Cooperation Council, 10-11 May 2004, Taipei)," *ABA Journal of Banking & Finance*, Vol XXI, No. 2, 2006, pp. 47-80; and *Developing Bond Markets in APEC: Towards Greater Public-Private Sector Regional Partnership: Report of a Joint Conference Organized by the APEC Business Advisory Council, the Asian Development Bank Institute and the Pacific Economic Cooperation Council, 21-22 June 2005, Tokyo, Japan* (Singapore: Institute of Southeast Asian Studies 2005).

sector 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 three major parts:

- *Part 1 provides a broad overview of the development of Latin American bond markets and regional cooperation, which includes a discussion of the Asian experience in regional bond market development cooperation.*
- *Part 2 describes key developments in the three focus economies (Chile, Mexico and Peru).*
- *Part 3 describes the discussions on the challenges and prospects for regional capacity-building and public-private sector collaboration in the development of bond markets.*

A concluding section summarizes the key points and provides recommendations for APEC.

PART 1: REGIONAL COOPERATION AND THE DEVELOPMENT OF LATIN AMERICAN BOND MARKETS

A. OVERVIEW OF LATIN AMERICAN BOND MARKET DEVELOPMENT

In recent years, local currency debt has overtaken international sovereign bonds, with the former's share of international investors' emerging market debt trading rising to two-thirds of the total today from two-fifths at the beginning of the decade. Since the Asian financial crisis, governments have increasingly relied on local debt markets to meet their financing needs. Over the past ten years, the outstanding stock of emerging market domestic debt securities has risen almost six-fold to around US\$6 trillion.³

Growth of investment in these markets has been due to a number of interrelated factors, which include cyclical factors (low global interest rates), increased activity of pension funds and global asset managers, improvements in market access and liquidity, the decline of home bias in developed economies, and the establishment of benchmark investment indices for emerging market bonds.

There has been significant development of local debt markets, including increased foreign participation and liquidity, improvements in market infrastructure and a wider range of financial instruments. However, while government bond markets have shown tremendous improvements, corporate issuance continues to lag behind in many of these markets, with governments and central banks accounting for around three-fourths of outstanding debt in emerging local debt markets.

³ The discussions for all three sections under Part I are based on a Fitch Ratings report written by David Riley and Richard Fox (*Local Currency Debt Markets Emerge from the Shadows*, Fitch Ratings International Special Report 2008); a paper by Ms. Lotte Schou-Zibell of the Office of Regional Economic Integration, Asian Development Bank; the presentations by Mr. Marcelo Paz, Investment Officer, Financial Markets Division, Structured and Corporate Department, Inter-American Development Bank; Mr. Srinivasa Madhur, Director, Office of Regional Economic Integration, Asian Development Bank; and Mr. William Hayes, Managing Director - Latin America, FitchRatings; and additional comments from Mr. Yoshihiro Watanabe, Co-Chair, Advisory Group on APEC Financial System Capacity Building, ABAC Finance and Economics Working Group Co-Chair, and Advisor, The Bank of Tokyo-Mitsubishi UFJ, Ltd.; Mr. Juan Francisco Raffo, ABAC Chair and Chairman, Raffo Group; Mr. Javier Kapsoli, Chair, APEC Senior Finance Officials' Meeting (SFOM) and General Director of Economic and Social Affairs, Ministry of Economy and Finance, Perú; and other forum participants.

One consequence of the underdevelopment of local currency corporate bond markets has been the recent dramatic growth of debt issued by emerging market banks and corporations in international markets. As such foreign currency borrowing from international capital markets and financial institutions increases, so do the risks for developing economies of contagion stemming from the current turmoil in global financial and credit markets. This underscores the importance of giving more attention to the development of corporate bond markets.

In Latin America (with certain exceptions), capital markets in general still have limited depth and liquidity. Bank loans remain the predominant source of finance. Compared to Asia, the depth of financial markets in Latin America remains low (bank credit in Latin America amounted to only around half of GDP in 2007, compared to 95% for Asia), and financial markets cater largely to governments (providing only 25% of funds to the private sector in 2003, compared to 80% in Asia). Nevertheless, there have been significant developments in the past few years.

In the past, Latin American governments dominated international debt markets, issuing US dollar denominated bonds to a small universe of dedicated investors in emerging market debt. As these governments' need for foreign borrowing declined with increased revenues from high commodity prices and sound fiscal policies, private sector international bond issuance has risen dramatically. (However, domestic and cross-border private sector issuance has been negatively affected by the developments in global financial markets since the second half of 2007.)

Companies from a wide range of industries including steel, telecommunications, petrochemicals, homebuilding and finance are accessing domestic and international financial markets, where liquidity has been fuelled by tremendous growth of assets under management by domestic pension funds and other asset managers. Following in the footsteps of governments setting local yield curve benchmarks, these corporate issuers are refinancing debt, investing in productive assets and funding regional and global acquisitions.

Local currency bond markets have benefited from the recent positive developments in Latin American economies brought about by sound fiscal policies, increased business confidence and improved political stability. Increased demand for funding is coming from companies expanding internationally and investing in productive capacity, infrastructure projects (particularly ports, airports and highways) and the mortgage market. These accounted for the growth of domestic bond issuance from US\$9.3 billion in 2004 to US\$28 billion in 2006.

These developments are taking place in the context of important changes in the region's financial markets. A wide range of alternatives are now becoming available in the market, including local currency bonds, asset-backed securities and non-recourse financing, while bank loans are becoming more competitive with maturities stretching out to as far as 20 years. Local currency bond markets are evolving with the growing number of local issuers.

Nevertheless, there remains much room for improvement. Domestic bond markets are still relatively small compared to the size of local pension funds. The costs of accessing local capital markets remain high. The issuer base is largely investment-grade – of the total number of bonds outstanding, those with local currency ratings (as of July 2008) given by Fitch above A- comprise 97% in Chile and 74% in Peru, and those above BBB+ make up 97% in Mexico.

B. REGIONAL COOPERATION TO DEVELOP BOND MARKETS: THE ASIAN EXPERIENCE

For most of their history, many developing Asian economies have been heavily reliant on equity and bank financing. After the Asian financial crisis demonstrated the need for liquid and robust local currency bond markets, governments in the region have undertaken significant efforts to develop these markets, individually and within the framework of regional financial cooperation. Regional cooperation has focused on a number of initiatives, such as the Asian Bond Market Initiative (ABMI), the Asian Bond Fund (ABF), the Asian Currency Note Programme and the Asian Bonds Online website.

The Asian Bond Market Initiative. The ABMI was launched by the ASEAN Plus Three (APT) Finance Ministers in August 2003 with the aim of fostering the development of regional bond markets by facilitating issuers' access to bond markets and removing impediments to bond market development. The ABMI focuses on priority areas that include securitized debt instruments, credit guarantee and investment mechanisms, foreign exchange transaction and settlement and credit rating systems.

The initiative has stimulated reforms in participating economies, including the unification of issuing authorities for government bonds, simplification of procedures for corporate bond issuance to promote securitisation and removal of barriers to bond issuance. The Asian Development Bank (ADB) has provided financial and technical support for studies (14 regional technical assistance projects to date since the launch of ABMI) and is working with governments in the design of a credit guarantee mechanism for local currency bonds. The government of Japan has also provided technical assistance to individual participating economies.

Recently, the APT and ADB have developed a new medium-term roadmap to accelerate bond market development, which identifies the key issues on which efforts will be focused, and establishes a structure and procedures to ensure effective and coordinated action. The new roadmap will focus on four key issues: promoting supply (issuance) of local-currency bonds; facilitating demand for these bonds; improving the regulatory framework; and enhancing related infrastructure.

Each of the four key issues has been assigned to a task force, supported by a fifth group called the Technical Assistance Coordination Team (TACT). The four task forces and the TACT are under the supervision of an ABMI Steering Group, which is also responsible for setting, reviewing and revising the roadmap, formulating a strategy to promote public awareness, assessing the practicability of the Task Force's studies, assigning responsibilities to task forces, creating new working teams as needed, and encouraging exchange of information within the APT through a self-assessment process.

The Steering Group reports to the APT Deputy Finance Ministers, who meet semi-annually, and the APT Finance Ministers, who meet once a year. The roadmap itself is to be reviewed every year and revised as needed.

The self-assessment process forms an important part of the new roadmap. Using benchmarks ("references for self-assessment") developed under the initiative, member economies conduct self-assessments and report periodically on its efforts, progress and experiences, thus contributing to information sharing and efforts to make bond markets more accessible to issuers and investors.

The Asian Bond Fund. The first Asian Bond Fund (ABF1) was launched by the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) in June 2003. The Fund pooled US\$1 billion of the eleven member central banks' international reserves and invested it in US dollar denominated sovereign and quasi-sovereign bonds issued by eight of the developing member economies. In June 2006, EMEAP launched the second Asian Bond Fund (ABF2), which pooled US\$2 billion of reserves distributed among eight single-market funds and the Pan-Asia Bond Index Fund (PAIF). The single-market funds invested in local currency sovereign and quasi-sovereign bonds issued by each of the eight developing member economies, while the PAIF is an index bond fund investing in local currency sovereign and quasi-sovereign bonds from all of the eight economies.

The ABF2 was designed to provide a low-cost and convenient way for investors to invest in Asian bonds, using passively-managed funds. Being a listed open-indexed fund, the PAIF allows institutional and retail investors easy access to local currency bond markets. The ABF2 has also helped regulators and policy makers identify and better understand – from their perspectives as investors in the fund – the practical impact of market impediments, such as capital controls, withholding taxes, regulatory barriers and weak market infrastructure. Thus, it contributed to a number of reforms, including the loosening of capital controls in China and Malaysia and the introduction of withholding tax exemptions on investment income to non-residents in Korea and Thailand.

The Asian Currency Note Programme. In September 2006, the ADB launched the ACN, under which it issued US\$10 billion in local currency bonds in several APT economies using common disclosure standards and terms and conditions governed by English law. This initiative facilitated the harmonization of these standards among member economies, as these standards were adopted to enable the ADB to issue bonds under the program in their respective markets.

Asian Bonds Online. The ADB developed the website to disseminate information on the bond markets of APT member economies. In addition, the ADB also publishes the semi-annual *Asia Bond Monitor*, as well as various working papers, reports and publications related to its ongoing research on bond market development issues.

These initiatives have contributed to the growth of emerging Asian bond markets⁴ in recent years. These markets have grown by 37% annually on average, with total bonds outstanding increasing from US\$160 billion in 1997 to US\$3.9 trillion in March 2008. The share of bond markets in emerging Asian economies' total financial sector assets has increased from 12% to 15% between 1996 and 2007. Although government bond markets have led the way, corporate bond markets have also exhibited significant growth with a wider variety of highly-rated issuers accessing the markets. As of March 2008, corporate bonds outstanding in emerging Asian markets amounted to about US\$1 trillion.

There is also increased cross-border corporate bond issuance, as regional issuers take advantage of improved access and liberalized rules on swaps and derivatives to issue bonds not just in the traditional offshore centers (Singapore and Hong Kong, China⁵), but also in other economies like Malaysia and South Korea. As new rules

⁴ Emerging Asian bond markets include China, Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore, Thailand and Vietnam.

⁵ Hereinafter referred to simply as “Hong Kong.”

and regulations are introduced and payment links among monetary authorities upgraded, new markets and products have developed, such as the markets for Islamic corporate certificates (sukuk), which are now being issued not just in Malaysia (which has accounted for about 70% of global issues), but also in Hong Kong, Brunei and Indonesia.

Nevertheless, despite considerable progress, there is still a long way to go in the development of emerging Asian bond markets. Compared to equity and bank funding, bond markets still account for the smaller portion of total financial sector assets. There is insufficient liquidity and markets remain fragmented. Corporate bond markets lag far behind government bond markets in terms of size. The region's mutual fund industry, although growing considerably, remains underdeveloped. Asset securitization, which has grown since the Asian financial crisis, particularly as a mechanism for credit risk transfer, also needs to be further developed.

The continued development of Asian local currency bond markets faces a number of challenges. These include strengthening legal and regulatory frameworks and accounting standards; removing impediments to market entry, investment and cross-border issuance; broadening and diversifying the investor base; developing derivatives and swap markets; strengthening risk assessment and management among financial institutions, credit rating agencies and regulatory agencies; enhancing transparency; and improving market infrastructure, particularly those related to clearing and settlement, credit guarantees and financial information.

The Asian experience illustrates the value of regional cooperation in promoting the development of local currency bond markets, involving governments and regional institutions. It provides examples of elements that are useful in designing regional cooperation initiatives in other parts of the world or expanded regional initiatives covering the broader Asia-Pacific region. The many challenges that still need to be addressed serve to underscore the importance of sustained regional cooperation for the continued progress of reforms and capacity-building efforts to develop bond markets.

C. REGIONAL COOPERATION AND LATIN AMERICAN BOND MARKETS

While Latin America has a long history of regional cooperation, its use as a means to develop financial markets is only at a very early stage, as governments begin to see the value of collaboration with the recent increase of cross-border bond issuance and investment. Considering the East Asian model, there is a similar potential in Latin America for more focused regional cooperation among governments with the participation of the Inter-American Development Bank (IDB).

The IDB has in the past contributed, and continues to contribute, to the development of Latin American financial markets through various initiatives. These include programs aimed at strengthening financial institutions; supporting local and regional debt and equity markets; supporting individual transactions with high demonstration effects; mobilizing private lenders and investors; targeting specific segments of financial intermediaries facing common challenges; supporting the development of new financial instruments; and supporting specific target financial activities with high social impact, such as mortgage finance, trade finance, consumer finance, SME finance and microfinance.

Currently, IDB plays various roles in the region's financial market development. Most of its efforts are focused on supporting the sustained development of capital markets through assisting economies in developing sound policies and regulatory frameworks. A smaller portion of its activities are related to its role as catalyst and

intermediary, such as in offering financial products to complement the role of private financial markets through credit, liquidity and maturity enhancement.

In the discussions that followed, a number of participants expressed the view that while the process of Latin American financial integration is beginning, there is a clear need for a concerted regional effort to lay the foundations for a truly integrated regional financial market. These efforts could focus on promoting effective local currency bond markets and cross-border investment and issuance through measures aimed at creating adequate legal, policy and regulatory frameworks, increasing the size and diversity of long-term investors and issuers, enhancing market liquidity, removing barriers, promoting adequate disclosure requirements, developing a strong credit culture, promoting integration with global capital markets and helping make available independent, objective standards for measuring risk/return trade-offs, among others.

While securities regulators are able to address a number of these issues, such as harmonization, among themselves, a neutral forum would be useful in facilitating agreement and ensuring sustained efforts over an extended period of time. Participants from the private sector urged the initiation by Latin American governments of a concerted regional cooperation effort to promote the development of local currency bond markets and facilitate cross-border investment and issuance, with the involvement of IDB and the private sector, including through domestic financial industry associations and regional organizations such as ABAC.

PART 2: KEY DEVELOPMENTS IN THE THREE FOCUS ECONOMIES

A. CHILE

The Chilean local currency bond market is currently valued at around US\$45 billion. Three major categories of fixed-income securities comprise Chile's domestic bond market: (a) central bank and treasury bonds; (b) enterprise bonds, which include bonds issued by corporations, banks and asset-backed securities; and (c) mortgage notes. The amount of enterprise bonds outstanding has grown during the past six years, overtaking central bank and treasury bonds. Bonds issued by private issuers now make up the largest portion, with 72% of total fixed-income securities as of 2007, and with the highest share of GDP (22.5%) among Latin American economies.⁶

Private financial instruments (aside from shares) include corporate bonds (44% of the total as of 2006), commercial papers (13%), mortgage notes issued by banks (9%), asset-backed securities (5%) and credit notes (2%). Corporate bonds have driven the growth of Chile's bond markets. In contrast to most Latin American economies, the market for government bonds has grown more slowly in relation to GDP, while the corporate bond market has grown faster.

Major issuers of corporate bonds are firms from the infrastructure (with a 33% share of the value of total bonds issued from 2000 to first quarter of 2008, encouraged by

⁶ This section is based in large part upon the presentations on the Chilean bond market made by Dr. Guillermo Larraín Ríos, Superintendent, Office of the Superintendent of Securities and Insurance of Chile; Mr. Jorge Errázuriz Grez, President, Celfin Capital Corredores de Bolsa S.A.; Mr. Danilo Radovic, Executive Director JP Morgan, Chile; and Mr. Jorge Muñoz, Managing Director, Banchile Asesoría Financiera S.A., with additional comments by Mr. Francisco Garcés, Board Member, Banco de Chile, and other forum participants.

positive measures such as the concession program of the Ministry of Public Works), retail (19%), energy (18%), and utilities and telecommunications (10%). Nearly half of corporate issues are made by multinational enterprises or consortia led by foreign firms. The bond market has been the preferred source of financing for infrastructure projects.

Chile's private sector is also an active issuer of bonds overseas, with a total of 34 bonds issued and a combined market value of about US\$10 billion, among which 9 were in the global market, 10 in the Yankee market and 15 in the Eurodollar market. Major issuers with 85% of these issues are the industrial and electrical sectors (with three firms having a combined share of 50%). Chilean bonds issued overseas have an average maturity of 17 years.

The development of the bond market has been driven mainly by liquidity and facilitated by the development of a market yield curve for all tenors, both arising from the large size of the portfolio managed by institutional investors. As a percentage of GDP, assets under management by institutional investors in Chile (about 106%) is much higher than its Latin American neighbours (26% in Mexico, 23% in Brazil and 16% in Peru), and does not compare very unfavourably with the USA (180%).

The growth of pension funds' investment portfolio has come from the increased inflow of resources from affiliates attracted by higher returns, following the implementation of the multi-fund system and tax incentives. The portfolio composition has been shifting away from government papers and mortgages toward equity, foreign investment and corporate bonds. In the case of life insurance companies, the investment portfolio mix has been changing with the growing weight of long-term corporate and infrastructure bonds.

The pension fund sector is the largest source of demand for the fixed-income market, with assets under management amounting to 62% of GDP. Other major investors are life insurance companies and mutual funds (with assets amounting to 18% and 12% of GDP, respectively). The relatively large amount of assets held by life insurance companies makes Chile an exception in Latin America, where the role of insurance companies is generally smaller compared to Asia.

Pension funds, which account for investments using mark-to-market criteria, are large players in bonds but not in derivatives due to regulatory constraints. Life insurance companies, whose assets are mostly generated in the annuity business and whose accounting is based on book value criteria, are active in both bonds and derivatives markets. Mutual funds are open and use mark-to-market criteria in accounting. Banks are large players in derivatives and bonds, focusing mainly on central bank bonds.

Institutional investors hold 90% of Chile's corporate bonds, and accounts for the long maturities of these bonds, as a result of structural and regulatory incentives for local investors to buy long-term bonds. Among APEC economies, Chile has the longest maturity of corporate bonds, with over 90% of bonds having maturities of over five years. Because pension funds and life insurance companies largely follow buy-and-hold strategies⁷ (average duration for bonds held by life insurance companies and pension funds are 9.3 and 7.8 years, respectively, compared to 0.8 years for mutual funds), secondary market liquidity is low.

There is a high degree of indexation in the Chilean bond market, with almost 90% of the market value indexed to a unit of account (UF) linked to the consumer price index. Efforts to nominalize the market have mainly come from the public sector; the

⁷ Insurance companies prefer longer maturities of around 20 years for the purpose of matching their assets with life-insurance and annuities liabilities.

percentage of bonds issued by the central bank denominated in Chilean pesos has risen over the past few years and reached 42% in 2006. However, nominalization has not gained favor in the private fixed-income market, with almost the entire market value of enterprise bonds and mortgage notes remaining indexed to the UF.

Chile faces important challenges in the further development of its local currency bond market.

- First, there is still very limited foreign participation. In Latin American bond markets, residents account for practically all bond issuances, compared to East Asia, where non-residents account for about 8% of bond issuance. Among concerns cited by foreign issuers are the local stamp tax, which could increase the all-in cost particularly for medium-term bonds, the relatively long (4-month) time frame of first-time registration procedures and the requirements for local investment grade rating. Foreign investment in the Chilean bond market is discouraged by a 35% tax on capital gains for foreign investors, as well as the lack of liquidity in the secondary market for buyers.
- Second, the market for high-yield corporate bonds and asset-backed securities remains underdeveloped, due to the lack of investor appetite related to the current regulatory framework. Institutional investors are subject to several regulatory limits that allow them to invest mainly in investment-grade securities (local rating of BBB or higher). Practically all the bonds issued in the Chilean bond market are rated A and above, with bonds rated A+ and above making up 55% of the total market value. In the case of asset-backed securities, 85% of the total market value is made up of securities rated AA and above.

To further develop the local currency bond market, the government is undertaking a number of reforms.

- As Chile becomes a capital-exporting economy, policy makers are taking steps to promote the internationalisation of fixed-income market supply and demand. Addressing the supply side, reforms focus on widening the set of eligible home economies and broadening the set of potential investors for bond issuance in Chilean pesos or UF, including foreign governments and multilateral agencies; as well as on rules for securities issued in Chilean pesos by foreign investors in off-shore segment of exchanges. Addressing the demand side, efforts focus on changing rules that define qualified investors to broaden the range of foreign instruments on offer.
- The second phase of Chile's capital market reform program includes reform of the pension fund industry, in particular to allow pension funds to invest in bonds issued by investment funds, as well as incentives to promote the venture capital industry. Among these incentives are an increase in the investment limits for insurance companies through the elimination of certain limits, allowing an increase of other limits, updating the insurance law as a consequence of commitments to free trade agreements, and providing guarantees for debt issues of eligible investment funds.
- A third phase of the capital market reform program currently being prepared for submission to the legislature would benefit the asset-backed securities market. It would include eliminating limits on the securitisation of bonds from the same credit or asset originator and the ceiling of 35% per originator, and allow the issue of lines of asset-backed securities to facilitate debt restructuring.

There was a discussion of cross-border transactions and regional financial integration in relation to a case study of a Chilean-incorporated company with direct investments in Peru (Cencosud S.A.) issuing bonds in Peruvian soles for investment by Peruvian pension funds and other institutional investors. Various considerations

for the issuer in making this transaction included benefits from diversification of financing sources, competitive yields and durations, natural hedge for operational currency, match between host economy and financing source and fast and seamless execution.

The bond issue benefited the Peruvian local currency bond market by contributing to the diversification of the issuer base, including regional diversification. Its attractiveness to Peruvian investors was due to a number of benefits, which included attractive long-term local currency yields and a AAA local currency rating (implying a pick-up over sovereign risk with the equivalent rating, which was A+ for Chile and BBB- for Peru).

The case study highlighted a number of factors that are likely to lead to the deepening of Latin American regional financial integration as a consequence of cross-border direct investment in the coming years. First, issuers face attractive funding prospects by accessing the local markets where they have direct investments. Second, these transactions provide local investors excellent opportunities to access a diversified base of issuers that are familiar to them with thoroughly understood risks. Third, liquid and accessible local derivatives markets allow for currency redenomination as well as interest rate hedges.

There were discussions on the impact of taxes on financial development and global financial integration. Taxes that affect Chile's local bond market include the stamp tax, the 35% capital gains tax on fixed-income instruments for foreign companies and the withholding tax on interest remittances, as well as the double taxation arising from the tax on stock dividends and from the inheritance tax.

Citing the growing trend toward regional economic integration to promote the expansion of business, participants pointed to the need for regional cooperation to address cross-border regulatory and tax issues, including harmonization of taxes and regulations affecting financial transactions. Experiences of regional cooperation elsewhere (such as that of the European Union) demonstrate the huge challenges involved in such efforts, and public sector participants noted that it would be easier to start with harmonizing regulations that cause distortions. A possible role for IDB to support this process was suggested.

B. MEXICO

With a current total value of US\$360 billion and growing rapidly, the Mexican bond market is one the largest in Latin America. Government issues dominate the market. Excluding bonds issued by commercial banks and non-registered debt in the Mexican Stock Exchange, the federal government accounts for 76% of bonds outstanding as of April 2008, with the central bank accounting for another 7% of bonds issued in conjunction with monetary policy and others – mostly the private sector – taking up the remaining 17%. In addition to these, a total of Mexican pesos 260 billion have been issued by foreign companies.⁸

The private debt market is composed of non-structured debt (secured and unsecured corporate debt and debt issued by federal and other government agencies that have

⁸ This section is based in large part upon the presentations on the Mexican bond market made by Mr. Rodolfo Campos Villegas, Director of Public Financing, Mexican Ministry of Finance and Public Credit and Mr. Arturo Monroy Ballesteros, Executive Director, Investment Banking and Structured Finance, Grupo Financiero Banorte; with additional comments from Mr. Kenneth Waller, Chairman, Financial Services Advisory Board, The Australian APEC Study Centre, and Senior Advisor, Australia ABAC Secretariat; and other forum participants.

not been endorsed by the federal government) and structured debt (CDOs mostly issued by banks to reduce pressures on their balance sheets, asset-backed securities that are primarily mortgage-backed and bridge loan securities, future flow securities mostly backed by toll road income and taxes, and debt with partial or total guarantees). Corporate bonds comprise the largest portion, with 34% of the total, but the share of structured debt has been rapidly growing, with the four categories of structured debt now making up almost half (49%) of the market.

In terms of interest rate type, 51% are floating rate bonds preferred by retail investors and mutual funds and 14% fixed rate bonds preferred by insurance companies, pension funds and also by mutual funds. 35% are inflation-indexed bonds, which are also preferred by insurance companies and pension funds. In terms of outstanding amount by credit rating, practically all bond issuances are investment-grade, with AAA bonds (domestic rating) comprising 68% of the total. In terms of institutional investors, pension funds make up 44% of the total, with mutual funds accounting for 39% and insurance companies 18%.

The development of the Mexican bond market has been driven by a number of factors.

- One is the expansion of pension fund assets. Net assets have grown as a percentage of GDP from 1.47% in 1998 to 8.06% as of March 2008. With the launch of new funds, new financial instruments and more flexible investment policies under the new legal framework, pension funds have contributed to increased trading, innovation and the extension of maturities.
- A second is foreign investor participation. Foreign investors have played an important role in the development of the market by providing demand for long-duration instruments, bringing in best practices in structuring and trading, and generating more liquid markets overall.
- A third is government policy, which covers the following:
 - Improvements in the market microstructure were brought about by reforms, including the improvement of auction schedules, changes in the bond reopening schemes, new regulations for repo and securities lending markets, introduction of the STRIPS program for government securities, and development of exchange programs for fixed-rate bonds and inflation-linked bonds and a buyback program for government securities.
 - The government introduced enhancements in communications strategy. This included the establishment of an investor relations office to develop a continuous dialogue with investors and analysts; the annual publication of the government's general issuance strategy as part of the Economic Policy Guidelines as well as a detailed document on the issuance strategy for the coming year; the establishment of a web page to provide timely and detailed information on the legal framework governing public debt, debt statistics and transaction report; and periodic surveys to collect market participants' opinions on prospective issues and operations.
 - Benchmark issues were developed, particularly through a debt strategy directed toward strengthening the fixed-rate and inflation-indexed benchmarks. This was undertaken by maintaining significant outstanding amounts for each benchmark with a reduced number of maturities across

the yield curve, thus providing sufficient liquidity throughout the yield curve.⁹

- A large number of key reforms in the legal and regulatory frameworks governing finance were undertaken during the last few years. Among the most important with respect to the local currency bond market are the new Securities Market Law, the Mutual and Investment Funds Law, the Reform of the Real Estate Investment Trusts, the National Banking and Securities Exchange Commission Law, the Reform to the Law of Credit Guarantees, the Mortgage Development Bank Reform and the creation of multiple purpose financial institutions (Sociedad Financiera de Objeto Múltiple or SOFOMES).¹⁰
- Improvements in the clearing and settlement infrastructure were made. Key developments include the arrangements of Euroclear and Clearstream with local banks for the settlement of local currency securities; arrangements to trade local instruments, including among foreign investors and between foreign and local participants; and access to secondary markets. Within Latin America, only debt issuance in Mexican and Argentinian currency can be traded through international clearing and settlement systems, as a consequence of the establishment of a clearing house for government securities, thus promoting the participation of foreign investors in the local market.
- A Market Makers Program was established to promote investment in government securities, increase liquidity in secondary markets, promote the development of the derivatives, repo and securities lending markets, and introduce international best practices. Under this program, market makers are bound to participate actively in primary auctions and in the secondary market, as well as quote two-way rates for government securities on a daily basis.

As a result of various reforms, the Mexican local government bond market has attained high levels of liquidity. Since 2007 on average, Mexican local debt instruments account for 25% of all local emerging bond market trading worldwide, ahead of Brazil and Hong Kong, which account for 15% and 5.5% of the total, respectively.

⁹ The issuance of Udibonos (inflation-indexed bonds) has been an important element of Mexico's public debt strategy, representing 14% of local government securities. With housing and infrastructure requiring increased use of these bonds, the government has initiated efforts to improve the efficiency of this market. After surveying market participants about Udibono issuance policy and the potential to further develop this market, the government started issuing a new three-year benchmark to complement the development of the short end of the real interest rate curve. This was followed by a freeze in the issuance of the 20-year Udibono and an increase in the monthly issuance of the 10- and 30-year Udibonos in order to strengthen these benchmarks. An exchange program for Udibonos was implemented in order to further strengthen benchmarks and increase their liquidity. The government announced the incorporation of Udibonos in the Market Makers' Program, with the objective of improving secondary market liquidity.

¹⁰ Others are the Organic Law of the National Savings and Financial Services Bank, the Credit Institutions Law, the Financial Groups Law, the General Law of Auxiliary Credit Organizations and Activities, the Insurance Corporation Law, the Organic Law of the Federal Mortgage Association, the Reform of Retirement Savings, the Law on Combating Money Laundering and the Financing of Terrorism, the Guaranteed Credit Competition and Transparency Law, the Popular Savings and Credit Law, the Organic Law of Rural Financing Institutions, the Reform of the Development Financial System, the Reform of Credit Institutions Law, the Reform of Bank Secrecy, the Insurance Sector Reform, the Banking Distress Law, the Credit Cards Cloning Prevention Law, the Law on Risky Capital Investments and the Pawnshops Law.

The Mexican Derivatives Exchange (Mexder) has been one of the most dynamic derivatives exchange in the world. To further develop this exchange, the governments need to address the limited trading volume of future contracts on federal government bonds, as well as promote the growth of the repo and securities lending markets in order to foster the trading of bond futures.

The ensuing discussions focused on issues related to foreign investors' participation, pension funds and regulatory reform.

Participants underscored the fact that, in Mexico's experience, foreign investors significantly contributed to the development of the market, lending support to the view that by providing consistent and sound policies, governments can ensure that increased foreign participation will benefit local markets instead of being a source of instability. In particular, given that the diversity (more than the breadth) of the investor base is very important for market development, governments should encourage greater foreign investor participation.

There was a discussion about restrictions on activities of pension funds, especially with respect to overseas investments. In many cases, such restrictions are in place for pension funds due to the mandatory nature of contributions (in contrast to mutual funds, for example), which involve the political justification that contributing workers' savings would finance domestic growth. Studies, including one on the European Union by the IMF, indicate that such restrictive policies come at enormous costs, most especially to employees contributing to pension plans.

Regulators, multilateral development institutions and international organizations like APEC can play constructive roles in effecting a change of mind sets. Given the political context in which these restrictions have been established and maintained, however, it would be useful to provide objective measurements of the costs and benefits of these restrictions on foreign investment that can facilitate a better understanding of issues on the part of political decision makers and the public.

The discussions also highlighted the importance of the constant upgrading of legal and regulatory frameworks to ensure the continued growth of the market. Finally, reference was made to taxes that act as barriers to financial development described in a paper submitted by ABAC. Withholding tax for residents is low at 0.85% and there are no stamp and inheritance taxes. However, a number of taxes apply to foreign nationals, including taxes on interest earned and withholding taxes and interest paid to reinsurance.

C. PERU

The Peruvian local currency bond market is a rapidly growing market that has allowed the government to progressively increase domestic funding of fiscal needs. Domestic bonds now supply all of the new funding raised by the government from capital markets, compared to only 29% of the total in 2003, when the government relied mostly on foreign currency bonds for its debt management operations. The share of local-currency denominated sovereign bonds in the public debt portfolio has risen dramatically from 8% in 2003 to 40% in 2008.¹¹

¹¹ This section is based in large part upon the presentations on the Peruvian bond market made by Mr. José Miguel Ugarte, Executive Director of the National Directorate of Public Debt, Peruvian Ministry of Economy and Finance; Mr. Nelson Dávalos, Director of Corporate Banking, Citibank, Peru; and Mr. Eduardo Herrera, Chief Investment Officer, Profuturo AFP, Peru, as well as additional comments by Mr. Jean Paul Chabaneix, Member of the Board of Directors, Procapitales (Association of Capital Market Promoting Firms) and other forum participants.

Private issuances, which were mostly denominated in US dollars in 2003, are now mostly in local currency. With the relatively low risk associated with Peru's economy and the liquidity of the capital market, issuers are able to raise funds at competitive levels vis-à-vis the market for bank loans, and the strength of the local currency has served to consolidate demand for domestic financial instruments.

The private sector debt market is still clearly at a very early stage of development, with demand and supply concentrated in a few institutional investors and issuers. Corporate bonds make up the large and rapidly growing part of the market, with asset-backed securities also increasing. In 2007, 77% of corporate bond issuances were concentrated in only fifteen companies. There is also a very high concentration of highly-rated bonds (mostly with local ratings of AA and above), especially as AAA-rated bond issuance has predominated during the past four years. Corporate debt with maturity of over five years has grown very rapidly over the past ten years and now make up the largest portion of the market.

Economic growth has encouraged the development of a number of infrastructure projects, which are expected to further stimulate the growth of the domestic capital market. It is expected that close to an estimated US\$3 billion in funding will be raised for new concessions and investment, half of which is expected to come from the domestic bond market.

Pension funds take up the major part of the institutional investor base, accounting for about half of total demand for public offerings and almost all of the demand for private placements in 2007. In the case of the government bond market, there have been major changes in the structure of the investor base since 2003, as non-resident investors increased their share from nothing in 2003 to around 38% today. The share of pension funds has also grown from 39% in 2003 to 46% as of May 2008. The share of banks and mutual funds decreased in 2007 from 30% and 17%, respectively to 6% and 3% today.

With respect to the legal framework governing capital markets, Peru's constitution does not discriminate between local and foreign investors, guaranteeing equal treatment and allowing residents to buy and sell foreign currency within the jurisdiction. Interests and capital gains from investments are currently income tax-exempt until the end of 2008. This will change when a new tax law takes effect in January 2009, although sovereign bonds will remain unaffected. There is a 0.07% tax on all banking transactions in domestic and foreign currency.

Over the last few years, the Peruvian government has been undertaking very serious efforts to develop the local currency bond market, through a number of measures:

- The government initiated the Market Makers Program with the objectives of promoting the development of a benchmark yield curve and the issuance of domestic local currency debt and reversing the dollarization of the economy. The program was launched with the expectation that it would help in the risk management of public debt, increase the share of local currency debt in the public debt portfolio and improve the transmission mechanisms for monetary policy. Market makers currently include four banks and Peru's development bank (Corporación Financiera de Desarrollo or COFIDE), which are the only agents authorized to participate in the sovereign bond auctions organized by the Ministry of Economy and Finance, while being required to provide daily bid and offer quotes.
- The government also launched a program to extend the local currency yield curve. At the end of 2004, the maximum fixed rate bond tenor was first raised to 7 years, and successively extended to 15 years in 2005, 20 years in 2006 and 30

years in 2007. This process was accompanied by a steady decline in interest rates, as long-term bond yields went down from 9.45% in 2004 to 6.61% in 2007.

- The current year's debt management program of the government is focused on further increasing the share of local currency and fixed-rate debt in total government debt; the continued reduction of the debt service for the next ten years to generate stable levels of debt service payments over time; and further promoting the development of the local currency market through the issuance of new benchmark bonds in association with the Market Makers Program.
- At the same time, the government is also currently undertaking reform of the local capital market, with the objectives of modifying the legal framework to incorporate new trends in the development of financial markets; further consolidating the yield curve through the development of new benchmark points; and establishing new mechanisms to improve market liquidity and the clearing process.

While effectively promoting currency diversification and maturity extension of sovereign debt through the above measures, the government has also been collaborating with the private sector to increase demand for local currency bonds and the diversity of the investor base.

A recent initiative was the issuance of new local currency benchmark bonds with a 2037 maturity to prepay part of Peru's debt to the Paris Club. The bonds were offered (in addition to local investors) to international institutional investors through a Global Depositary Note (GDN) structure, which permitted foreign investors to purchase the bonds directly and as the underlying asset of the GDN.

Although the underlying assets are denominated and paid in local currency, through the GDN, the principal and coupon payments are paid in US dollars by the Depositary. The structure is similar to that of American Depositary Receipts (ADRs), allowing GDN holders to surrender their GDNs and withdraw the underlying bonds from the Depositary at any time and vice versa, and thus to move between the international and local markets.

As a mechanism through which a local instrument is distributed in the international market, the transaction represented another successful and innovative step in the rapid evolution of Peru's external local currency market, increasing demand and competition for the instrument to the benefit of both issuer and investor. Marketed globally by Citi to investors with interest in Peruvian credit and local currency investment, the deal was two and a half times oversubscribed (despite the impact of the sub-prime crisis on financial markets), enabling the Peruvian government to upsize the issuance from the originally announced US\$1 billion to US\$1.5 billion and fund a greater portion of its obligation to the Paris Club in local currency.

While the sovereign bond market has benefited from various measures, attention also needs to be given to the further development of the corporate bond market. One major challenge is its limited depth. In terms of the size of the secondary market, the fixed-income market lags far behind the equities market, which has grown significantly over the past three years. It is very vulnerable to speculation, particularly in relation to short-term capital flows and short-term banking liabilities. Another major challenge is the inefficient pricing of the market.

The development of the corporate bond market would require addressing a number of key issues, among which are improving the efficiency of pricing; increasing the number and diversity of issuers, including the high-yield portion of the market; increasing the variety of financial instruments; inflation indexation; credit enhancements; market-making and tax-related issues. Addressing these issues will benefit the whole economy, and in particular will promote investment in infrastructure, which is currently limited due to the lack of appropriate financial instruments.

The ensuing open discussions focused on a number of issues. The first dealt with the impact of inflation-indexed bonds. Some participants observed that the issuance of inflation-indexed bonds alongside regular bonds could lead to a certain fragmentation of the market and diminish liquidity.

The second issue was related to tax-related issues. Reference was made to the impact that various taxes could have on financial development and integration, including existing taxes on financial transactions, assets and dividends, the withholding tax on interest from foreign bank loans and the tax on interest on foreign interbank loans. The introduction in January 2009 of the 5% capital gains tax rate that will be applied to corporate bonds but not to sovereign bonds was also mentioned, and the private sector expressed concern about the possible impact that this asymmetrical tax treatment might have on the development of the corporate bond market.

The third issue focused on the continuation of reforms. Participants commended the government of Peru for the successful implementation of regulatory reforms and the launch of the Market Makers Program, and discussed how the momentum of reform could be sustained, especially in view of the ongoing evolution of capital markets. There was agreement on the need for institutional arrangements to ensure the continued pursuit of the reform agenda, and that there is a role that APEC could play in promoting such arrangements through its work on structural reform.

The fourth issue dealt with public-private sector cooperation. Participants from the Peruvian pension fund sector noted the significant contribution of improved cooperation between the government and the pension fund industry to the success of reform efforts. This experience underscored the usefulness of public-private sector roundtables in the development of capital markets. Other participants emphasized the usefulness of such roundtables in helping regulators keep themselves updated on innovations in financial markets and in formulating appropriate responses to new challenges. Participants agreed that APEC can play an important role in fostering cooperation between the public and private sectors.

PART 3: CHALLENGES AND PROSPECTS FOR REGIONAL CAPACITY-BUILDING AND PUBLIC-PRIVATE PARTNERSHIP

A primary objective of the forum is to review capacity building initiatives in support of bond market development in the region, and to consider further initiatives that might be appropriate. The forum also examined the role that public-private partnerships can play in the development of the region's bond markets and in capacity-building efforts.¹²

Structural changes affecting financial markets pose a major challenge to developing economies. Over the past few years, there has been an acceleration of financial market deepening worldwide, with total financial assets growing faster than global

¹² This section is based in large part on the presentations made by Ms. Debra von Koch, Associate Director, Government Debt Issuance and Management Program, U.S. Department of the Treasury; Dr. Hemant Shah, Deputy Division Chief, Capital Market Development and Financial Infrastructure Division, International Monetary Fund; and Mr. Kenneth Waller, Chairman, Financial Services Advisory Board, The Australian APEC Study Centre, and Senior Advisor, Australia ABAC Secretariat, with additional comments by Dr. Julius Caesar Parreñas, Senior Advisor to the Chairman, Chinatrust Financial Holding Co., Ltd. and Coordinator of the Advisory Group on APEC Financial System Capacity-Building as well as other forum participants.

GDP and reaching a value equivalent to 350% of global GDP in 2006. In the case of debt securities, its share of total financial assets grew from 28% in 2000 to 41% in 2006. Financial deepening in emerging markets has risen at a faster rate, and in developing APEC member economies even more.

In general, the rapid growth of emerging local debt markets since 1998 has come with strong macroeconomic performance, significant advances in public debt management, improvements in issuance and diversification of the investor base. Foreign participation has been growing, although APEC emerging markets lag behind their counterparts in emerging Europe. Nevertheless, there remains a need for further consolidation of benchmark issues and acceptance of market discipline. The institutional investor base, though growing, is still small. Corporate debt markets remain underdeveloped.

There has also been an increase in emerging markets' exposures via complex financial instruments. Daily average turnover for currency derivatives in emerging markets has grown from US\$13.6 million in 1998 to US\$98 million in 2007. For interest rate derivatives, it grew from US\$0.2 million in 1998 to US\$13 million in 2007.

A number of structural impediments affect the growth of corporate bond markets in many developing economies. Within APEC, the most common structural impediments in emerging markets include the small number and size of corporate issues, lack of confidence in credit rating services, insufficient market liquidity and limited investor base. In addition, common broader problems include incomplete yield curves, inadequate governance, lack of transparency, restrictions on foreign investor activity, the impact of certain taxes, lack of repo and derivatives markets, and inadequate infrastructure for trading and settlement.

Addressing these most common impediments would require attention to a number of measures. These include the development of mortgage- and asset-back securities markets, relaxing restrictions on pension funds, improving tax treatment and access to foreign investors, enhancing market infrastructure, promoting regional initiatives to provide investable indices, harmonized regulation and markets, and strengthening legal frameworks for public and private issuance, disclosure and accounting.

The task of addressing these issues is complex, involving the definition of roles and objectives within the context of competing domestic and regional priorities, as well as legal and regulatory changes. It involves structural changes that are often long-term and imply varying degrees of culture change. It also requires a variety of approaches that include training programs, policy dialogues and experience-sharing. APEC's renewed effort to address structural change at the ministerial level is a good step forward in resolving these issues.

Various international institutions are active in providing capacity-building assistance to emerging markets to develop financial markets. Among these (in addition to regional institutions such as the ADB and the IDB) are the Group of Eight (G8), the Organization for Economic Cooperation and Development (OECD), the International Monetary Fund (IMF), the International Finance Corporation (IFC) and the World Bank (WB).

For example, the IMF undertakes capacity-building activities in a number of emerging markets with respect to strengthening the securities market regulatory framework, sovereign debt management, pension reform, and developing securities, derivatives and repo markets. Its research focuses on asset-backed securitisation in emerging markets, the second-generation reform of pension systems, derivatives markets and improving databases.

Another example is the Global Emerging Markets Local Currency Bond (GEMLOC) program launched by the World Bank Group in October 2007, which aims to help emerging market countries attract more investment and develop their local currency bond markets by linking policy reform and investment. Under this program, the World Bank provides advisory services to help emerging market economies implement policy reforms and improve their market infrastructure.

The program involves a new index called the Global Emerging Markets Bond Index (GEMX), which was launched in early 2008. Inclusion in the GEMX is based on market size and underlying criteria that establish transparent guidelines for economies to use in implementing reforms so as to improve their index weight and attract additional investment. It is also designed to allow institutional investors around the world to benchmark themselves to this asset class in a transparent and objective way.

Developed member economies can also make significant contributions to capacity-building efforts within APEC. The United States Treasury Department's capacity-building program to support the development of local currency bond markets provides an example. Efforts are focused on bilateral technical assistance to finance ministries and central banks, which are coordinated by the Treasury's Office of Technical Assistance.

The Treasury's bilateral assistance projects are largely characterized by the provision of sustained field-based technical experts to developing economies over a specified number of years. These programs are based on terms of reference that establish mutually agreed project objectives and identify the parameters of collaboration between the Treasury's technical experts and host economy authorities, in a way that is tailored to local conditions. The experts include former regulators and market participants who are able to help in the formulation and implementation of capital market development plans.

The Treasury's capacity-building program is better understood by describing the development of financial markets in terms of a pyramid with money markets at the bottom, above which, in ascending order, are the markets for treasury bills, notes and foreign exchange; the long-term government bond and municipal debt markets; the corporate bond, mortgage-backed and asset-backed securities markets; and at the top investment funds and the equity and derivatives markets. The Treasury's bilateral assistance projects are largely focused on the bottom end of the pyramid (money, treasury bills/notes and foreign exchange markets), where the development of the liquidity management infrastructure provides the solid foundation for the subsequent development of the capital market.

The Treasury's experience highlighted a number of critical factors for success. First, the project needs to have firm support from the counterpart economy; in particular, the buy-in from the top level of government is important. Second, the counterpart must have the capacity to move things forward through political and administrative processes. Third, communications, especially with market participants, is of vital importance.

Recently, the Treasury submitted a proposal to APEC that combines bilateral assistance to developing member economies with the production of a joint paper that outlines general lessons related to the development of capital markets in APEC economies.

The model of sustained field-based technical assistance as exemplified by the US Treasury's capacity-building program can be considered as complementary to existing policy dialogues under the APEC framework as well as short-term capacity-building programs such as seminars, forums, workshops or one-time field-based

assistance lasting up to several weeks. Thought could be given to the development of a more comprehensive effort within APEC that integrates these various elements in a way that promotes greater synergy, efficiency and effectiveness.

In addition to individual governments and agencies and international financial and development institutions, such a comprehensive effort should also involve the business sector, particularly as the APEC agenda is to a great extent about enhancing the business environment. Public-private partnership (PPP) should be the default option, given that capacity-building challenges are aimed at promoting investment and trade as much as structural reform and improving growth, and the success of efforts requires intellectual and practical analysis from various perspectives.

The success of regional efforts also requires the support of various constituencies, but most especially of the business sector. Changes in trade and investment-related policies, including taxation regimes, financial regulatory frameworks ultimately impact on investment decisions and business structures. For these reasons, PPP needs positive and constructive recognition by APEC.

An important challenge is how collaborative efforts can be undertaken in a way that makes efficient use of limited resources. This may be achieved in a number of ways. One is through a change in the administration of APEC projects funded from the APEC Support Fund and APEC's operational account. Some devolution of the APEC Secretariat's function of administering regional projects to approved project coordinators could be considered. This would involve developing relationships based on good governance, trust and integrity, and delegation of authority to competent capacity-building agencies.

Another way is by strengthening connectivity between regional and domestic efforts. A review of APEC's working procedures could be undertaken to ensure that APEC can support member economies that wish to implement regionally agreed policies and reforms. This would also require the different APEC fora to determine priorities and sectoral focus of their work, particularly in relation to financial, economic and structural reform agenda.

With respect to the development of emerging bond markets, collaboration among governments, the private sector and international institutions have been growing in recent years. Reference has already been made to previous public-private sector dialogues on bond market development that have generated important general principles and provided valuable insights on the requirements to support relevant objectives such as establishing level playing fields, enhancing risk management and promoting stable macroeconomic environments, among many others.

The APEC Public-Private Sector Forum on Bond Market Development can play an important role in fostering connectivity by identifying particular issues of concern to individual economies and contributing to improved coordination between these economies, on one hand, and regional and international institutions, on the other, in establishing, implementing and synergizing relevant capacity-building programs.

There are ample incentives for focused and sustained involvement of the public and private sectors in this undertaking. For the public sector, these reform efforts would significantly contribute to economic growth, improved productivity and living standards and efficiency gains through competitive and deep financial markets. The private sector would reap clear benefits from sound and fair legal and regulatory frameworks, the adoption of international standards and practices, market-determined prices, competitive markets and a growing investor and issuer base, among others.

Building the legal and institutional frameworks for efficient bond markets requires a structural reform context, involving high-level political commitment to build confidence in the process. Linking the work being undertaken in this area by the APEC Finance Ministers to that of the APEC Economic Committee can help ensure priority attention and continued commitment to reforms aimed at developing bond markets. The APEC Ministerial Meeting on Structural Reform provides significant impetus to this process.

Given the above considerations, there is a need for efforts to deepen the connectivity between various regional capacity-building initiatives and the implementation of identified and agreed reforms in member economies. One way of doing this is through an APEC policy review on connectivity, focused on how this can be undertaken to support reform efforts of interested economies. This review should involve the public and private sectors and relevant international institutions. The Advisory Group could play an active role in this process, by providing analysis of the progress of reforms in economies that have previously been the focus of the Forum at an appropriate time in the future. The outcome should be defined and proposals for moving forward presented.

The discussions that followed the presentations focused on the issue of promoting greater synergy among capacity-building efforts and the role of regional cooperation in addressing tax harmonization.

There is recognition that coordination among the various capacity-building efforts being undertaken by international organizations and institutions has not been sufficiently addressed. There are some efforts being undertaken, such as efforts within the G8 to establish communication mechanisms among participants and set up data bases. Participants also noted that international cooperation efforts are not organized in the same way as corporate projects, and there is a need to encourage more pre-consultations, concrete suggestions, and efforts to translate the results of dialogues into concrete actions.

There is also a need to mobilize funding from other sources, such as the private sector and private foundations, to complement resources from governments, regional organizations and international institutions, in undertaking collaborative projects. In this respect, getting public and private institutions to more actively support reforms and promoting greater connectivity are important.

Finally, participants agreed that tax harmonization is an important issue for the development and integration of local currency bond markets, but this process is politically difficult and will take a very long time to complete. APEC could play a role by providing a forum for the sharing of information among different jurisdictions, thus laying the foundation for further collaborative efforts in the future.

CONCLUSIONS AND RECOMMENDATIONS

This forum marks another important milestone in efforts to promote public-private sector collaboration to develop bond markets within the APEC framework. The following are the major conclusions and recommendations arising from the presentations and discussions in the forum:

- There has been very significant development of bond markets in Asia and Latin America as a result of policy and regulatory reforms over the past few years, but key challenges remain. These include issues such as improving market infrastructure, improving access and standards of use (e.g., market entry, cross-border issuance and investment, regulatory and legal framework), enhancing

transparency, strengthening risk assessment and risk management among financial institutions and regulatory authorities, and increasing market liquidity.

- While Asian financial integration, through such initiatives as the ABMI and ABF, has been actively promoted by governments, the beginnings of financial integration in Latin America are being driven by cross-border investment and issuance related to cross-border foreign investment. The results of these transactions have benefited Latin American economies and demonstrated that foreign investors provide stability to markets. Regional financial integration in Latin America should be facilitated through closer collaboration among regulators and policy makers with more active support from international institutions such as the Inter-American Development Bank.
- While the past few years have seen governments actively undertaking reforms, the development of bond markets is a continuing issue that needs to be sustained in the face of innovations in financial services and the emergence of financial stresses that generate political pressure for policy and regulatory responses. Consequently, there is a need for institutional arrangements to ensure continued reforms and improvements on a long-term basis and spanning political cycles.
- Taxes have a significant impact on the development of bond markets, including cross-border investment and issuance. Given the importance of bond markets, governments should keep this in mind when undertaking tax policy changes. APEC could play a role in addressing the impact of taxes on bond markets. Initiatives that may be considered include a survey of individual member economies with the support of finance ministries, central banks and financial regulatory agencies; undertaking regular reviews of these taxes within a regional context; and holding regional discussions with the aim of promoting concrete steps by individual economies to address adverse impacts of taxes on bond market development and cross-border transactions, including through harmonization.
- Within APEC, developed member economies can play an important role in promoting policies that lead to market development in developing member economies. The US Treasury's capacity-building program for emerging capital markets provides important insights on how this can be undertaken and the key success factors. Consideration could be given to how the synergy of such programs with other regional efforts within APEC may be enhanced.
- International institutions like the ADB, the IDB, the IMF, the OECD and the World Bank play a very useful role in bringing onto the table the experiences not just of APEC economies, but also of non-member economies. Examples are the ADB's role in the ABMI, the IDB's support for capital market development in Latin America, the IMF's research and capacity-building programs to assist emerging market economies, the OECD's roundtables for capital market regulators, and the World Bank's GEMLOC project. APEC should consider how their programs can be more effectively deployed in conjunction with each other and with other capacity-building efforts in the region.
- Importance needs to be given to capacity-building in certain priority areas, such as securitization, legal frameworks, local pension funds, market infrastructure, participation of foreign investors and issuers, the impact of taxes on bond market development, and regional initiatives particularly with respect to harmonization of regulation and market practices.
- Experiences in Latin America underscore once again the positive contributions of closer collaboration between the public and private sectors to the success of efforts to develop domestic financial markets. APEC economies could benefit from

exchanges of information on best practices and implementing mechanisms for cooperation with the private sector. Holding regular roundtables involving relevant officials and regulators, the local financial industry and private sector organizations, as well as financial sector experts should be seriously considered.

- Within APEC, there is a need to deepen connectivity between various capacity-building initiatives and the actual implementation of reforms in member economies. In this process, there is a critical role for public-private sector collaboration in generating support for policy measures, particularly with respect to corporate bond markets. The APEC Finance Ministers could consider APEC policy review on connectivity, focused on how regional and international capacity-building activities can more effectively support reform efforts of interested economies. This review should involve the public and private sectors and relevant international institutions.

APPENDIX A: FORUM PROGRAMME

The Second APEC Public-Private Sector Forum on Bond Market Development

A WORKSHOP ORGANIZED BY
THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY BUILDING
THE APEC BUSINESS ADVISORY COUNCIL
IN COOPERATION WITH THE MINISTRY OF ECONOMY AND FINANCE, PERU AND
PROCAPITALES

9 July 2008
Libertador Palacio del Inka Hotel
Cusco, Peru

- 8:30 AM **SESSION 1: INTRODUCTORY SESSION – PUBLIC AND PRIVATE SECTOR PERSPECTIVES ON THE DEVELOPMENT OF BOND MARKETS IN THE ASIA-PACIFIC REGION**
- Forum and Session Chair:* Mr. Yoshihiro Watanabe, Co-Chair, Advisory Group on APEC Financial System Capacity Building, ABAC Finance and Economics Working Group Co-Chair, and Advisor, The Bank of Tokyo-Mitsubishi UFJ, Ltd.
- 8:30 **Opening remarks by the Forum and Session Chair**
- 8:40 **Welcome remarks**
Mr. Juan Francisco Raffo, ABAC Chair and Chairman, Raffo Group
Mr. Javier Kapsoli, Chair, APEC Senior Finance Officials' Meeting (SFOM) and General Director of Economic and Social Affairs, Ministry of Economy and Finance, Perú
- 9:00 – 10:00 **Presentations by selected speakers**
- Overview of Latin American local currency bond markets**
Mr. Marcelo Paz, Investment Officer, Financial Markets Division, Structured and Corporate Department, Inter-American Development Bank
- Regional cooperation to develop bond markets: The Asian experience**
Mr. Srinivasa Madhur, Director, Office of Regional Economic Integration, Asian Development Bank
- The development of Latin American corporate bond markets**
Mr. William Hayes, Managing Director – Latin America, FitchRatings
- Private sector perspectives on promoting the growth of corporate bond markets**
Mr. Jorge Muñoz, Managing Director, Banchile Asesoría Financiera S.A.
- 10:00 **Open discussion**
- 10:15 **Summary and concluding remarks by the Forum and Session Chair**

- 10:20 Coffee break
- 10:40 **SESSION 2: THE PERUVIAN BOND MARKET**
Session Chair: Mr. Jean Paul Chabaneix, *Member of the Board of Directors, Procapitales (Association of Capital Market Promoting Firms), Peru*
- 10:40 **Introduction by the Session Chair**
- 10:45 **Presentation**
Mr. José Miguel Ugarte, *Executive Director of the National Directorate of Public Debt, Ministry of Economy and Finance, Perú*
- 11:15 **Comments**
Mr. Nelson Dávalos, *Director of Corporate Banking, Citibank, Peru*
- 11:25 **Comments**
Mr. Eduardo Herrera, *Chief Investment Officer, Profuturo AFP, Peru*
- 11:35 **Open discussion**
- 11:55 **Summary and concluding remarks by the Session Chair**
- 12:00 Noon **LUNCH Hosted by the APEC 2008 High Level Extraordinary Commission (CEAN) Peru**
- 1:30 PM **SESSION 3: THE CHILEAN BOND MARKET**
Session Chair: Mr. Francisco Garcés, *Board Member, Banco de Chile*
- 1:30 PM **Introduction by the Session Chair**
- 1:35 **Presentation**
Dr. Guillermo Larraín Ríos, *Superintendent, Office of the Superintendent of Securities and Insurance, Chile*
- 2:05 **Comments**
Mr. Jorge Errázuriz Grez, *President, Celfin Capital Corredores de Bolsa S.A.*
- 2:15 **Comments**
Mr. Danilo Radovic, *Executive Director JP Morgan, Chile*
- 2:25 **Open discussion**
- 2:45 **Summary and concluding remarks by the Session Chair**
- 2:50 **SESSION 4: THE MEXICAN BOND MARKET**
Session Chair: Mr. Kenneth Waller, *Chairman, Financial Services Advisory Board, The Australian APEC Study Centre, and Senior Advisor, Australia ABAC Secretariat*
- 2:50 **Introduction by the Session Chair**
- 2:55 **Presentation**
Mr. Rodolfo Campos Villegas, *Director of Public Financing, Ministry of Finance and Public Credit, Mexico*
- 3:15 **Comments**
Mr. Arturo Monroy Ballesteros, *Executive Director, Investment Banking and Structured Finance, Grupo Financiero Banorte*

3:30	Open discussion
4:05	Summary and concluding remarks by the Session Chair
4:10	<i>Coffee break</i>
4:30	SESSION 5: CONCLUDING PANEL DISCUSSION: CHALLENGES FOR CAPACITY-BUILDING AND PROSPECTS FOR PUBLIC-PRIVATE PARTNERSHIP
	Session Chair: Dr. Julius Caesar Parreñas, <i>Senior Advisor to the Chairman, Chinatrust Financial Holding Co., Ltd. And Coordinator, Advisory Group on APEC Financial System Capacity-Building</i>
4:30	Introduction by Session Chair
4:35 – 5:20	Presentations
	Capacity-building for emerging bond markets: Lessons from the US Treasury’s bilateral technical assistance programs Ms. Debra von Koch, <i>Associate Director, Government Debt Issuance and Management Program, U.S. Department of the Treasury</i>
	Capacity-building for emerging bond markets: Challenges and opportunities Dr. Hemant Shah, <i>Deputy Division Chief, Capital Market Development and Financial Infrastructure Division, International Monetary Fund</i>
	Capacity-building for emerging bond markets: The role of public-private sector partnership Mr. Kenneth Waller, <i>Chairman, Financial Services Advisory Board, The Australian APEC Study Centre, and Senior Advisor, Australia ABAC Secretariat</i>
5:20	Open discussion
5:40	Summary and concluding remarks by the Session Chair
5:50	Closing remarks Mr. Yoshihiro Watanabe, <i>Co-Chair, Advisory Group on APEC Financial System Capacity Building, ABAC Finance and Economics Working Group Co-Chair, and Advisor, The Bank of Tokyo-Mitsubishi UFJ, Ltd.</i> Mr. Jean Paul Chabaneix, <i>Member of the Board of Directors, Procapitales</i>
6:00	End

APPENDIX B: LIST OF ABBREVIATIONS

ABA	Asian Bankers' Association
ABAC	APEC Business Advisory Council
ABF	Asian Bond Fund
ABMI	Asian Bond Market Initiative
ACN	Asian Currency Note (Programme)
ADB	Asian Development Bank
ADR	American Depositary Receipt
APEC	Asia-Pacific Economic Cooperation
APT	ASEAN Plus Three
ASEAN	Association of Southeast Asian Nations
CDO	Collateralized Debt Obligation
COFIDE	Corporación Financiera de Desarrollo
EMEAP	Executives' Meeting of East Asia-Pacific Central Banks
G8	Group of Eight
GDN	Global Depositary Note
GDP	Gross Domestic Product
GEMLOC	Global Emerging Markets Local Currency Bond
GEMX	Global Emerging Markets Bond Index
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IMF	International Monetary Fund
MEXDER	Mexican Derivatives Exchange
OECD	Organization for Economic Cooperation and Development
PAIF	Pan-Asia Bond Index Fund
PPP	Public-Private Partnership
SFOM	Senior Finance Officials' Meeting
SME	Small and Medium Enterprise
SOFOMES	Sociedad Financiera de Objeto Múltiple
STRIPS	Separate Trading of Registered Interest and Principal Securities
TACT	Technical Assistance Coordination Team
UF	Unidad de Fomento (unit of account)
WB	World Bank