Harmonization of Bond Standards in ASEAN+3

1. Introduction

While it remains uncertain whether the worst part of the global financial meltdown that was triggered by the United States' (US) subprime crisis has passed, the East Asian economy has thus far weathered the global financial turbulence relatively well. Indeed, East Asia's limited exposure to subprime-related financial products has helped mitigate the impact of the crisis. In addition, the region's relatively fast recovery has shown that reform efforts undertaken in response to the 1997/98 Asian financial crisis have led to more resilient and healthier financial sectors than were in place a decade ago.

One of the lessons from the 1997/98 Asian financial crisis was that a financial system with multiple intermediary channels is more stable and robust in the face of large financial shocks than a system with a single intermediary channel. The absence of strong and vibrant capital markets in Asia was invariably identified as one of the major structural weaknesses that caused and exacerbated the 1997/98 crisis. Since then, repeated calls have been made to establish regional bond markets in East Asia. A more balanced financial system and well-developed bond markets can reduce the likelihood of a recurrence of financial crises in Asia by mitigating the problems of "double mismatches," namely, the mismatches in maturities and currencies in the external financing of East Asian economies. The development of regional bond markets is also expected to contribute to greater mobilization and recycling of the abundant regional savings within the region.

In response to these calls, a number of initiatives have been undertaken to develop regional bond markets in East Asia. The Executives' Meeting of East Asia–Pacific Central Banks (EMEAP) has established two Asian Bond Funds to create and expand demand for Asian bonds denominated in local currencies as well as the US dollar. The ASEAN+3 Finance Ministers' Meeting (AFMM+3) has undertaken the Asian Bond Market Initiative (ABMI) with to develop local currency denominated regional bond markets in East Asia. Since its endorsement in 2003, working groups and task forces organized under the ABMI have held a range of discussions and conducted research to highlight the major obstacles to developing regional bond markets and to identify effective strategies to overcome these obstacles.

Table 1-1: Local Currency Bonds Outstanding

(USD billion)

	1997	2003	2004	2005	2006	2007	2008	2009. 6
Japan	4421.9	6433.36	7456.86	7032.17	7095.56	7644.58	9511.84	9041.34
PRC	116.4	448.46	623.76	899.24	1184.12	1689.83	2213.35	2308.73
Korea, Rep. of	130.3	513.9	656.66	753.68	921.51	1026.69	816.7	901.17
Malaysia	57	93.72	96.77	106.7	123	164.3	163.24	173.64
Thailand	9.6	58.05	66.69	79.3	109.57	139.32	140.98	158.97
Indonesia	45.1	64.45	60.53	54.09	76.72	85.23	68.77	84.36
Singapore	23.8	67.16	79.92	83.12	99.39	121.81	128.79	132.68
Hong Kong, China	45.8	71.84	78.21	85.6	96.17	97.98	92.46	111.29
Philippines	18.5	30.86	36.17	42.13	47.19	58.02	56.86	57.25
Total	4868.4	7781.8	9155.57	9136.03	9753.23	11027.8	13193	12969.4

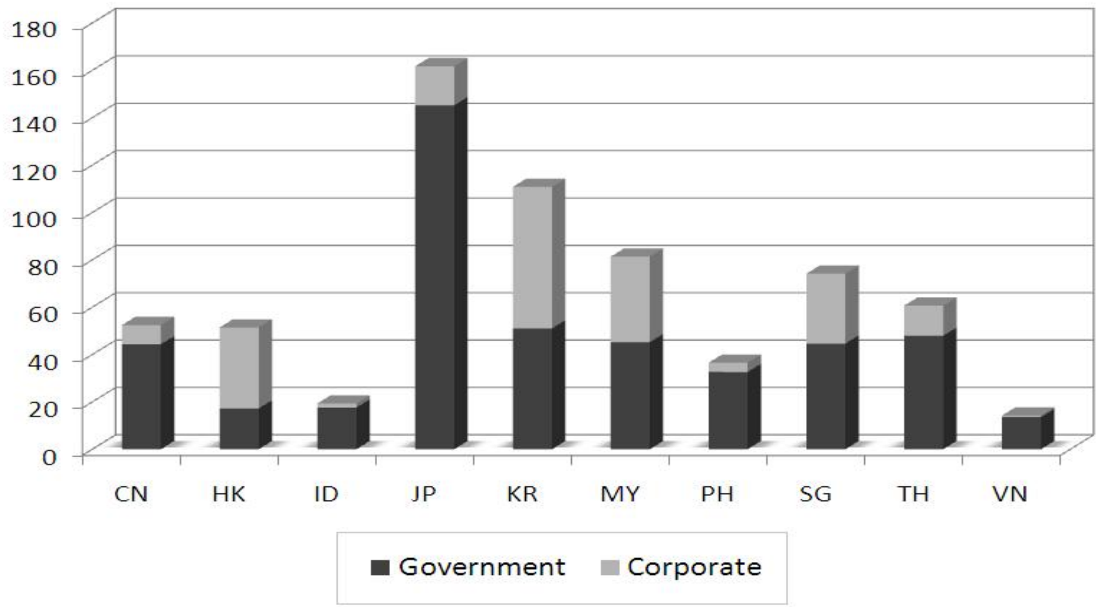
PRC = People's Republic of China. Source: Asian Bond Online.

Under such initiatives and through the efforts of individual countries, local currency denominated bond markets in the region have achieved remarkable growth in terms of size and diversity of issuers. As **Table 1-1** shows, the total volume of local currency bonds outstanding for major East Asian countries has almost tripled in size from USD4.8 trillion in 1997 to USD13 trillion in 2008. As of 2008, emerging Asia, excluding Japan, accounted for 6% of the outstanding volume in global local currency bond markets, which is more than the global share of the United Kingdom (UK), Germany, or France. Local currency bonds have been issued by various entities in East Asia, including international financial institutions and multinational corporations, as well as governments in the region.

While the recent growth of East Asian bond markets is remarkable, the region's bond markets have room to grow even more. **Figure 1-1** shows the relative size of local currency bond markets as a ratio of nominal gross domestic product (GDP). As can be seen, bond markets in many East Asian countries remain relatively small compared to those of advanced countries. Asia's continued economic development and the evolution of its financial systems, including more developed capital markets, will further enhance the growth potential of the region's bond markets.

Figure 1-1: Local Currency Bonds Outstanding as a Ratio of GDP (2009.6)

(% of GDP)



Source: Asian Bonds Online.

1.1. Asian Bond Standards: Why We Need to Harmonize Bond Standards

Along with the growth of national bond markets, the harmonization of domestic markets in East Asia and their eventual integration into a large and active regional bond market can yield several economic benefits.

First, the harmonization of segmented markets into a larger and more homogeneous market will lead to efficiency gains through the realization of economies of scale. Normally, economies of scale exist in financial market transactions. The larger and more standardized a market is, the less costly and more liquid the underlying market will be. Hence, bond market issuers can benefit from lower cost financing as harmonization will reduce the cost of transactions in both primary and secondary markets.

Second, bond market investors can also benefit from the harmonization of Asian bond markets through reduced investment costs for individual domestic market research.

Consequently, harmonization could facilitate cross-border transactions that would, in turn, accelerate integration of capital markets in the region.

Third, harmonization would also provide a superior investment frontier for both regional and global investors, bringing diversity into the market and broadening the scope of risk diversification given that countries in the region remain at different stages of economic development and possess a range of growth potential. The increase in diversity in risk preferences would also facilitate the more efficient pricing of risk.

Fourth, East Asia as a whole can better establish and utilize capital market infrastructure, including trading platforms, clearing and settlement functions, price discovery, and credit rating systems. Building adequate capital market infrastructure takes time and is often very costly. Developing and sharing harmonized market infrastructure would greatly reduce investment requirements in East Asia.

Fifth, the creation of an integrated regional bond market in East Asia can help alleviate global imbalances by better matching East Asia's vast savings with investment opportunities within the region. As shown in **Figures 1-2** and **1-3**, large current account deficits in the US have been financed by capital inflows, in particular from the foreign exchange reserve holdings of East Asia. Indeed, the current global financial crisis has highlighted the importance of creating high quality asset markets in Asia as the high propensity toward savings in many emerging market countries and the limited supply of low risk and high quality financial assets have led to excessive holdings of US treasury bonds by Asian countries, which in turn has led to a low interest rate and lax monetary environment that created asset market bubbles (see Caballero [2008] [1] and Shin [2008] [2]). The harmonization of bond markets in East Asia may not lead to an immediate expansion of the availability of lower risk and higher quality assets in Asia. However, as emphasized above, it can expand the set of investment opportunities within the region for private investors and help mitigate lopsided official foreign exchange reserve accumulation by encouraging private capital flows within East Asia.

[1] Caballero, Ricardo, Emmanuel Farhi, and Pierre-Olivier Gourinchas. 2008. An Equilibrium Model of Global Imbalances and Low Interest Rates. *American Economic Review*, Vol. 98. pp. 358-393.

[2] Shin, Hyun Song. 2008. Securitization, Subprime Mortgages and Global Imbalances. Presented at the Hong Kong Institute for Monetary Research (11).

Figure 1-2: US Current Account Deficit and Capital Flows

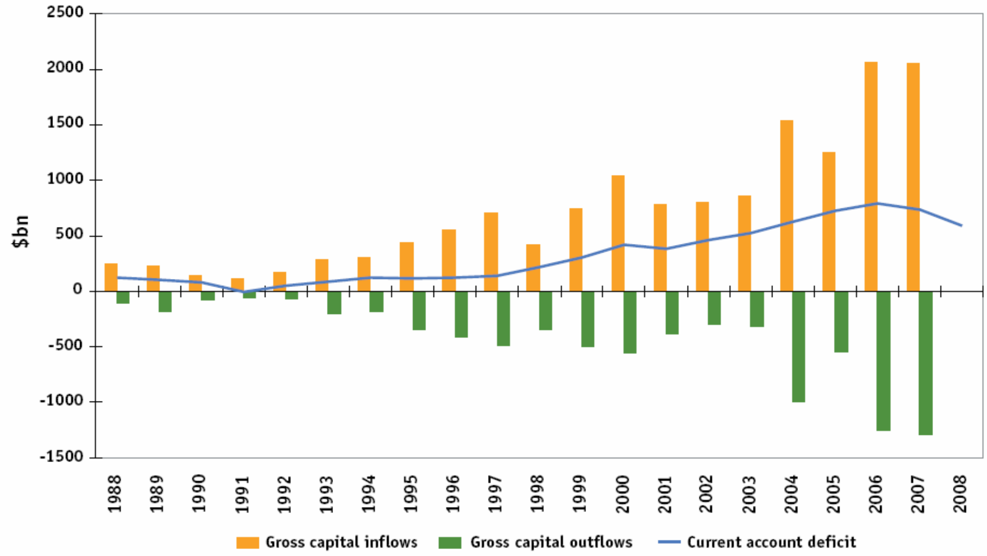
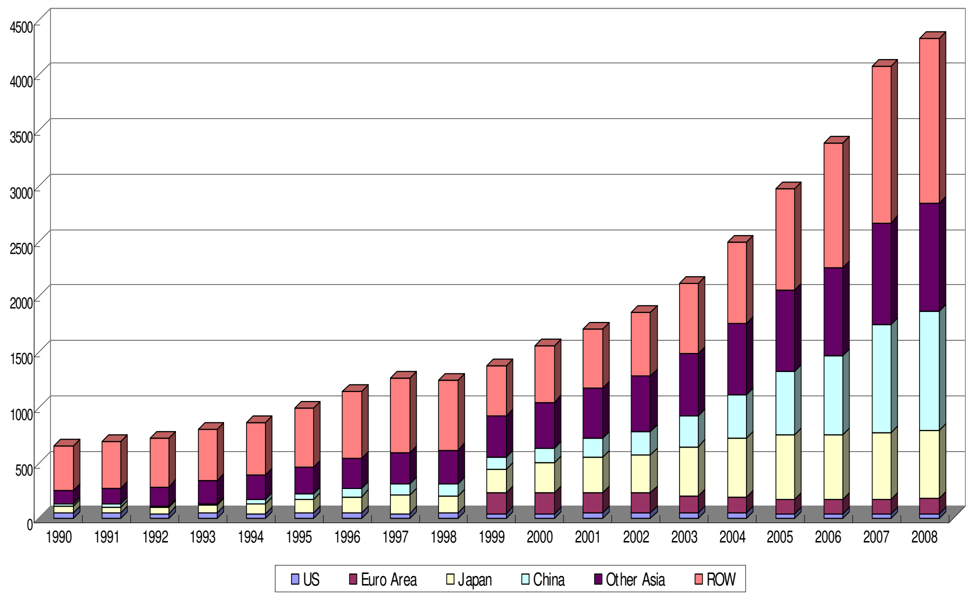


Figure 1-3: Foreign Exchange Reserve Holdings



Source: IMF, International Financial Statistics (IFS)

The harmonization of bond markets in East Asia offers the potential to mitigate the region's currency mismatch problem. From the early stage of the ABMI, the issuance of currency basket bonds, or an Asian currency unit (ACU), has been proposed as a way to overcome the currency mismatch problem. One of the ways to promote an ACU is to increase supplies of investment-quality, local currency denominated bonds so that private investors can form a portfolio basket with the currency risk diversified through a variety of local currency bonds. If local currency denominated bonds from different countries were pooled to form a currency basket bond, it would be much easier if the standards for these local bonds were harmonized. The harmonization of bond standards in Asia would also facilitate secondary market transactions and create additional liquidity in the market.

Despite the economic rationale of creating a more harmonized and integrated bond market in East Asia, several critical impediments exist. First, Asian bond markets are highly fragmented as each country has its own currency. Few cross-border, intra-regional portfolio investments occur. Unlike Europe, the absence of a common currency is a major hurdle in achieving bond market harmonization in East Asia. Second, Asian bond markets are highly lopsided with respect to volume. Outstanding bonds are concentrated in a few countries. For instance, the combined outstanding volume of bond markets in Japan, the People's Republic of China (including Hong Kong), and the Republic of Korea (Korea) accounts for almost 95% of total volume in the region. Third, East Asian countries are at heterogeneous stages of economic development. The state of development in capital market infrastructure and legal systems also differs widely across countries within the region. Furthermore, while institutional investors are developing in some Asian countries, bond markets in many countries suffer from the lack of sufficient demand as commercial banks still play a central role in financial intermediation and there is no strong and diverse institutional investor base.

The harmonization of heterogeneous bond markets in East Asia requires significant effort. While the experience of the European Union (EU) proves that differences in language and socio-political system can eventually be overcome, such differences still appear to be barriers in East Asia. Each county in the region has its own interests, values, and rationales for the differences. The harmonization of bond standards may be impossible to achieve in the short-run. However, individual East Asian countries can start learning lessons from each other and move towards an improved domestic regulatory environment. Thus, if bond markets in each country were to begin to move in the same direction towards harmonization, it would be a very important and critical message in itself. If emerging Asian markets are to play a bigger role in the global economy in the aftermath of the current global financial meltdown, they will need to demonstrate the effectiveness of their strategies to develop better-functioning capital markets. In this regard, the harmonization of Asian bond standards can play a catalytic role.

1.2. What Needs to be Harmonized and Integrated, and How?

An ideal way of developing a regional bond market in East Asia is to develop domestic bond markets in each country and harmonize these markets into an integrated market by allowing cross-border issuance and investment by foreign entities. However, as mentioned above, the bond markets of East Asian countries are highly fragmented due to different currencies and regulations. Indeed, while this approach is the most natural and desirable, it would take a very long time to achieve bond market integration if applied in East Asia. Consequently, in order to accelerate integration and create an effective regional bond market in due course, it is necessary to harmonize domestic bond markets first. More specifically, in order to encourage issuer and investor participation in the region's bond markets, it is desirable to harmonize bond standards and practices at the domestic level.

In principle, there are numerous items that need to be harmonized, which include issuing procedures, settlement process, listing and disclosure, international securities identifying numbers (ISIN), electronic disclosure, documentation, secondary market practices, syndicate rules, and accounting and auditing, among others. In addition, financial laws and regulations, taxation and foreign exchange, capital controls, and legal resolution procedures need to be reviewed to diagnose whether they are impeding the development of bond markets in the region.

However, as observed from the experience of Europe, harmonization of issuing standards and regulations across a region is an extremely challenging task because of a lack of motivation and the diverse positions of each domestic economy. For instance, Scott (2007) has investigated three approaches to harmonize bond markets in East Asia, namely, by multilateral agreement, mutual recognition, and utilization of offshore markets. The first two approaches regard harmonization of onshore markets.[3]

First, the harmonization of standards in primary bond markets can be accomplished through an agreement of all participating countries to harmonize the regulations regarding bond issuance. This is the most ideal process of integrating primary bond markets since the approach focuses on developing and liberalizing domestic bond markets by adopting one set of rules for the primary issuance of securities. There are, however, significant problems with achieving harmonization through this approach. First, it is difficult to find an optimal level of regulation since each country is likely to adopt a rule that is close to its preference. Therefore, it is doubtful that all countries would come to a consensus on implementing a single rule that satisfies every country. Another problem with the multilateral agreement approach is that periodic updates and interpretations of the agreements are necessary, and this process would likely be daunting because achieving a mutual consensus among many countries is difficult. Indeed, the European experience demonstrates that the harmonization of regulations through multilateral agreement is extremely difficult to achieve.

Second, the harmonization of primary bond markets can be also accomplished by the participating countries entering into an agreement under which each country recognizes the bonds issued and registered in other countries the same as it recognizes its own registered bonds. In this mutual recognition system, a host country recognizes another country's rules as valid when securities are issued in the territory of the host country. The EU permits its member countries to issue securities throughout the EU under home state rules. The Multijurisdictional Disclosure System (MJDS) adopted by Canada and the US is another example. Under the MJDS, US companies can issue securities in Canada under US rules and Canadian companies can issue securities in the US under Canadian rules.[4]

This method also relies on each country's domestic market development and liberalization, which takes a relatively long time, especially if the bond markets of the participating countries are at different stages of development as is the case in East Asia. Another weakness of this approach is that issuance of securities is likely to be concentrated in the country with the lowest level of regulation as a result of forum shopping, which means that unless the issuance standards and regulations of participating countries are somewhat harmonized, it would be difficult to reach an agreement on this single passport approach.

The third approach is to achieve harmonization through offshore markets. According to this approach, issuers from different countries are allowed to issue bonds in a common international bond market without registering them in their home countries. An existing international bond market, such as the Eurobond market, can be chosen or a new international bond market can be established. Since bonds are issued in the same international market, the issuers face the same set of rules and standards. These rules and standards, as well as market conventions, can be harmonized through self-regulatory organizations. However, there are also disadvantages to this offshore market approach, including the loss in efficiency of dividing liquidity between domestic and international bond markets.

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3 Scott, Hal S. 2007. The Development of Asian Bond Markets: The Offshore Option. *Harvard Public Law Working Paper* No.07-06.

4 ASEAN has also made some progress in this regard. In June 2009, Malaysia, Singapore, and Thailand jointly announced the ASEAN and Plus Standards. The scheme will facilitate multi-jurisdictional offerings of plain equity and debt securities in Malaysia, Singapore, and Thailand by allowing the issuer to comply with one single set of common disclosure standards, known as the ASEAN Standards, together with limited additional requirements prescribed by each jurisdiction, known as the Plus Standards. Hence, it is a hybrid of the single rule agreement and mutual recognition approaches. The scheme reflects the desire of ASEAN securities regulators to facilitate fundraising activities within ASEAN and to enhance the visibility of ASEAN capital markets as an attractive investment destination for global investors.

What is the most appropriate approach for bond market harmonization in East Asia? In sum, this report proposes two distinct approaches across government bond and corporate bond markets. For harmonization of government bond markets, a more gradual bottom-up approach that focuses on the onshore and secondary markets is proposed. For the harmonization of corporate bond markets, a more rapid and general approach that focuses on offshore and primary markets is proposed.

No strong motive exists to harmonize regulations in primary government bond markets by compromising their own regulations and issuing standards on the part of respective sovereign issuers. Moreover, onshore markets are the main financing sources for fiscal requirements as governments prefer local currency debt to avoid foreign exchange problems and the accumulation of foreign debt. Hence, as a first step, it is ideal to begin promoting harmonization from the secondary market's standards and practices. Sufficiently detailed, comprehensive, and extensive studies are required to understand national differences in secondary government bond markets and the reasons why such differences persist before identifying ways in which to begin harmonization. Therefore, the involvement of experts is indispensable. Given heterogeneous stages of economic development and different socio-political practices, consensus building through a gradual, bottom-up approach is appropriate for the harmonization of government bond markets.

Scott (2007) concludes that it would be very difficult to integrate primary bond markets through the on-shore approach at this stage of bond market development in Asia. He notes that the European experience demonstrates that extensive measures must be taken to achieve an integrated onshore system for primary markets, including initial measures of convergence in key bond market standards and regulations, transnational institutions to formulate and implement rules, acceptance of a common language for offering documents, and effective enforcement. All four of these measures are currently absent in East Asia.[5] Hence, a more gradual approach to introducing some of these measures is inevitable for harmonization of onshore government bond markets, which is precisely the rationale of initially focusing on the secondary market in the case of government bonds.

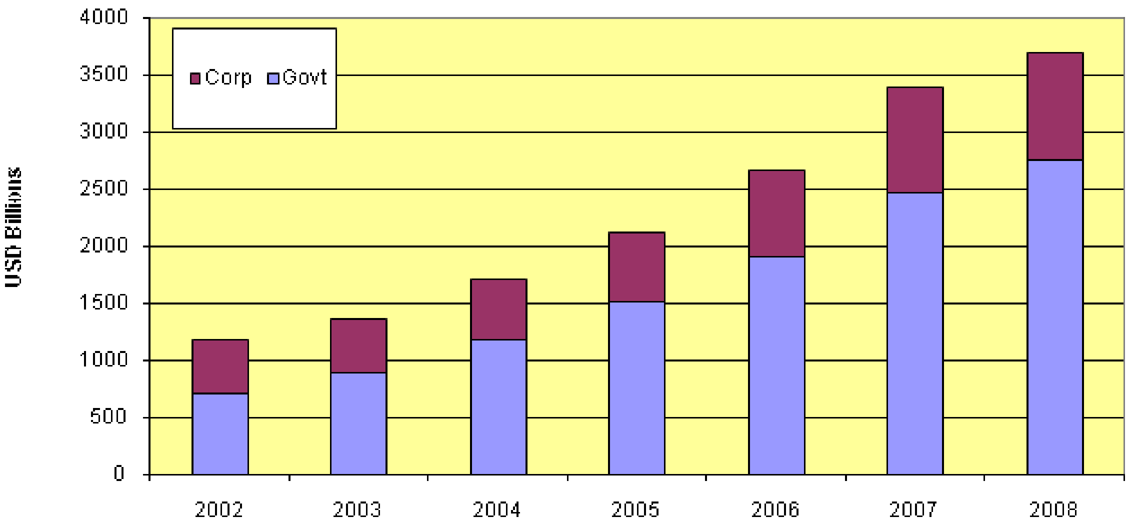
However, a more comprehensive, offshore approach can be applied to corporate bond markets. As suggested by Scott (2007), an offshore approach does not require harmonization of the heterogeneous rules and standards of participating countries. Adopting an offshore approach with a standardized single platform, rather than onshore integration with harmonized regulations, would be more effective and realistic in creating a regional bond market in East Asia, especially in corporate bond markets. More specifically, the present report proposes the creation of an offshore market especially designed for private placement for professionals. The Asian professional offshore securities market is a private placement market targeted for professional (wholesale) market players within and outside Asia, and comprising simplified registration and listing requirements. It aims to create an Asian version of European markets where local currency denominated bonds can be issued and traded in Asia.

[5] Again, an early attempt in this regard is the ASEAN and Plus Standards among Malaysia, Singapore, and Thailand.

2. Towards Harmonized and Integrated Government Bond Markets in ASEAN+3

2.1. Introduction

As discussed in the introduction, ASEAN+3 countries have reached consensus on the imperative of fostering liquid and efficient bond markets in Asia through the harmonization of bond standards and regulations. Unlike Europe, where adoption of a single currency provided key momentum for harmonization of its bond markets, East Asian countries will require more cooperative and systematic joint efforts to overcome heterogeneity across the region in the state of bond market development. Yet, the market environment for harmonization is improving in the region. As **Figure 2-4** shows, East Asia has seen relatively strong growth in local currency bond markets during the last five years. This momentum is expected to continue, especially in government bond markets as the recent global financial crisis has raised Asian authorities' funding requirements to finance



Note: The region covers People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Thailand; and Viet Nam.

Notwithstanding the improving market environment, the harmonization of onshore government bond markets is a challenging task. In the absence of strong motives, such as a single currency or economic union, and in the absence of a transnational authority as in Europe, it is difficult to expect sovereign authorities to readily compromise their own regulations and standards in the primary government bond market.

This report has earlier emphasized that a differentiated approach is necessary for the harmonization of government bond markets and corporate bond markets. For government bond markets, a more gradual, bottom-up approach that begins promoting harmonization from secondary market standards and practices is preferred. The bottom-up approach should be predicated on an understanding of national differences in the secondary government bond markets, which requires sufficiently detailed, comprehensive, and extensive studies. In order to alleviate information asymmetry between domestic and foreign market players, it is necessary to share comprehensive, structured, and updated market information among participants. This section focuses on the bond markets of Japan and the Republic of Korea (Korea) to provide a benchmark framework for detailed analyses of

Table 1-2: Initial Strategies to Harmonize Bond Markets in East Asia

	Onshore	Offshore
Primary markets		Corporate Bonds
Secondary markets	Government Bonds	