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“DEVELOPING EFFICIENT DOMESTIC CAPITAL MARKETS: THE ASIAN EXPERIENCE”

Financing the City: New Approaches to Local Currency Financing

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Prepared remarks

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The growth of Asian bond markets since the Asian financial crisis has been has been by any measure a notable development in global capital markets terms. It has attracted much interest from outside the Asian region. It is illustrative that HSBC asked by both the African Development Bank and the Inter-American Development Bank to host workshops at their annual meetings on the lessons that those regions can learn from Asia's experience. Of course neither of those regions shares to the same degree Asia's strong propensity for savings. In terms of those savings we can now see with the benefit of hindsight that the scale of portfolio capital flow reversal that triggered the Asian financial crisis was in fact small in relation to the domestic savings of the crisis affected countries. Quite correctly policy makers have accepted that if those

savings can be channelled into well functioning domestic capital markets, Asia's vulnerability to another financial crisis is reduced. Another factor has driven policy makers' efforts to develop local bond markets. Because savings rate are likely to decline from their high historic levels, savings must also be allocated more efficiently than in the past. This explains the growth in collective savings schemes, whether in mandatory pension funds, in insurance or in mutual funds.

In my remarks today, I would like to examine those factors that have contributed to the success of today's Asian bond market, and to place the Asian bond market in some kind of global context. I would also like to look forward and suggest some steps that would ensure that the Asian bond market plays a bigger role in financing the region's infrastructure development. The region's policy makers in general and the Asian Development Bank in particular have a key development role to play and are clearly motivated to play that role. The ADB has shown a strong conviction in its mission to provide long term fixed rate local currency financing in all the countries in which it operates. This conviction is demonstrated both by the ADB's own funding and guarantee activities and by its promotion of long term hedging and derivatives markets. And lastly I will offer some remarks about the potential for the Islamic capital market to provide its share of the region's infrastructure financing requirement.

I may be called to task for referring to "Asia's bond market" because there are of course vast discrepancies between individual Asian countries. And progress to date in developing a regional bond market remains

limited. My first slide shows how local currency debt has remained the dominant component of government borrowing in countries like China and Korea. In Thailand the local debt market shrank in importance in the mid 1990s but increased in importance as the Thai government funded its post crisis fiscal deficits. The declining percentage of local currency government debt in the Philippines reflects the growing use of overseas borrowing by that country. In fact the Philippines is the only Asian country that sources a significant proportion of its debt stock in foreign currency.

All other Asian sovereigns have less than 10 billion US dollars in foreign borrowing each.

Since the 1997 financial crisis Asia's local currency bond markets have shown a dramatic growth in the annual volume of issuance. Whereas the volume of borrowing in the G3 currencies has been generally flat. The growth in local bond markets has been driven both by high levels of domestic liquidity and by supportive government initiatives. Within this framework the fact remains that Asia's domestic markets are still too diverse to be considered a regional market. There is a clear need to direct development away from divergence and towards convergence.

My next slide shows the size of the individual Asian local currency bond markets measured in relation to gross domestic product. In every Asian country except Indonesia the local currency bond market has grown in relation to GDP since the 1997 financial crisis. In Malaysia the local

currency bond market has grown from 56 % of GDP to 95% of GDP. Similar percentage growth has been seen in Korea and Thailand.

Consider also the improvement in Asian's credit profile since the year 2000. Note the breadth of Asia's individual country ratings: from Singapore, Taipei China and Hong Kong as the highest rated countries down to the Philippines and Indonesia with the lowest ratings. Obviously several countries remain unrated while others are exploring the possibility of getting a first time rating.

It is the upward trend in virtually all country ratings that is significant. The favourable trend in Asian country ratings evidences the real change in the Asian economies over the last five years. Broadly speaking a pattern of budget surpluses and current account deficits has been replaced by a pattern of (eminently financeable) budget deficits and current account surpluses.

Just as there are wide variations between the credit profile of different Asian countries, there are major differences in local interest rate levels. In several Asian countries, notably Hong Kong, Singapore and Taipei China long term interest rates are lower than in the United States or Europe : in Indonesia and the Philippines rates are considerably higher, reflecting their worse fiscal and inflation situations.

Let us now look at the relative size of the corporate portion of domestic bond markets in Asia. The corporate component of domestic bond markets has grown in most Asian countries. But compare the situation in Hong Kong where corporate bonds are 78% of the market with China where the corporate portion as defined is less than 3%. The growth of corporate bond markets are important because it is a truism that banks are a less than perfect source of financing for long term large scale infrastructure investment. Asian governments have on the whole shown a strong awareness of the importance of establishing robust local bond markets. They also know that the ideal bond market will be characterised by a broad range of issuers including the host government, banks, housing finance and leading corporations.

The most far thinking governments in Asia have developed such markets even if they lacked a strong fiscal incentive to do so.

Corporate bond markets will generally price off a government yield curve, so we are seeing a greater focus on developing local currency bond markets at the government level. The pioneer here was Hong Kong which established its Exchange Fund Note programme over 10 years ago at a time of fiscal surplus. The example of Thailand since the financial crisis is even more notable. The Thai Government resumed issuing government bonds in 1998 after a ten year absence. Over the last five years the outstanding value of the total bond market has quadrupled to the level of 2.3 trillion baht. Declining interest rate levels have encouraged Thai corporations to tap the local bond markets for all their funding needs. The level of outstanding foreign currency borrowing has evaporated, with

a number of companies eliminating their overseas borrowing entirely. Ideally Asian countries should now strive to achieve a regional securities framework that encourages increased capital flow within the region and recycles surplus liquidity within Asia, to the ultimate benefit of the Asian economies.

An encouraging aspect of the growth of Asia's bond market has been the healthy co-operation between government regulators and market participants. The point being that exchanges can be opened and regulatory regimes established but it is market participants that breathe life into the process.

Many Asian countries have established primary dealer systems because they have recognised the value of engagement with banks and securities firms. Malaysia, Korea, Hong Kong, Thailand and India are among the countries that have introduced primary dealer systems to their government bond market. The role of primary dealer brings obligations, such as committing to bid in bond auctions, but primary dealers usually enjoy funding benefits from the government in return. In this way a capital market culture can be created which fosters a range of committed participants.

Asian governments have also been open to securing technical assistance from a variety of sources in both the official and private sectors. From the private side I would just mention the importance of credit rating agencies. A number of Asian countries have established local rating agencies to provide a boost to the local corporate bond market. In addition to the Asian Development Bank, technical assistance has been readily available from the World Bank and the International Finance Corporation. The IFC has invested in credit rating agencies, securities firms and in pension funds and other asset management companies. The IFC, the World Bank and the ADB are all making great efforts to issue bonds in the region's local bond markets and to provide guarantees for private sector issuers in those markets, of which more later.

Something that is also highly impressive in the Asian context has been the level of co-operation and information sharing within the region. We have seen several encouraging regional bond market development initiatives. This has included the Asian Bond Market Initiative and the

dialogue within the APEC Finance Ministers Meeting. Another example is Asian BondsOnline.

This a website launched by the Asian Development Bank and several Asian countries. It offers information on market infrastructures, rules and regulations, data and market commentary.

We are also seeing a highly positive role played by the Executives' Meeting at East Asian Pacific Central Banks. Their co-operation resulted in the launch of the Asian Bond Fund, or ABFI, through which they invested collectively in Asia's US dollar denominated bonds. Initial capital of 1 billion US dollars was targeted for investment in sovereign and quasi sovereign bonds. In 2004 the eleven central banks embarked on a more ambitious initiative, referred to as ABF2. The idea of ABF2 is that a 2 billion US dollar fund will invest exclusively in Asian local currency bonds. A Pan Asian Index Fund will be established based on eight individual country fund components. The central banks have the added ambition of opening up the fund to private sector investors. This process will require the central banks to work together to identify and eliminate any regulatory or tax obstacles to such private sector investment.

For all the reasons that I have outlined Asia should be uniquely equipped to finance its infrastructure investment – roads, water, ports, power – through local currency bond markets. Remarkable progress has been made in the region's major economies in developing the infrastructure for

primary and secondary bond markets. The availability of local funding options for foreign issuers is well developed in Hong Kong and Singapore with few regulatory restrictions.

But the market for foreign issuers is less well developed in the Philippines, Indonesia and China. So what remains to be done? Asian investors have developed a growing appetite for credit and currency risk. But a lack of supply of bonds from Asian issuers, combined with a low interest rate environment, have encouraged investment in non-Asian credits. Much of Asia's capital is still leaving the region with Asian demand not being met by Asian supply.

What will it take to establish a securities framework that will encourage increased capital flow within the region and recycle this ample liquidity within the Asian region?

In one specific respect Latin America has innovated where so far no Asian country has sought to tread. During 2004 Uruguay and Colombia both came to market with global bonds denominated in their own domestic currencies. This mechanism had an obvious appeal to international investors who would have had to cope with domestic tax and custody implications if they bought bonds locally. It may be an attractive idea for Asian issuers that lack a strong domestic investor base. The Asian policy maker may also wish to focus on a more obvious set of steps including the more systematic encouragement of financial intermediaries, regional clearing and settlement procedures, developing

mortgage and other asset backed securities markets or simplifying tax regimes.

But I will focus on just two key imperatives, both ones where the Asian Development Bank can itself make a major difference in terms of market development: the first being the creation of benchmark bonds and yield curves and the second the development of long term hedging instruments particularly interest rates swaps.

Let me start with the issue of benchmark bonds and yield curves. On the supply side we are seeing significant growth in the importance of Asian pension funds, insurance companies and mutual funds. As an example, the Employees Provident Fund in Malaysia has total assets of more than Ringgit 220 billion or US\$60 billion and is growing by at least 10% per annum.

The growth of entities such as this will encourage more transparent and liquid secondary markets. In the case of derivatives markets these are increasingly well developed with onshore and offshore currency swap curves developed out as far as 10 years. A common feature of these funds is that they have a long maturity horizon, and they face a major challenge in terms of the mismatch of their assets and liabilities. In the early stages of growth, NBFIs generally invest their resources in bank deposits and shorter dated securities. As assets under management increase they seek to allocate a larger proportion of assets to longer dated government and private sector bonds. The government bond market plays a critical role because it provides the benchmark for other issuers.

In the absence of benchmark government bonds there is a strong onus on policy makers to encourage the issuance of relatively risk free securities such as mortgage backed, multilateral development bank or quasi sovereign bonds. In the last category we have borrowers such as the MTRC. The MTRC has been a mainstay of issuance in the Hong Kong market: just last week they worked with HSBC to raise 10 and 15 year fixed rate funds at rates as low as of 4.5% and 4.75% respectively. Multilateral development banks have been large scale issuers in the Hong Kong market for a number of years and more recently have tapped bond markets in Philippine pesos, Malaysian Ringgit, Korean won and Singapore Dollars. Some of these countries require the funds to be reinvested locally, others accept the possibility that the funds will be swapped into US dollars and lent elsewhere. Either way these issues can help support a risk free, or relatively risk free, benchmark off which other issuers can build their own credit and yield curves.

Asian governments have been increasingly willing to open their bond market to supranational issuers, with the ADB to the fore in this process. A year ago, HSBC had the honour of lead managing ADB's first issue in the Indian rupee market. This 10 year issue was the first issue by a foreign issuer in the Indian market and it was the tightest priced non-government bond ever in the Indian market. ADB also opened the Malaysian market with a five year issue and hopes are high that the Thai baht market will be opened shortly. The Thai bond market is one where the ADB has also contributed to market development by issuing a partial credit guarantee facility to allow local issues to access the market.

If issuance in other Asian markets is slow the reason has been the relative shape of the government bond yield curve and the cross-currency swap curve. Hopefully this will change as local Asian companies seek out opportunities in the swap market to lock in fixed interest rates in their local markets in an increasing rate environment. But another impediment to MDB issuance in Asian currency markets remains the complexity of bond documentation and other legal and regulatory requirements. MDB issuers do not always have the opportunity to issue bonds using their standard international bond documentation. If progress is to be made towards a genuinely regional bond market, Asia's policy makers should be encouraged to relax the legal and regulatory restrictions that are currency impeding market development.

In some Asian countries the local bond market is still not sufficiently developed for the ADB to issue long term bonds. Recognising this market gap, the ADB has developed a truly innovative local currency swap mechanism. To the best of my knowledge this swap mechanism has not been attempted by any other MDB. Despite its relatively simplicity the ADB's local currency swap mechanism has great potential to generate long term local currency financing across the bank's member countries. More than that it could also assist those countries in their market development by helping define a yield curve in their currency. The initiative involves ADB undertaking a fixed rate local currency swap with a developing member country and using the local currency proceeds to provide long term lending to private sector financial intermediaries for on-lending to local borrowers. The mechanism is a "win win" for the ADB, the member country and the final borrower.

The member country is acquiring a long dated hedging instrument which will assist its external debt management. The ADB secures long term local currency funding in a maturity that it would not otherwise be able to access and passes the benefit to local borrowers, which may be a local company or the subsidiary of a multinational corporation. The fixed rate will obviously be a matter of negotiation between the ADB and the member country bearing in mind the likely end demand for the funds. But the ADB's ability to negotiate the fixed rate should be greatly assisted by the growing appetite of international investors for long term local currency risk. To an increasing degree international investors are willing to take a risk on local interest rates rather than buy debt issued by a developing economy in US dollars. This would make them a natural counterparty to the ADB either directly or acting through the local government.

In its turn this mechanism could act as a stimulus for foreign direct investment, particularly for projects in the infrastructure sector with revenues denominated in local currency. Multinational sponsors in the power or water sectors will not invest unless they have the confidence that tariffs can be sustained at levels that permit full recovery of their investment. But consumers are not always sympathetic when they see escalating tariffs through increases in interest rates or even inflation let alone as a result of a currency devaluation. The knowledge that finance can be raised locally on a long term basis can be a key spur to foreign direct investment and ease local concerns about the possibility of escalating tariffs.

I would like to close by highlighting another area in which the cult of innovation is strong. The Islamic capital market is reaching a scale and depth that should command the attention of the region's borrowers. HSBC shares the general view that the total funds invested consistent with the Islamic principles exceed US\$250 billion in aggregate and the market is growing by more than 15% per annum. As the market deepens, Islamic finance sources are offering both longer terms and more competitive pricing. For example, HSBC has arranged a 17 year Islamic finance tranche as part of a power plant financing in the United Arab Emirates. Our Sukuk for the Government of Malaysia was the first international issue to be rated and listed, with a structure approved by a reputable Shariah board of scholars. It also established that it was feasible for governments to tap sources of Islamic finance at a cost comparable to more traditional markets. More recently when we were executing the IFC's first Malaysian Ringgit financing, we found that an Islamic financing was more cost effective than a conventional bond issue. IFC's Ringgit Sukuk issue was priced 10bp inside prevailing Malaysian government bond yields.

In terms of Islamic finance, Malaysia has shown the strongest commitment to market development. As a result more than half the issuance in the corporate bond market in the corporate bond market is in Islamic form. The bulk of this issuance in 2004, 51 separate Sukuk issues, came from the infrastructure sector, comprised of utilities, construction and real estate companies. The Sukuk issue by Tanjung Bin

Power was the largest issue in 2004. Sukuk has been proven to be able to achieve a rating as high as that of the issuers other unsecured obligations.

Depending on the value of the asset involved and the strength of the associated contracts, a Sukuk issue can secure a rating that exceeds the issuer's direct debt as in the case with other secured debt.

Innovations such as Islamic bonds will reinforce the importance of the Asian bond market for issuers within the region and from outside the region. Asia's local currency bond market outstandings exceed the equivalent of 1.6 trillion US dollars having doubled since the Asian financial crisis. There is every reason to hope that this pace of growth can be sustained.

Thank you for your attention.