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Technical Assistance for the ASEAN+3 Regional Multicurrency Bond (Financed by the Japan Special Fund)

June 2005

Asian Development Bank

ABBREVIATIONS

ABMI	–	Asian Bond Markets Initiative
ADB	–	Asian Development Bank
APEC	–	Asia-Pacific Economic Cooperation
ASEAN+3	–	Association of Southeast Asian Nations plus People's Republic of China, Japan, and Republic of Korea
DMC	–	developing member country
ECU	–	European Currency Unit
PRC	–	People's Republic of China
SDR	–	special drawing rights
TA	–	technical assistance
WG	–	Working Group

NOTE

In this report, "\$" refers to US dollars.

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I. INTRODUCTION

1. The Asian Development Bank (ADB) was requested by the Asian Bond Markets Initiative (ABMI) Working Group on New Securitized Debt Instruments (Working Group [WG] 1) during their meeting held in November 2004 to undertake a study on the feasibility of issuing Asian multicurrency bonds. The ABMI is a regional initiative established under the Forum of Finance Ministers of the Association of Southeast Asian Nations (ASEAN) and the People's Republic of China (PRC), Japan, and Republic of Korea (ASEAN+3). The President approved the technical assistance (TA) concept clearance on 25 February 2005.¹ The design of the TA was discussed with the countries concerned at the working group meeting held at ADB headquarters on 8 March 2005. The working group also reported the outcome of the meeting to Deputy Finance and Central Bank Officers' Meeting for ASEAN+3, held in Lao People's Democratic Republic (Lao PDR), in April 2005.

II. ISSUES

2. One of the causes of the 1997 Asian financial crisis was the mismatch in maturity and currency between debt and revenue for borrowers in the region. The excessive dependence on bank financing without effective governance and alternative sources of funds created a situation where domestic banks and companies borrowed in short-term foreign currency for long-term local currency-generating projects. Although the region has since experienced a remarkable recovery, without a well-developed and efficient source of long-term local currency, these mismatches remain a source of financial vulnerability in the region.

3. Since 1997, ASEAN+3 and many other forums, including the Asia-Pacific Economic Cooperation (APEC) has been fostering regional efforts to address this issue of developing domestic and regional bond markets in Asia. In December 2002 in Chiang Mai, the ASEAN+3 finance officials endorsed the proposal to establish the ABMI to support their work in this area. The ABMI emphasized the need for a joint and comprehensive set of actions by the ASEAN+3 countries to develop domestic and regional bond markets in two broad areas: (i) facilitating access to these markets by a wide variety of issuers, and (ii) creating an environment conducive to developing domestic and regional bond markets. Under the ABMI, six voluntary working groups have been established² to examine the factors necessary for bond market development. These working groups are expected to provide input for decision making by the ASEAN+3 finance ministers. ADB has been a member of all the working groups since their inception and has been requested to provide various assistance, including TA support.³

¹ The TA first appeared in *ADB Business Opportunities* (Internet edition) on 19 January 2005.

² The six working groups are on (i) New Securitized Debt Instruments (chaired by Thailand)–WG 1; (ii) Regional Credit Guarantee and Investment Mechanism (chaired by Korea and PRC)–WG 2; (iii) Foreign Exchange Transaction and Settlement Issues (chaired by Malaysia)–WG 3; (iv) Issuance of bonds denominated in local currencies by multilateral development banks, foreign government agencies (chaired by the PRC)–WG 4; (v) Rating Systems and Dissemination of Information (chaired by Singapore and Japan)–WG 5; and (vi) Technical Assistance Coordination (chaired by Malaysia, Indonesia, and Philippines)–WG 6.

³ ADB is currently providing assistance to WG 2 through a study on a regional guarantee and investment mechanism (ADB, Oct 2003. *Technical Assistance for ASEAN+3 Regional Guarantee Mechanism*, Manila. [RETA 6127]). TA has also been provided to WG 3 through a study on a Regional Settlement Linkage (ADB, Dec 2003. *Technical Assistance for ASEAN+3 Regional Settlement Linkage*, Manila. [RETA 6161]). Through WG 5, the local and regional credit rating agencies have also been supported by ADB's coordination with the Asian Credit Rating Agencies Association. This also included the establishment of the Asian Bonds Online Web site - <http://asianbondsonline.adb.org> (JFICT9040). ADB also co-hosted a seminar with WG 4 in Beijing, PRC, for the issuance of local currency bonds by non-domestic issuers in June 2004.

4. Multicurrency bonds were first issued in the early 1980s during currency volatility and have attracted investors for a long time. Reverse dual currency bonds, for example, were crucial for developing the foreign currency-denominated bond market in Japan. Preliminary work done by WG 1 has therefore suggested that development of multicurrency bonds can bring about numerous benefits to the domestic and regional bond markets in Asia. First, this type of instrument will assist in providing long-term local currency funds thereby enhancing borrowers' ability to reduce currency and maturity mismatches. The availability of financing alternatives for Asian borrowers looking to raise capital will reduce their reliance on traditional bank borrowings, which was one of the causes of the 1997 Asian financial crisis. Second, a regional multicurrency bond will also offer an attractive alternative investment instrument to investors and hence provide diversification and reduce risk for investors. Third, the creation of a new asset class will allow more investors into Asia and widen the investor base. Last, as multicurrency bond can be used as a hedging instrument to mitigate currency risks, this also invariably lead to further growth of the Asian currency swap market. An active currency swap market can contribute to more liquid bond markets.

5. With recent uncertainty on the future of the exchange rate between the US dollar and regional currencies, there has been recent growing interest to create an Asian multicurrency bond. However, considering the perceived regulatory and technical impediments, for the ASEAN+3 markets, the initial costs for developing this kind of new product are considered very high relative to potential profitability. The private sector thus has not shown much appetite to develop such a product on its own initiative, as there is no assurance that the issue will be successful or that successive issues will follow to make up for the initial investment. However, because of the perceived merits in market development, the ABMI could jump-start the development of the product through this study.

6. One objective of the ABMI, as mentioned earlier, is to facilitate access of the bond market to both issuers and investors. Therefore, one issue for consideration in the study would be to identify the needs of these potential investors and issuers. This is imperative as the feasibility of any multicurrency bond structure hinges to a large extent on the support by market participants as they will ultimately determine issuance, success, and sustainability of any bonds issued. Besides targeting domestic investors in each of the ASEAN+3 countries, there should also be further considerations for global investors as well. Secondary liquidity of the bonds would be important for all investors, especially so for global investors. In buying multicurrency bonds, investors are faced with currency and credit risk and according to preliminary market consultation with investors in Tokyo and Hong Kong, China, investors are prepared to face only one risk at one point in time. Therefore, partial credit guarantee by multilateral or bilateral government financial agencies would also be explored. On potential issuers, the overall cost would need to be attractive in order to attract more candidates for issuance. In this regard, issuers with higher credit standing (possibly supnationals, sovereigns, or quasi-sovereigns) would be considered good candidates. It is noteworthy that at the WG 1 meeting in March 2005, some ASEAN+3 countries provided positive feedback regarding the possibility of a sovereign issue.

7. There are several impediments faced when issuing/investing in multicurrency bonds in Asia, which inhibit the growth of domestic and regional bond markets in the region. These impediments could include technical (settlement and clearing system), market (e.g., liquidity, credit risk) and regulatory impediments, which were highlighted as one of the major obstacles during preliminary market consultations. The prohibition or restriction on swaps, short selling, and offshore markets are hurdles not only for multicurrency products but for bond markets in general. The study would therefore seek to address these impediments and examine various ASEAN+3 countries' regulatory frameworks that are conducive to this product and suggest

implementation strategies that would mitigate instabilities in the wake of regulatory change. The participation of the ASEAN+3 governments in the ABMI will help facilitate the removal of some of these regulatory uncertainties and impediments. This will not only enhance the environment for developing multicurrency bonds, but also improve general conditions for bond market development in domestic and regional markets.

III. THE TECHNICAL ASSISTANCE

A. Impact and Outcome

8. The TA aims to support the development of domestic and regional bond markets and reduce financial vulnerabilities in the region. It is expected to facilitate greater cross-border investment and issuance opportunities in the ASEAN+3 countries. The proposed study would therefore first examine the merits and demerits for investors, countries, issuers, and intermediaries in addition to the issuance of multicurrency bonds and its contribution to bond market development (e.g., adding liquidity and providing greater diversity to the product base). The feasibility of and impediments to (common as well as specific to each market) issuance of multicurrency bonds denominated in ASEAN+3 currencies will then be explored. The study will also identify the possible and optimal structure for potential private sector issuers (although the structure may be applicable to a variety of issuers). The study will take into consideration the technical, regulatory, and market impediments. Possible credit guarantees will also be explored. Through close consultation with market participants, practical structures for multicurrency bonds will be proposed and recommendations will be made to policy makers as to what the member countries of ASEAN+3 could do to enable and encourage the development of the market for this type of bond.

B. Methodology and Key Activities

9. Drawing lessons from past experience (such as the development of dual-currency bonds, the European Currency Unit [ECU]/euro, and special drawing rights [SDR]) and through dialogue with institutions and market participants, the study will assess the feasibility and acceptability of multicurrency bonds denominated in an Asian currency. Given that the final output of the study will be driven by the market to a large extent, the design of the TA will be kept reasonably flexible so as to cater to the needs of the domestic and regional bond markets. ADB will oversee the progress of the study in consultation with members of WG 1 to ensure that the TA satisfies the objectives of the study. Several market consultations will also be organized to obtain market inputs to ensure the feasibility of the study. The envisaged TA will involve six components.

10. **Market Assessment.** Analysis of the reasons why investors purchase multicurrency bonds will be undertaken. Drawing from earlier experience on dual currency bonds in other markets and the development of the ECU/euro and SDR will provide valuable lessons when designing the structure of the multicurrency bonds.

11. **Diagnostics on the Merits and Contribution to Bond Market Development.** The benefits of a multicurrency bond issuance will be examined from various perspectives, including issuers, investors, intermediaries, and governments. Its overall contribution to bond market development in general (such as providing greater flexibility, liquidity, and diversity) will also be analyzed to enhance better understanding of the bond market by government officials.

12. **Identification of Balanced Structure.** Through the examination and analysis of previous and existing multicurrency bond structures from within and outside the region, the TA will recommend the best structure for issuance. The structure will include various currency combinations, structures, types (e.g., securitization), maturities, and distribution channels in order to appeal to a wide variety of issuers and investors. The proposed structure will take into consideration the potential size of the market segment and this, in turn, will depend on the expected issuer and investor base.

13. **Identification of Impediments.** Through mainly market consultation and research, the study will identify the major obstacles that issuers and investors face when issuing/investing in multicurrency bonds in the region. This could include an analysis on technical issues (such as those related to settlement and clearing); regulatory impediments (such as restrictions on issuance, sales, trading, tax, and eligibility requirements); and market issues (such as the lack of hedging instruments, a swap market, liquidity, credit risks, and investor perceptions). A study on the status of swap markets in each domestic ASEAN+3 market will also be included. These impediments could be dealt with by prioritizing them according to benefit, using a realistic time frame and sequence.

14. **Practical Case Study.** In consultation with members of WG 1 and market players, potential structures involving several ASEAN+3 currencies, e.g., cross-border securitized bonds utilizing Japanese yen, Korean won, and Thai baht as principal and/or interest, will be proposed. This component is meant to provide a practical example that could be implemented in the near future upon agreement by relevant parties. In view of different stages of bond market development among countries, a three-stage development process will be explored. Stage 1 will explore dual-currency and synthetic (two currencies) bonds, stage 2 will look at synthetic bonds that comprise more than two currencies, and stage 3 will examine benchmark basket bonds.

15. **Recommendations and Proposed Road map.** A road map for policy makers on what may be done to enable and encourage issuance will be drawn up. The road map will take into consideration country-specific issues such as stage of development, national finance goals, and state of the regulatory and nonregulatory framework. Appropriate steps to mitigate financial instability in the wake of financial regulatory changes will also be examined.

C. Cost and Financing

16. The total cost of the TA is estimated at \$400,000 equivalent. ADB will provide the entire amount on a grant basis from the Japan Special Fund, funded by the Government of Japan. Appendix 2 gives the details of the TA cost. The participating countries of the working group have financed the costs of the preliminary activities, and will continue to bear the ongoing costs of the working group.

D. Implementation Arrangements

17. ADB will be the executing agency for the TA. It will be administered by the Office of Regional Economic Integration. In consultation with the chair of the working group, ADB will supervise the work of the consultants.

18. Under the TA, three international consultants (two structured bond specialists for 4 person-months each and a legal and regulatory specialist for 1 person-month) will be engaged for a total of 9 months. They will be engaged by ADB as individual consultants following ADB's *Guidelines on the Use of Consulting Services*. The consultants will have demonstrated and comprehensive experience related to bond markets and developments of such markets. The outline terms of reference for consulting services are presented in Appendix 3.

19. The TA will be implemented over 6 months and will begin in June 2005 and be completed by November 2005. The consultants will prepare (i) an interim report and present this to the working group after 3 months; and (ii) a final report of completion of the study after 5 months. A presentation comprising the content of the draft report will be conducted to obtain comments from working group members by approximately August 2005 and circulated to working group members for comments. Between June and August 2005, various market consultation seminars will be held in various ASEAN+3 countries with market players and government officials. With the inputs obtained, the interim report will be revised and a draft final report will then be circulated to working group members for comments around November 2005. A seminar will be arranged to present the final report to the working group. The report will be used for further discussions and consideration on the concrete steps to take to facilitate the issuance of multicurrency bonds in the ASEAN+3 countries. The outline of the content of the report is attached in Appendix 4.

IV. THE PRESIDENT'S DECISION

20. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$400,000 on a grant basis for the ASEAN+3 Regional Multicurrency Bond, and hereby reports this action to the Board.

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Indicators/ Targets	Data Sources/ Reporting Mechanisms	Assumptions and Risks
Impact To develop domestic and regional bond markets and reduce financial vulnerabilities in the region.	Size of regional bond market	Market statistics on growth of bond markets in the ASEAN+3 region.	
Outcome Facilitate greater cross-border investment and issuance opportunities in ASEAN+3 countries.	Issuance of multicurrency bonds denominated in ASEAN+3 currencies.	Market statistics on cross-border multicurrency and other bond issuance denominated in ASEAN+3 currency.	Assumptions: <ul style="list-style-type: none"> • Market conditions are conducive. • Adequate support from governments.
Outputs Assess the feasibility and acceptability of multi-currency bonds denominated in ASEAN+3 currencies.	Road map for policy makers on the impediments to be removed for such issuance. Practical and ideal structures conducive to market development.	Monthly progress reports Interim report Final report	Assumption: <ul style="list-style-type: none"> • Sufficient market consultation and input reflected in the research for practical application.
Activities and Milestones Present interim report to working group – August 2005 Consultation with market participants – June – August 2005 Final presentation to working group – November 2005			Inputs International consulting services (9 person-months at \$270,000) Market consultation and seminars Miscellaneous costs

ASEAN + 3 = Association of Southeast Asian Nations plus People's Republic of China, Japan, and Republic of Korea.

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Cost
Asian Development Bank Financing^a	
1. Consultants	
a. Remuneration and Per Diem	
i. International Consultants ^b	270.0
b. International and Local Travel ^c	65.0
c. Reports and Communications	10.0
2. Training, Seminars, and Conferences ^d	30.0
3. Miscellaneous Administration and Support Costs	5.0
4. Contingencies	20.0
Total	400.0

^a Financed by the Japan Special Fund, funded by the Government of Japan.

^b Assuming 9 persons-month of international consulting services at \$30,000 per month.

^c Assuming 13 international trips at \$5,000 per trip.

^d Assuming two seminars (presentation to working group) at \$15,000 per meeting.

Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

1. The responsibilities of the consultants are as follows:
 1. **Structured Bond Specialist–Team Leader** (4 person-months)
2. The specialist will have had extensive experience in capital markets, especially in structured bonds. The specialist will coordinate with the other two consultants to incorporate their views into the requested reports. The specialist will perform the following tasks:
 - (i) Provide a market assessment on the dual currency bonds issued regionally and globally, so far. Analyze the reasons why investors purchased these bonds and the lessons to be learned from other multi-currency bonds issued, including the European Currency Unit [ECU]/euro, and special drawing rights [SDR]).
 - (ii) Provide diagnostics on the merits and contribution by the issuance of multi-currency bonds to bond market development. The analysis should look at the merits to the country, investors, issuers, and intermediaries. On its contribution to bond market development, issues such as ability to promote liquidity to the market and provide diversification should be further explored.
 - (iii) Identify the optimal structure for the multi-currency bonds for both the investors and issuers (buy and supply side). The study should then further identify the “balanced structure,” the structure that is most ideal for both investors and issuers. The various types, such as the use of securitization, of multi-currency bonds should be further explored.
 - (iv) Identify the impediments faced when issuing multi-currency bonds. This should include a review of (a) technical impediments; (b) regulatory impediments; and (c) market concerns, including a detailed study on swap markets in the ASEAN+3 region.
 - (v) Provide appropriate recommendations for policy makers for consideration. The recommendation should comprise a road map for individual countries since this depend on the market and the stage of development in each country is different. A regulatory framework matrix should also be constructed and nonregulatory impediments should also be examined. The appropriate steps to mitigate the financial instability during financial regulatory changes should also be investigated.
 - (vi) Together with the other consultant, prepare and present the final report to the working group.
 - (vii) Assist in arranging and writing notes of meetings for the market consultation meetings.
 - (viii) Perform other tasks reasonably requested by the Asian Development Bank.

2. **Structured Bond Specialist** (4 persons-month)

3. The specialist will perform the following tasks:

- (i) Assist the team leader in providing a market assessment on the dual currency bonds issued regionally or globally so far. The analysis should study the reasons why investors purchased these bonds and the lessons to be learned from other multi-currency bonds issued, including ECU/euro and SDRs.
- (ii) Assist the team leader in providing diagnostics on the merits and contribution by the issuance of multi-currency bonds to bond market development. The analysis should look at the merits to the country, investors, issuers and intermediaries. On its contribution to bond market development, issues such as ability to promote liquidity to the market and provide diversification should be further explored.
- (iii) Assist the team leader in identifying the optimal structure for the multi-currency bonds for both the investors and issuers (buy and supply side). The study should then further identify the “balanced structure,” the structure that is most ideal for both investors and issuers. The various types, such as the use of securitization, of multi-currency bonds should be further explored.
- (iv) Prepare practical case study for consideration. The case study should comprise a 3-stage development for multi-currency bonds and this should include: stage 1—issuance of dual currency bonds and synthetic (two currencies) bonds; stage 2—issuance of synthetic (more than two currencies) bonds and asset-backed securitization; and stage 3—issuance of benchmark basket bonds.
- (v) Provide appropriate recommendations for policy makers for consideration. The recommendation should comprise a road map for individual countries since this depend on the market and the stage of development in each country is different. A regulatory framework matrix should also be constructed and nonregulatory impediments should also be examined. The appropriate steps to mitigate the financial instability during financial regulatory changes should also be investigated.
- (vi) Together with the team leader, prepare and present the final report to the working group.
- (vii) Assist in arranging and writing notes of meetings for the market consultation meetings.
- (viii) Perform other tasks reasonably requested by the Asian Development Bank.

3. **Legal and Regulatory Specialist** (1 person-month)

4. The specialist will perform the following tasks:

- (i) Analyze the necessary regulatory environment that will be conducive for issuance of multicurrency bond in ASEAN+3 countries.

- (ii) Review the various regulatory framework and policies in each domestic bond markets that currently exist in ASEAN+3 countries.
- (iii) From a financial sector policy perspective, identify major policy, regulatory and legal factors that impede the issuance of multicurrency bonds in each ASEAN+3 country.
- (iv) Assist the team by providing inputs on legal and regulatory issues for a road map for policy makers on what may be done to enable/encourage issuance. Appropriate steps to mitigate financial instability during financial regulatory reforms must also be examined in the recommendation.
- (v) Perform other tasks reasonable requested by the Asian Development Bank

DRAFT OUTLINE OF THE REPORT

- I. Executive Summary
- II. Introduction
- III. Market Assessment for Dual Currency
 - A. Why investors buy such products
 - B. Lessons learned from other multicurrency bonds (e.g., dual currency, ECU/euro)
- IV. Diagnostics on the Merits and Contribution to Bond Market Development
 - A. Merits to investors, issuers, intermediaries
 - B. Contribution to bond market development
- V. Identification of Balanced Structure
 - A. Demand and supply side
 - B. Various combination and structures
- VI. Identification of Impediments
 - A. Technical
 - B. Regulatory
 - C. Market Concerns
- VII. Practical Case Study
 - A. Stage 1: Dual currency, synthetic (two currencies)
 - B. Stage 2: Synthetic (more than two currencies)
 - C. Stage 3: Benchmark basket bond
- VIII. Recommendation
 - A. Road map
 - B. Mitigating steps