

ASIAN DEVELOPMENT BANK

TAR:OTH 37352

**TECHNICAL ASSISTANCE
FOR THE
ASEAN+3 REGIONAL GUARANTEE MECHANISM**

October 2003

ABBREVIATIONS

ABMI	–	Asian Bond Market Initiative
ADB	–	Asian Development Bank
ASEAN+3	–	Association of Southeast Asian Nations plus People's Republic of China, Japan, and Republic of Korea
ASIA Ltd.	–	Asian Securitization and Infrastructure Assurance Ltd.
DMC	–	developing member country
TA	–	technical assistance

NOTE

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

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I. INTRODUCTION

1. The voluntary working group, created under the Forum of Finance Ministers of the Association of Southeast Asian Nations (ASEAN) and People's Republic of China, Japan, and Republic of Korea (ASEAN+3) on Guarantee Mechanism for the Asian Bond Market Initiative (ABMI) has requested the Asian Development Bank (ADB) to support the work of the group by conducting a study on guarantee mechanism in the region through technical assistance (TA).¹ The use of guarantees is thought of as one way of accelerating the development of domestic and regional bond markets in ADB's developing member countries (DMCs). The design of the TA was discussed with the concerned countries at the working group meeting held in Hua Hin, Thailand, on 10 July 2003. The TA framework is in Appendix 1.

II. ISSUES

2. The mismatch in maturity and currency between debt and revenue for borrowers in the region intensified the effects of the Asian financial crisis that began in 1997. Although the region has experienced remarkable recovery, in the absence of a well-developed, efficient source of long-term local currency, these mismatches remain as a major source of financial vulnerability in the region. The ASEAN+3 and other forums, including the Asia-Pacific Economic Cooperation (APEC), have been trying to address this issue through the development of domestic and regional bond markets.

3. The ABMI was endorsed at the ASEAN+3 deputies meeting in Chiang Mai, Thailand, on 17 December 2002. The ABMI emphasizes the need for a joint and comprehensive set of actions by the ASEAN+3 countries in two broad areas: (i) facilitating access to the market by a wide variety of issuers, and (ii) creating an environment conducive to developing domestic and regional bond markets. Six working groups have been set up to examine the factors necessary for bond market development.² These working groups are expected to provide valuable input to the decision making by the finance ministers of ASEAN+3. ADB has been a member of the voluntary working group on guarantee mechanism for the ASEAN+3 since the group's inception in February 2003. The working group was constituted against a background of recent impressive growth in the Korean bond market, which is attributable largely to the use of guarantees and securitization. This model, as well as other similar arrangements, may act as guide in accelerating the development of bond markets in ASEAN+3 countries. The use of guarantees could also assist in developing the intra-regional bond market and recycling the savings of the region to be used for developing regional economies so that they may become less vulnerable to changes in the external environment.³ By bridging the risk perception gap, credit enhancement and structured products may be used to encourage cross-border investment in the region as well as from international investors outside the region. Guarantees will be an intermediate measure and should be gradually reduced as investors become accustomed to structures and credit risk.

¹ The TA first appeared in *ADB Business Opportunities* (Internet edition) in June 2003.

² Creating new securitized debt instruments (Thailand), credit guarantee mechanisms (Korea), settlement and exchange regulations (Malaysia), issuance of local currency bonds by nondomestic issuers (People's Republic of China), local and regional rating agencies (Singapore and Japan), and technical assistance coordination (Indonesia and Philippines). Chair countries are noted in parenthesis.

³ Foreign exchange risk can be minimized by matching the currency of revenue and issuance. Intraregional export receivables can be securitized and targeted toward the market of the receivable denomination. For example, Indonesian exporters may securitize their Singapore dollar receivables to issue Singapore dollar bonds.

4. The voluntary working group has identified several domestic guarantee agencies, as well as bilateral and multilateral institutions that provide local currency guarantees. However, there are very few guaranteed local currency bond transactions in the market. The reasons vary, from lack of market acceptance for the guarantee to structural hurdles caused by processing lead time. To utilize guarantees for catalyzing the accelerated development of the domestic and regional bond markets, the working group needs an in-depth study of the existing facilities and their performance, including the difficulties they may be facing.

5. Asian Securitization and Infrastructure Assurance Ltd. (ASIA Ltd.) was set up in 1995 with the special mandate of helping bond market development in the region through the provision of bond guarantees.⁴ The company was hard hit by the Asian financial crisis and is now dormant. Other private sector guarantors from Asia have come and gone. A careful analysis of the factors that resulted in these companies' failure to establish themselves in the region is pertinent when considering the efficiencies and pitfalls of guarantee facilities outcomes. The lessons learned, when compared with international best practices, are expected to provide valuable insights in determining the next course of action for Asian countries.

6. Currently there is no best-practice model for guarantee facilities that can be readily applied to improve the effectiveness of the domestic or regional agencies. In this regard, a key mandate of the working group in fact is to develop a model that may be used as a benchmark to examine the existing facilities and suggest measures for improvement. This best-practice model may be applied as a benchmark not only for ASEAN+3 countries but also for other DMCs. It is however anticipated that, even with all possible improvements, the existing agencies may not be sufficient to realize the desired outcomes — to develop bond markets regionally — because of limitations resulting from the organizational constraints of existing agencies. The potential and limitations of the facilities need to be critically examined in establishing effective domestic and regional mechanisms for the development of bond markets.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

7. The TA aims to identify, assess, and compare guarantee mechanisms that are appropriate to support the development of domestic and regional bond markets in the ASEAN+3 countries, particularly Indonesia, Malaysia, Philippines, and Thailand. The TA will review existing and past mechanisms, and international and regional best practices, and will consider the most effective guarantee mechanism to foster development of an ASEAN+3 bond market.

B. Methodology and Key Activities

8. Through dialogue with institutions and market participants, as well as research into past data, the study will evaluate the use or potential application of such guarantees as credit enhancement for bonds. Given the evolving nature of the capital markets, the design of the TA will be kept reasonably flexible so that it can meet the emerging needs of the domestic and regional bond markets. ADB staff will work closely with the working group and the consultants to ensure that the TA satisfies the objectives of the study. The consultants will liaise with other working

⁴ ADB. 1995. *Report and Recommendation of the President to the Board of Directors on a Proposed Equity Investment in a Regional Bond Insurance Company*. Manila. ADB invested \$20 million for equity participation in ASIA Capital (Private) Ltd. which is the sole shareholder of this company.

groups to leverage off their studies for the infrastructure and other areas they covered. The envisaged TA will comprise five components.

1. Existing Guarantee Facilities

9. The study will first examine the domestic, private, bilateral, and multilateral guarantees available to borrowers domestically and regionally. The structure and extent of the guarantee, the eligibility of the borrower, acceptance by investors and lenders, flexibility, applicability to the bond market, and usage are some items that will determine effectiveness. The adequacy of the existing facilities for the development of the bond market will be examined in close consultation with market participants. ADB and other organizations have done numerous studies on the bond markets in the region. Those papers will be carefully examined. The TA will not duplicate work that has been done, but will update and expand those studies.⁵

2. Previous Guarantee Mechanism

10. Guarantee facilities that have become inactive in or have ceased to exist in the region will be studied to determine the reasons for their failure. The business model, the capital structure, products, and guarantee criteria will be the main areas covered. After the first component and this component are completed, a presentation will be made to the working group, including an assessment of the strengths and weaknesses of the existing facilities.

3. Best-Practice Model

11. From the examination and analysis of the existing facilities, previous structures, and select guarantee facilities outside the region, the TA will recommend a best-practice model for a domestic and regional guarantee facility. The model will include business scope, capitalization, risk management, credit evaluation, and staffing. The model will feature a robust structure capable of withstanding macroeconomic shocks such as those that occurred during the Asian financial crisis.

4. Improvements to the Existing Facilities

12. The TA will compare existing domestic and regional facilities with the best-practice model, with a view to making suggestions for improving existing facilities, considering the specific institutional and country circumstances.

⁵ Asian Development Bank (ADB). 1997. *Technical Assistance for the Review of the Mortgage-Backed Securities Markets in Selected Developing Member Countries*. Manila.

———. 1998a. *Technical Assistance for the Study of Financial Markets in Selected Member Countries*. Manila.

———. 1998b. *Technical Assistance for the Study on the Development of Government Bond Markets in Selected DMCs*. Manila.

Asian Development Bank Institute (ADBI). 2000. *Working Paper No. 11. The Case of the Missing Market: The Bond Market and Why It Matters for Financial Development*. Tokyo.

———. 2001a. *Working Paper No. 15. Designing a Financial Market Structure in Post Crisis Asia – How to Develop Corporate Bond Markets*. Tokyo.

———. 2001b. *Research Paper No. 24. Searching for New Regulatory Frameworks for the Intermediate Financial Market Structure in Post Crisis Asia*. Tokyo.

———. 2001c. *Research Paper No. 25. Overview of Financial Market Structures in Asia – Cases of the Republic of Korea, Malaysia, Thailand, and Indonesia*. Tokyo.

5. Potential and Limitations of Existing Facilities

13. Keeping in mind the suggested improvement and the possible time frame and costs for implementing of the existing facilities, the TA will examine the potentials and limitations of possible improvements of the existing facilities and consider their adequacy, considering the need to develop bond markets in the region without delay.

C. Cost and Financing

14. The total cost of the TA is estimated at \$500,000 equivalent, comprising \$455,000 in foreign exchange and \$45,000 equivalent in local currency. The TA will be financed on a grant basis by ADB's TA funding program. Appendix 2 gives the details of the TA cost. The members of the working group have so far financed the costs of its preliminary activities, and will continue to contribute to its ongoing operations costs. The chair of the working group (from the Ministry of Finance of the Republic of Korea) has engaged two capital market consultants to assist in the preliminary studies, and the Prime Minister's Adviser for Thailand has been active in the discussions. The expenses of the working group will continue to be borne in part by the participating countries.

D. Implementation Arrangements

15. The TA will be implemented by ADB (in coordination with Southeast Asia Department, Mekong Department, and Office of Cofinancing). In consultation with the chair of the working group, ADB will supervise the work of the consultants.

16. Under the TA, three international consultants in the fields of financial sector policy, bond markets, and guarantees, respectively, will be engaged for a total of 10 person-months. The international consultants will be supported by four domestic consultants from Indonesia, Malaysia, Philippines, and Thailand (8 person-months). They will be engaged by ADB as individual consultants following ADB's *Guidelines for the Use of Consulting Services* and other arrangements satisfactory to ADB for engaging domestic consultants. The consultants will have demonstrated and comprehensive experience related to bond markets and the development of such markets. The bond market specialist will act as the team leader for the study, and will coordinate the activities of the two other international consultants and the four domestic consultants, in coordination with ADB and the working group. The outline terms of reference for consulting services are presented in Appendix 3.

17. The TA will begin in September 2003 and will be completed by the end of April 2004. The consultants will prepare (i) an inception report, within 1 month of the TA's start; (ii) an interim report, after the completion of the first two components or within 4 months; (iii) a draft final report, within 5 months; and (iv) a final report on completion of the study. A draft of the interim report will be circulated for comments to the working group members. Upon receipt of the feedback on the draft report on the first two components, a presentation seminar will be arranged for the working group around January 2004. A draft final report with all five components will be circulated to the working group in February for comments. Upon receipt of the feedback, a second seminar will be arranged to present the final report to the working group in April 2004. The report will be used for further discussions and consideration of concrete actions for developing domestic and regional guarantee mechanisms to facilitate the accelerated expansion of the bond market in the ASEAN+3 countries.

IV. THE PRESIDENT'S DECISION

18. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$500,000 on a grant basis for the ASEAN+3 Regional Guarantee Mechanism, and hereby reports this action to the Board.

TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Indicators/ Targets	Monitoring Mechanism	Assumptions and Risks
Goal Efficient and effective regional and domestic bond market	Increase in volume of long-term bonds in the domestic and regional markets	Market statistics	Infrastructure for domestic and regional market is adequate.
Purpose Use guarantees to accelerate the development of domestic and regional markets	Increased use of guarantees for local and regional bond market issuance	Market statistics	There are no regulatory, legal, and financial impediments that cannot be overcome through structuring.
Outputs Determine the best-practice model for developing domestic and regional bond markets Suggest improvements to the existing facilities by comparison with the best-practice model	Comparison with guarantee mechanisms outside the region	ASEAN+3 working group and ADB	Information on domestic and regional guarantee mechanisms is available.
Suggest potential and limitations of existing facilities, considering the regulatory, legal, and market impediments			
Inputs International and domestic consulting services	10 person-months of international and 8 person-months of domestic consulting services		
Activities Present to working group the analysis of current and previous guarantee mechanisms Present to working group the final report	Jan 2004 April 2004		

COST ESTIMATES AND FINANCING PLAN
(\\$)

Item	Foreign Exchange	Local Currency	Total Cost
Asian Development Bank (ADB) Financing^a			
1. International and Domestic Consultants			
a. Remuneration and Per Diem			
i. International Consultants ^b	300,000	0	300,000
ii. Domestic Consultants ^c		40,000	40,000
b. International and Local Travel ^d	35,000	5,000	40,000
c. Miscellaneous Administrative and Support	2,000	0	2,000
2. Report Preparation, Production, and Distribution	5,000	0	5,000
3. Seminars ^e	50,000	0	50,000
4. Contingencies	63,000	0	63,000
Total	455,000	45,000	500,000

^a Financed by ADB's TA funding program.

^b Assuming 10 person-months of international consulting services at \$30,000 per month.

^c Assuming 8 person-months of domestic consulting services at \$5,000 per month.

^d Assuming 7 international trips at \$5,000 per trip.

^e Assuming two seminars (Presentation to Working Group) at \$25,000 per meeting.

Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

1. The responsibilities of the consultants are as follows.

A. International Consultants (10 person-months)

1. Bond Market Specialist and Team Leader (5 person-months)

2. The specialist will have had extensive experience in capital markets and capital market research. The specialist will coordinate with the other consultants to incorporate their views into the requested reports. The specialist will perform the following tasks:

- (i) Identify the existing local currency guarantee available in the region: local, bilateral, multilateral, or private entities.
- (ii) Analyze the characteristics of the existing guarantees, including business scope, capital structure, ownership, risk mitigation, credit evaluation, staffing, and government authorization.
- (iii) Analyze major policy, regulatory, institutional, management, operational, and financial factors that impede the effectiveness or use of the existing guarantees.
- (iv) Examine guarantee schemes that were previously available in the region and determine why they failed. The analysis will include business scope, capital structure, ownership, risk mitigation, credit evaluation, staffing, and regulatory hurdles.
- (v) Survey the bond markets for current and potential demand from bond investors for guaranteed bonds.
- (vi) Analyze the bond markets in detail to determine the type of guarantee support (credit guarantee, political risk guarantee, swap counterparty guarantee, etc.) necessary (the extent and quality) to increase the investment appetite for domestic and regional bonds.
- (vii) Determine the best-practice model for domestic and regional guarantee facilities. The model will include business scope, capital structure, ownership, risk mitigation, credit evaluation, staffing, and government authorization.
- (viii) Prepare suggestions to improve existing facilities based on the best-practice model, keeping in mind institution-specific issues.
- (ix) Determine the potentials and limitations of existing facilities, considering the improvements suggested and the time frame for implementation.

2. Financial Sector Policy Specialist (2.5 person-months)

3. The specialist will perform the following tasks:

- (i) From a financial sector policy perspective, analyze major policy, regulatory, institutional, management, operational, and financial factors that impede the effectiveness or use of the existing guarantees.
- (ii) From a financial sector policy perspective, review and comment on the best-practice model for guarantees.
- (iii) Reflect the varying policy perspectives in the local markets as well as the regional market in the suggestions for improving the existing facilities.
- (iv) In terms of financial policy, analyze the potential and limitations of the existing facilities considering the improvements suggested and the time frame for implementation.

3. Guarantee Specialist (2.5 person-months)

4. The specialist will carry out the following tasks:

- (i) Analyze the currently available guarantee schemes and those that were previously available in the region. Determine the reasons why the latter schemes failed. The analysis will include assessing the capital management, risk diversification, risk mitigation, credit evaluation, business scope, and staffing.
- (ii) Summarize the structures and merits of applicable guarantee facilities outside of Indonesia, Malaysia, Philippines, and Thailand.
- (iii) Suggest a structure for the best-practice model including capital management, risk diversification, risk mitigation, credit evaluation, business scope, and staffing.
- (iv) Review and comment on the improvements, potential, and limitations of the existing facilities.

B. Domestic Consultants (8 person-months)

1. Domestic Bond Market and Financial Policy Specialists

(2 person-months each for consultants in Indonesia, Malaysia, Philippines, and Thailand, respectively)

5. The domestic consultants will have had extensive experience in the domestic bond market, and knowledge of financial sector policy matters. They will assist the international consultants to undertake the following tasks:

- (i) Identify the availability of local currency guarantees for domestic borrowers: local, bilateral, multilateral, or private entities.
- (ii) Summarize the characteristics of the existing guarantees, including business scope, capital structure, ownership, risk mitigation, credit evaluation, staffing, and government authorization.
- (iii) Identify major policy, regulatory, and domestic market practice factors that impede the effectiveness or use of the existing guarantees.

- (iv) Identify and examine guarantee schemes that were previously available in the region and determine why they failed. The analysis will include business scope, capital structure, ownership, risk mitigation, credit evaluation, staffing, and regulatory hurdles.
- (v) Review and comment on suggestions to improve existing facilities based on the best-practice model, keeping in mind institution-specific issues.
- (vi) Review and comment on potentials and limitations of existing facilities, considering the improvements suggested and the time frame for implementation.