Survey on Corporate and Government Bond Markets in the Asia Pacific Region

Analysis and Issues

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I. INTRODUCTION

At the last APRC Meeting in Singapore on 25 November 2004, the Financial Services Agency of Japan (FSA) presented "The Survey Result on Corporate and Government Bond Markets in the Asia Pacific Region", which was jointly conducted with the Securities and Exchange Commission of Thailand (SEC). The domestic bond survey is comprehensive, covering topics on primary and secondary markets; settlement system; and regulations and oversight functions. Although the survey does not seek an analytical answer for each topic in depth, the findings reveal a number of interesting features of the domestic bond market in the Asia Pacific Region. Members suggested that an additional analysis of common impediments should be useful. As a result, this paper is prepared accordingly.

II. ANALYSIS AND ISSUES

A. Effective government bond market

Effective government bond market is a foundation for the development of the bond market as a whole, as well as of other related markets. Experiences in developed markets generally show that the following components are helpful for the development of an effective government bond market: (i) regular, systematic issuance; (ii) effective primary dealer system; and (iii) effective hedging and liquidity enhancement facilities.

(1) Regular issuance

Having a regular, systematic issuance programme allows dealers or market makers and other institutional investors to plan their investment and trading strategy effectively. In addition, regular issuance across maturities facilitates the construction of risk-free government bond yield curve serving as benchmark rates for pricing of private sector issues. Moreover, regular issuance provides sufficient supply to the market continually, adding to market liquidity.

Out of 11 jurisdictions that provide the information on government bond issuance, six have the annual issuance calendars published in advance either at the beginning or the end of each year, or by the budget time each year. Nonetheless, the depth of information provided in the annual issuance calendar varies from one jurisdiction to another. Another three jurisdictions indicate having issuance calendars that are pre-announced quarterly.

Accomplishing a regular predictable issuance programme pre-announced far in advance is not easy especially when cash flow needs are volatile and when there is a restriction in creating public debt. Alternative measures that could be considered include buy-back of off-the-run issues and re-open of benchmark issues to improve depth. Moreover, jurisdictions which are unable to give detailed information on issuance longer than one quarter in advance may consider adding some form of annual announcement with less detail such as possible amount for the year.

(2) Primary dealer/market maker systems

The system of primary dealers or market makers can help enhance market liquidity significantly. Three respondents, out of 11, do not have such a system. Among the remaining eight, their privileges and obligations vary widely. Only a few give primary dealers the exclusive right to participate in the auction of government securities. Two of them also give an exclusive access to the central bank liquidity facilities (*i.e.* SBL and repo). One gives tax exemption on trading incomes. On the other hand, a few others do not have clearly defined privileges and obligations. And as a result, their primary dealer systems are not very effective.

The bond market would benefit most from the primary dealer system only if attractive incentives exist. The most important incentive appears to be an exclusive access to participate directly in the auctions of government securities. Also, their privileges and obligations should be made balanced and clearly defined.

(3) Hedging and liquidity facilities

Hedging and liquidity enhancement facilities permit intermediaries to actively perform market-making function as well as permit more participation of other players. Without hedging facility, market participants have no choice to manage their investment positions when the market moves against them, whilst the lack of liquidity enhancement facility would distort market turnover. These facilities are also necessary for development of the corporate bond market.

In a few markets, hedging and liquidity facilities either are not present or are still in their infancy. And for those markets having such facilities, some of them are available in the OTC market only. OTC derivatives may less accessible for general investors given the need to manage the counterparty risk and the large transaction size. Therefore, the introduction of a futures market should be introduced.

A few markets have developed their SBL/repo relatively quickly by way of having central facility (either provided by the exchange or depository centre) to help lower barrier to entry for participants as the system may be too costly for an individual agency.

B. Sound market and transparency

A function to publish post-trade information or market indications should be established for the purpose of both encouragement of bond investment and effective monitoring and surveillance of the market.

(1) Facts found for trade information

In order to ensure that issuers may raise funds anytime when they need and investors may buy and sell bonds anytime when they wish, it is necessary to establish well-informed and liquid secondary market in each jurisdiction.

Disclosure of trade information, as a tool of ensuring transparency of the secondary market, was surveyed in detail. The survey result reveals the following three common features on disclosure of trade information.

First, pre- and post-trade information at the exchange is widely available in most jurisdictions for both government and corporate bonds.

Second, pre-trade information in the OTC market is, in general, accessible by limited market participants, *e.g.* persons authorised by the securities regulator or central bank in many jurisdictions.

Third, post-trade information in the OTC market has two phases; (i) post-trade information of government bonds is widely available through a website of the regulator or central bank, or terminals of information vendors, but availability of post-trade information of corporate bonds varies from jurisdiction to jurisdiction; executed prices are disclosed in public via a website and/or terminal of information vendors, a self-regulatory organisation collects and disseminates such information, or other special facilities have such roles in some jurisdictions, and (ii) there are also jurisdictions where either no post-trade information in the OTC market is available, or only the executed prices limited to certain liquid bonds are disclosed or executed prices are not in public but indications or statistics prices, based on the indication provided by intermediaries, are published in some jurisdictions.

(2) Transparency encouraging bond investment

Limited post-trade information in the OTC market raises the issues; this means investors lack proper information for investment judgment and may cause negative impact to the bond investment, especially by retail investors as they do not understand a proper market level before and after the transactions. This was pointed out by the SC2 in its report, "Transparency of Corporate Bond Markets" that "*[r]etail investors, however, have neither the same access to information nor the same ability to calculate fair value and prices, as do institutional investors. (…) If they cannot determine whether the prices available or received are fair and/or reasonable, they are less like to participate actively in the market.*"[1]

In addition, lack of post-trade information does not encourage institutional investors to join the bond market, either, because they cannot evaluate their portfolio easily. In this context, disclosure of post-trade information or, at least, any information which

[1] See *Transparency of Corporate Bond Markets* (May 2004) at page 26.

indicates the market level is quite important to establish and develop domestic bond markets in the long-term view. "*Increased transparency can enhance liquidity by increasing investor confidence*", while "*it may adversely impact liquidity*".[2] The level of corporate bond market development is varied in the APRC region, and each jurisdiction should consider introducing an appropriate level of transparency to satisfy investor's confidence and market development in a balanced way.

(3) Transparency ensuring sound market

Limited post-trade information in the OTC markets lacks an appropriate monitoring and surveillance tool by the securities regulators as well. In the OTC market, an order is executed by agreement between an intermediary and an investor, but the intermediary normally has wider range of market information than the investor and there might be a room to manipulate the market. In addition, when a transaction is executed at the price which is far from the proper market value, this might be intended by either party to realise artificial profits or losses. In either cases, securities regulators shall keep the tool of monitoring and surveillance, on time or *ex post facto*, therefore, the post-trade information is also important. This was also a big discussion in the SC2 report. The report finally suggested as the *Core Measure* that the surveillance methods should be introduced to promote the market integrity, depending on the situations of the market.[3]

(4) Means for implementation

Here are some examples of means of implementation in order to enhance post-trade information in the OTC market. The level of requirement should be carefully considered, depending on the situations of the market.

(i) A function should be established to concentrate post-trade information and to distribution it to the public; whatever a form of the function is, such as a website of a regulator, central bank, and industry association or information vendors. In a jurisdiction where such a function has already been established, it should be encouraged to cover a wider rage of the outstanding issues of bonds in the markets.

(ii) A function should be established for intermediaries to report indicative price information and to disseminate such indications.

(iii) In case of less frequent transactions and latest executed prices not being available, stale prices are not suitable for both information of investment judgment and evaluation. It may be useful to prepare and provide a 'yield matrix by ratings and maturities' for illiquid bonds.

[2] *Ibid.*
[3] Core Measure 3 "*Regulatory authorities should have in place appropriate information gathering and surveillance methods or systems for trading in the corporate bond market in order to promote the integrity of the market, including best execution and other investor protection requirements. The design of any system should take into account the type of trading activity and investor participation in the market.*" *Supra*, at page 35.

III. CONCLUSION

The effective government bond market is a foundation in developing the corporate bond market and related interest derivatives markets. Experiences in developed markets show that important components are regular issuance, effective market making system, and effective hedging and liquidity facilities.

Key issues arising from previous analysis include improving market depth through buy-back and re-open, making privileges and obligations of primary dealers more clearly defined and exclusive, and developing hedging and SBL/repo facilities, possibly by way of having a central facility.

In addition, the survey also reports a gap of market information accessible by different groups of investors (*i.e.* market intermediaries vs. public investors). As a result, approaches to enhance sound market and transparency should be introduced especially for disseminating of post-trade information or other market indications. This is to allow investors at large to access adequate information for making informed decision for their investment, and also to allow securities regulators to use such information for effective market monitoring and surveillance.

Approaches to enhance price transparency could be different, depending on types of trade information. Priority should be given to the centralisation for post-trade information to be collected and disseminated, either organized by a public provider or an industry association. Also, market intermediaries should report indicative prices and such prices should be managed before they are disclosed to the public. Moreover, in case of illiquid bonds, the construction of a yield matrix by ratings and maturities would be more helpful than stale prices.