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ASIA'S DEBT CAPITAL MARKETS**

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Making Markets: Reforms to Strengthen Asia's Debt Capital Markets

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Abstract

Liquid markets for debt securities exist comprehensively in no East Asian economy other than Japan, even though short or medium-term bonds are issued in most and Asian borrowers are established (though generally not prolific) international issuers. Today's markets provide a borrowing medium (not always effectively) for Asian governments, financial institutions and some companies, but investor activity is closely correlated with bank credit creation. Above all, the region's markets provide no real guard against crisis or contagion, nor act as a balance to banking systems susceptible to distortion and event risk. Asia's economies may not suffer general capital shortages but poor resource allocation is pervasive and would be greatly improved by efficient national and regional financial markets.

Seven years after its most profound financial crisis, Asia risks new contagion from any similar, unforeseen loss of confidence. Active debt capital markets would help limit such risks. The world's foremost bond markets developed as a result of intense national needs, and while economic growth will inevitably lead to greater bond issuance and trading this will be insufficient for the region's wider requirements without official sponsorship of active cooperative market reform.

This paper contains three linked policy proposals: a matrix of steps to remove legal, fiscal, regulatory or systemic obstacles or omissions that hinder market usage; measures to encourage the development of a unified regional offshore market for local and major currency risk; and the concept of a regional body to promote the creation of asset-backed securities on a scale not previously contemplated and greatly expand activity in Asia's debt markets.

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The University of Hong Kong's Asian Institute of International Financial Law is managing a project to monitor Asia's financial markets, working in conjunction with the Hong Kong Institute of Economics and Business Strategy, the Centre of Asian Studies and the Center for China Financial Research. The project forms part of the University's East Asian International Economic Law and Policy Programme.

Members of the project team are assisting national policy makers, international financial organisations and private sector participants in preparing recommendations for financial market reforms, both national and regional, and in assessing the value to the economies of the region of financial integration and continuing capital market development, including workable new financial structures.

The views expressed in this paper are those of the authors and do not necessarily reflect those of the Hong Kong Institute for Monetary Research, its Council of Advisors, or the Board of Directors.

1. Introduction

A previous HKIMR working paper showed that markets for debt securities exist comprehensively in no East Asian economy other than Japan, even though short or medium-term bonds have been issued in almost all, and Asian borrowers are established (though not prolific) international issuers in major currencies.¹ The paper reviewed all existing domestic currency markets for debt securities in East Asia and the most important cross-border public debt markets for Asian credit risk.² Asia's modern economies have not in aggregate been subject to non-cyclical shortages of capital but their capacity efficiently to allocate financial and related resources has been pervasively suspect. The paper argued that active debt capital markets will improve national and regional resource allocation through providing an unbiased, comprehensive and transparent price mechanism and widen the choice of risks available to investors. In so doing, such markets will also diminish potential instability and contagion of the kind experienced after the 1997-98 regional crisis.³

For twenty-five years, the region has maintained an orientation for export promotion similar to that first adopted in the 1950s by Japan, which fuelled previously unrecorded growth in capital asset formation. The greater part of that investment has been privately sourced and privately deployed, with a reliance on internal funding and bank borrowing.⁴ Governments have generally avoided heavy military spending as a share of national output, and comprehensive state welfare or pension schemes are largely absent. Except in times of crisis, governments fund their current spending needs with local currency bond issues bought (by choice or otherwise) predominantly by commercial banks. Often irregular, such supply cannot simultaneously sustain monetary policy needs, bank liquidity requirements and meet demand from institutional investors. The role of debt securities in East Asia is consistently less prominent than elsewhere, both before and since the 1997-98 crisis. Debt capital markets in non-Japan East Asia, with the sporadic exception of Korea, fail to provide the resource potential for national economies in the way commonly expected among established market economies.

The earlier paper argued that those advanced economies that elected to build fully developed debt capital markets have a history of financing organised conflict, coming in the mid-20th century to maintain regular fiscal deficits to sustain military or welfare spending.⁵ If Asia is to be an exception it must recognise a contemporary need as compelling as war. The crisis and its aftermath provides such motivation: ignoring output losses in Korea and Southeast Asia, the costs to governments of supporting stricken banking sectors were enormous⁶ and an overhang of impaired assets has not been fully realised, especially

¹ Lejot, Arner, Liu, Chan & Mays (2003). Unless stated a 'major' currency is a 'core' or 'G-3' currency (euro, yen or US dollar) or one used as a continual cross-border currency of issue, currently Australian or Canadian dollars, Swiss francs or sterling.

² The review economies are the People's Republic of China ('China'), Hong Kong SAR, China ('Hong Kong'), India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, China ('Taiwan') and Thailand.

³ This paper refers to the 'Asian crisis' but sees it as financial only in the first phase. The crisis became pervasive in its social, economic and political consequences.

⁴ Again, as in Japan one generation previously (Goldsmith, 1983).

⁵ 'Welfare' in this context means non-contributory public spending on education, employment, health, social security or social infrastructure.

⁶ Estimated as shares of GDP in the 12 months to July 1998 to be 17 per cent for Indonesia; 2 per cent for Korea; 13 per cent for Malaysia; and in the 12 months to July 1999 22 per cent for Thailand (Lindgren, Tomás, Baliño, Enoch, Gulde, Quintyn & Teo, 1999).

in China and parts of Southeast Asia. In the longer-term, further substantial needs may originate from infrastructural and social requirements.

The attention given to the debate by policymakers since 2001-02⁷ suggests that structural reforms may shortly be made feasible. Several ministerial or official groupings are working with interrelated agendas, and the results may be more substantial than those of past undertakings. Three APEC⁸ teams are examining capital market development and hope to decide whether securitisation can provide a continuous fundraising mechanism in the region and further assist the recycling of non-performing financial assets (NPLs). The ASEAN+3 cluster⁹ is undertaking similar research in the practicalities of promoting securitisation and external credit enhancement as interrelated ways to encourage market usage. Last, Thailand has since 2002 led participants in the Asian Cooperation Dialogue,¹⁰ exploring regional cooperation to encourage capital market activity. This paper seeks to identify how well-established market-based initiatives can combine symbiotically with recent proposals and reforms in public policy of the kind under consideration (nationally and regionally) to result in the permanent expansion of existing markets and the successful opening of new developing markets in the region.

Section 2 contains three proposals to improve market operations while section 3 describes the main features of domestic and offshore markets in the review economies.

2. Policy Needs and Recommendations

An earlier paper¹¹ described the efforts rehearsed by private and official interests in building viable international and local capital markets for Asian debt before and since the 1997-98 crisis; how the results are sparse except in offering a means for conspicuous issuers to borrow, central banks to influence money market activity (often in limiting ways that lessen price transparency) and how these hopeful markets are thus subject to regular questioning. Asia's fixed income markets are of scant use to many potential participants, including most classes of non-bank investors and a majority of aspiring borrowers, and fail to induce sufficient non-core currency issuance of adequate risk quality to satisfy regional and domestic investors. Above all, they provide no guard against crisis or ensuing contagion, nor act as a balance to banking systems that are susceptible to complex monopoly, distortions in resource allocation

⁷ Including the creation in 2003 by the EMEAP central banks group of a major currency Asian bond fund, and plans for a larger family of funds to invest in Asian currency risk. EMEAP, the Executives' Meeting of East Asia-Pacific Central Banks, comprises Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore and Thailand. The preliminary structure of the second fund announced in April 2004 comprises new single currency and regional index funds that will each invest in sovereign and quasi-sovereign debt issues (see section 2 p5 *infra*).

⁸ The Asia-Pacific Economic Cooperation forum's West Pacific members are EMEAP plus Brunei, Papua New Guinea, Taiwan and Vietnam.

⁹ Association of Southeast Asian Nations (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam). ASEAN+3 is an ad hoc group that includes China, Japan and Korea. Six ASEAN+3 teams are currently engaged in work on specific topics for the group's Asian bond market initiative.

¹⁰ Comprising the ASEAN+3 members, together with Bahrain, Bangladesh, India, Kazakhstan, Kuwait, Oman, Pakistan, Qatar and Sri Lanka.

¹¹ Lejot, Arner, Liu, Chan & Mays (*op cit*).

and to event risk.¹² Too little collaborative public effort has been made to stir activity: specific action beyond exhortation or planning is needed from Asia's governments and the official groups now deliberating on their behalves.

Left to grow alone, Asia's domestic markets will fail to generate adequate liquidity or activity. The world's most sophisticated debt markets sprang from the most essential needs, enabled by reform and product innovation, and would otherwise have evolved neither as far nor fast. Only economies with a history of financing organised conflict or extensive state welfare programmes have nurtured fully developed debt capital markets.¹³ Nowhere else has the need been as large or the motivation as great. Asia must recognise a contemporary need with as great an imperative as war: the shocks of 1997-98 and their aftermath may have created such motivation, especially when taken together with a regional need for improved resource allocation and investment in infrastructure. One year after the Asian crisis began, Hong Kong's senior financial official asked impassionedly, 'how is it that we in Asia have never been able to replicate the eurobond market success [...]?'¹⁴ He might privately have welcomed the crisis as providing suitable reason: if market activity is stirred so as to assist in solving the banking sector's post-1997 burden of impaired assets the ongoing result will be depth and liquidity of the order envisaged by the most optimistic participants, and systemic reform that will constrain future post-shock contagion and support future economic development.

This section advances policy suggestions and recommendations for reform, all appropriate to the region and intended to promote supply and usage and to widen participation.¹⁵ The ten most important elements are:

- For each currency sector and regionally, standardise and broaden the range of available feasible debt instruments, especially as to issuers and maturities.
- Establish and consolidate benchmarks (normally single obligor government or quasi-government securities) across a declared range of maturities; introduce and adhere to visible debt issuance programmes, nationally or regionally.
- Remove restrictions on trading techniques, including bond or note repurchases on all investment grade issues, short selling, and the freest use of OTC (over-the-counter) or exchange traded interest rate and currency derivatives compatible with declared exchange rate policy.

¹² Consumer finance has become highly competitive in Asia in the last decade but complex monopolies widely exist in SME financing and retail deposit taking, whereby two organisations maintain a sizeable joint market share or a larger number act as an effective cartel.

¹³ While the conception of those markets dates from the late-18th century their modern (liquid) form is highly contemporary (from no earlier than the mid-1970s) so that on a developmental timeline Asia is not far 'behind'. The eurobond market experienced prolonged spells of chronic illiquidity at recently as the late 1980s.

¹⁴ Financial Secretary Donald Tsang, speech to Asian Bond Market conference, 4 July 1998.

¹⁵ Based upon conditions outlined previously by Lejot, Arner, Liu, Chan & Mays, *op cit* pp23-25.

- Standardise clearing (real-time book entry settlement and delivery) systems and custody requirements to provide reliability, eliminate principal risks in the settlement process and promote market integrity so as to encourage investor confidence. Remove obstacles to the use of securities financing by conventional bond and note repurchase and lending, so to support efficient trading techniques and safeguard settlement liquidity.
- Where necessary, require market-makers to provide trading liquidity in benchmark notes and bonds. Ensure that bank liquidity requirements and day-to-day central bank operations do not generally hinder liquidity in benchmark securities (through an over-reliance on bond repurchases). Ensure that trading systems allow an open, efficient price discovery mechanism that is fully visible to end users, rather than a closed circle of central and commercial banks.
- Promote securitisation and other credit transfer mechanisms through regulation or legislation (and consultation with all established credit rating agencies) to allow the dependable structured pooling of risks (generating both short and medium-term instruments) to enhance weak credits and assist risk and liability management by banks.
- Remove regulatory restrictions that prevent non-bank institutional investors from acquiring or trading in term debt securities of any kind, subject only to agreed credit rating floors that are purposefully harmonised, and in money market instruments whether or not rated.
- Where necessary, remove common barriers that prevent investors to establish a legal basis for trading, ownership and settlement.
- Remove (or as a minimum standardise and simplify) withholding taxes on securities, collateral assets and their sale; eliminate differential treatments among interest-bearing and other debt instruments; and remove differential source taxation of identical investments by banks and non-bank institutional investors.
- Support common portfolio accounting standards among investor groups, in particular to apply similar requirements among banks and non-bank financial institutions.

These needs are optimal, non-parochial but not infeasible.¹⁶ It is unreasonable to expect even incomplete reforms to be introduced speedily throughout the region. Were agreement to emerge from today's platoon of working groups then attendant legislation is still unlikely to pass quickly and untroubled.¹⁷ This paper's proposals balance the most desirable reforms with recognition of an inevitable resistance to change by government and other entrenched interests. For example, the institutional structures proposed later in this section could be used to bring into effect all the detailed prescriptive measures listed in the following table 2.1 though without demanding that hesitant governments of less-developed markets relinquish full authority to those forces of which they may be suspicious, in many cases correctly.

¹⁶ Proxies may eventually develop for the factors listed here; for example, using cash swap curves as a substitute for conventional risk-free benchmark yield curves (Lejot, Arner, Liu, Chan & Mays, *op cit* pp22).

¹⁷ Whether by design, Taiwan's 2002 Financial Assets Securitisation Law was enacted in haste and is widely regarded as deficient save for limited use.

There are three strands to these recommendations; they address all main aspects of the market's needs.

Proposal I	Proposal II	Proposal III
Agreement among ASEAN+3 members to introduce essential legal, fiscal, systemic and regulatory measures to remove identified impediments to market participation and growth, and introduce reforms to encourage harmonisation and regional usage.	A collaborative regional public debt market for domestic and major currency issues, monitored by confederal regional regulation in an established Asian financial centre.	A new regional body as part of an institutional mechanism for credit enhancement to support credit risk transfer and facilitate and encourage the securitisation of a wide range of assets and risks, and the creation of a new source of well-rated risk.
(See p6 <i>infra</i>).	(See p18 <i>infra</i>).	(See p24 <i>infra</i>).

Each proposal is intended to be long lasting in impact and its implementation influenced by continuing objectives, rather than the cyclical factors of financial conditions or confidence. Nonetheless, this is an opportune time to begin reform. The practicalities of creating a second regional EMEAP fund to invest in Asian currency instruments are considerable, for example, except in relation to two EMEAP constituent currencies.¹⁸ They may not be adequately resolved without the adoption of many of the changes specified in Proposal I and for which Proposal II would give momentum and strategy. In the absence of such developments, the second fund is likely to be unduly constrained by both currency composition and its freedom to invest and divest holdings, regardless of investment objectives.

The proposals are not mutually exclusive. First, the simplest means to remove identified detailed obstacles to growth and development (Proposal I) is to permit a collaborative offshore market for which from inception no impediment or obstacle can exist (II).¹⁹ Second, permitting the operation of an offshore domestic market (II) will facilitate the speedy introduction of more complex mechanisms to allow securitisation on the broadest scale (III), even without changes to existing law.

The remainder of this section describes the operation of each proposal and how their respective advantages represent favourable practical solutions to the region's needs.

¹⁸ The exceptions among EMEAP's target currencies are Hong Kong and Singapore dollars (see p2 *supra*) for there will be no investments in Australian or New Zealand dollars or yen instruments. The announced single currency and regional index funds are effectively a means to lessen problems associated with direct investment in local currency instruments by offshore investors and certain domestic investors, such problems relating to custody, enforcement of rights, reliability of transfer, taxation and other matters shown in Table 2.1, which exist in all cases to varying degrees except in Hong Kong and Singapore.

¹⁹ 'The rapid emergence in the 1960s of a worldwide Eurocurrency market [...] resulted from the peculiarly stringent and detailed official regulations governing residents operating with their own national currencies.' McKinnon (1977 p2).

Proposal I: specific measures agreed among participating governments to remove obstacles to market growth, so as to promote efficiency and activity.

The success of all pro-market reform will be limited if governments fail to address a compendium of impediments that deter activity and penalise participants throughout East Asia, even in markets regarded as advanced. The measures listed in this proposal are examples of essential changes, without which activity will not develop to its potential, institutional investors will be constrained and forego opportunities, and the region will continue to lack the dependable risk averse macroeconomic characteristics of active, non-contiguous debt capital markets. This section identifies commonalities in problems associated with legal, regulatory and enforcement issues and systems questions.²⁰ It contains a common approach to revealing and encouraging reform to assist with investor and issuer appraisal of the results.

Successful markets are sustained by accommodative legal systems and bankruptcy procedures, and are regulated independently with clarity and fairness. No aspect of market issuance or trading distinguishes unreasonably between classes of issuer or investor. Systems providing for data gathering or dissemination, settlement, payments and custody are simple in use, coordinated and risk-minimising, and the market is supported by a core of institutional buyers of term securities. No such markets properly exist within the EMEAP circle except in Australia and Japan.²¹ Reform has seldom been proposed in a fashion sufficiently specific to provide reliable guidance for legislation or rule changes. One reason is the opacity of existing rules: for example, most ASEAN withholding tax regimes are unclear, whether by application, tariff, amelioration or the reliability of collection. Banks are favoured in this respect over other financial institutions that have fewer chances to exploit fiscal loopholes or claim treaty exemptions made freely available to the banking sector.²² Withholding taxes can create long-term distortions in resource allocation; they generate substantial revenue in no review economy and would not do so in any purely domestic capital market even with substantially increased turnover.

Policy formation must address all significant institutional blockages and how they hinder activity, including the framework and application of regulatory guidelines for banks, pension and mutual funds, insurance companies and borrowers. It must lessen obstacles in relation to withholding taxes, differentials in the application of taxes and tax treaties, restrictions on settlement or custody, arbitrary differences in creditor status that constrain institutional investment, legal risks for investors, creditor claims and property rights generally and specifically in receivership or bankruptcy. It must also examine cultural factors that may cause obstructions relating to corporate governance, disclosure and ownership. Last, for structured finance techniques to become a significant aspect of capital market activity, each legal, regulatory, taxation and accounting system must provide simply for the true sale of financial claims and associated collateral assets, and minimise title uncertainties arising from set-off, the incidence and collection of duties, the giving of notices, permissible foreign ownership, and concerns as to partial enforcement or

²⁰ The main effects of which were characterised in Lejot, Arner, Liu, Chan & Mays, *op cit* pp23-27.

²¹ Hong Kong and Singapore approach international standards but suffer anomalies, restrictions and a lack of turnover in many instruments (see Table 2.1 p10 et seq *infra*).

²² The interplay between withholding taxes and associated tax treaties may cause a net transfer to the offshore banking sector that distorts the pricing of credit risk and can stimulate short-term capital flows from offshore. For example, it was influential in the accumulation by many European banks never represented in Asia of relatively high levels of Korean and ASEAN risk assets prior to the Asian crisis.

contract integrity. Restrictions and legal uncertainties that impede securities financing (mainly bond and note repurchase and bond lending) will lessen dealing and settlement liquidity for all investors and professional traders.²³ Regulators have often sought to dampen trading regarded as destabilising but limitations on market techniques that are generally considered legitimate may heighten volatility by inducing unwarranted selling. Domestic and foreign investors are hindered in both long-term investment and day-to-day trading by the poor availability of local currency short and long-term hedging products and supportive credit risk procedures for risk netting and collateralisation. Similarly, low risk instruments to house investors' short-term liquidity are available only in core currencies. Asian money market instruments may not exist, are taxed at source, or are artificially scarce, effectively held within a closed circle of central banks and their domestic banking acolytes. This lessens choice, efficiency and reduces price (interest rate) transparency.

Meeting these objectives requires three problems to be solved: intentional or implied restrictions, omissions of law or practice, and unnecessary inconsistencies within and among national bond markets. The elements in this matrix of market obstacles and omissions divide into four categories: legal, fiscal, regulatory and systemic, the aggregate effect of which is to prohibit or deter issuance and investment. The four parts of Table 2.1 list issues within this framework for which attention is most needed and especially where that need is common to several of the review countries. They apply to both government and corporate long-term debt markets, and to a majority of the review economies' domestic money markets. Some of these problems and disparities are widely known, especially in the sense that those risk-preferring organisations dealing in Asian bonds welcome credit and price discontinuities and the trading anomalies that they create: this is true in measure of the proprietary activities of banks and private funds. Until these questions are resolved general trading activity will be permanently constrained to the detriment of wider interests within the financial sector and notably in terms of regional crisis containment. The most damaging features are obstacles and omissions, since market discrepancies can often be reflected in the pricing of risk, but domestic irregularities relating to matters of law are also damaging and not fully compensated in ratings, risk or pricing.

The legal and regulatory points cited in parts 1 and 3 of Table 2.1 are connected to certain of the putative findings of contemporary 'law and finance' theory,²⁴ that legal environment and differences in the ways that investors are protected by national jurisdictions or regulations are strong determinants of the effectiveness of individual financial systems, including the scale and depth of capital markets, and may ultimately be reflected in national economic performance. Investor protection is typically shown by variables representing indexes of creditor rights, quality of creditor claims or judgement enforcement and the likelihood of expropriation against owners (shareholders, and in some cases creditors). A second thread of the theory argues that legal origins or traditions significantly influence investor protection and

²³ 'Securities financing' refers chiefly to repurchase arrangements, securities lending and to collateralisation. Bond or note repurchases ('repos') are a trading tool most common in use in Asia by central banks influencing day-to-day liquidity and may be used by professional traders for the same motive. Investors lend or borrow securities to increase portfolio returns or facilitate short sales; securities lending thus affects settlement liquidity. Collateralisation using debt securities is integral to managing counterparty credit risk in interest rate swaps and other medium-term OTC derivatives.

²⁴ Beginning with La Porta, Lopez-de-Silanes, Shleifer & Vishny (1997 and 1998). Beck & Levine (2003) review the theory's literature. King & Levine (1993) and Levine (1997) examine broader relationships between financial and economic development, suggesting general acceptance of strong causal links between the functioning of financial systems and economic growth. This extends specific aspects of finance-growth studies, the literature for which is substantial, perhaps beginning with Goldsmith (1969), and extends to specific questioning of debt market development in Asia (for example, Eichengreen & Luengnaruemitchai, 2004).

the sophistication of national financial systems. Some views further hold that common law traditions better support creditor rights and effective markets compared to jurisdictions based on civil law, and conversely, that such protection of creditor rights improves the functioning of capital markets because the quality of enforcement rules and practice varies with legal systems.²⁵ These issues affect the remedies and reforms to be considered by national governments. If the nature or origin of legal systems is a strong determinant of financial development, then some of the problems identified in Table 2.1 may be intrinsic and incapable of piecemeal remedy. If the root of these concerns is based upon factors so fundamental then the harmonised approach to reform sought by APEC and ASEAN+3 working groups cannot be feasible in outcome.²⁶

Practice is unlikely to produce so rigid a result. There are accepted examples in Asia (and elsewhere) of civil law economies that sustain flourishing debt capital markets and of common law jurisdictions that fail so to do.²⁷ Experiences within the EU since 1986 suggest that harmonisation to minimum standards, coupled with mutual recognition, can be effective across economies with differing legal and institutional settings. Further, unsecured rights attaching to debt claims are different in character to the corporate governance issues linked to equity claims, where agency concerns are direct and permanent. In addition, empirical problems associated with assessing comparative creditor rights may suggest that the theory is advanced from a common law perspective, for example, as the choice of proxy variable cannot easily control for common law systems inherently encouraging commercial dispute at law. The role of debt is less easily examined by the law and finance school than rights and obligations associated with equity claims,²⁸ although they have been taken in aggregate to signify degrees of national investor protection. Last, law and finance theory studies that amalgamate in analysis the claims of banks and outstanding non-financial sector bondholders presume in so doing that debt creditors have collateral rights that are typically absent from contemporary debt issues.

From an Asian reforming perspective, the scale of bank assets in an economy²⁹ cannot signal financial market sophistication.³⁰ Lending cartels are widespread; large companies may choose to raise funds

²⁵ Testing law and finance theory is made difficult because aggregate data on debt (creditor) claims are erratic compared to equity claims, which (by convention) are consistent and simpler to measure. The determined variable 'debt' has been commonly taken as the sum of bank claims against the non-banking sector and disclosed or public non-financial bond issues (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 1997 & 1998). This may exaggerate sophistication in a bank-based financial system; it may also confuse aspects of creditor rights relating to the protection or enforcement of collateral since a far higher proportion of bank claims are secured than amounts owed to bondholders. Such data weaknesses cloud the contention that the treatment of debtor claims necessarily signifies effective financial markets.

²⁶ Recent broader work examines the determinants of bond market capitalisation relative to national income in Asia and more generally for up to 49 local currency markets (respectively, Eichengreen & Luengnaruemitchai, *op cit*, and Burger & Warnock, 2004). Both studies concur with La Porta *et al* that country size, economic growth, creditor rights and certain risk factors are important determinant of bond market size, but Eichengreen & Luengnaruemitchai find that Asia's lack of large markets also reflects conservative fiscal policies and historic cultural factors. Both studies acknowledge data limitations, for example, hindering analysis of the determinants of market activity (turnover) and in suggesting reverse causality. Further analysis is warranted based upon segmented market transactional data.

²⁷ Compare Japan or Korea with India and Malaysia, for example.

²⁸ Compared to equity, debt claims are less heterogeneous and complete associated data are less consistently available, either at national income accounting or transaction levels. Public (listed) issues are usually traded in ways that are wholly transparent only for professional counterparties; exchange listings for bonds usually entails only token reporting of buying, selling or prices.

²⁹ For example, measured against national income, corporate revenue and cashflow (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 1997).

³⁰ Anticipated by Goldsmith (1969 *op cit*) prior to data becoming even partially available.

offshore; indeed, large companies are able to obtain debt in all environments.³¹ As an example, the most dynamic part of the contemporary Chinese corporate sector has been found to have no reliance on traditional external finance;³² this sector accounts for the largest share of contemporary national growth. Chinese non-state enterprises are largely self-financing or have access to informal sources of external funding not visible in the domestic banking system, and the public sector is almost wholly responsible for China's outstanding domestic and foreign debt issues.

If constraints exist on general reform in the most pressing financial systems, how can public policy effectively promote market usage? The optimal approach may be to recognise that the issues cited in Table 2.1 are objectives to which all concerned governments must strive, accepting that the overall legal framework within which they approach reform may not be conducive to specific changes, however necessary, or at worst may make repealing existing rules unreliable. The approach taken by Korea and Taiwan in promoting laws to allow securitisation may be models for broader initiatives.³³ Public policy must also promote risk-averse reform rather than allow liberalisation of the type seen often before 1997, which contributed to the scale of the Asian crisis and contagion. Proposals I and II require improvements in the regulation of issuers and investors, and the taxation of issuers, banks and investors. In helping to shape policy reform each will have corollary effects on the development of Asia's banking sectors, particularly in risk management and product innovation, in lessening the contagion effects of future crises of confidence, and in reducing the occurrence of moral hazard in inherently conflicted bank-dominated economies.

There is considerable value to a harmonised regional approach to reform despite inherited institutional obstacles that make common objectives achievable only in different ways.³⁴ First, joint efforts over an agreed period show purpose to market participants. Second, the sharing of intelligence and resources is valuable despite intrinsic national differences in systems and solutions. Third, collective action will support future intra-regional non-core currency investment and trading. The subsidiarity principle of the EU may be a guide for this purpose: the 1987 Single European Act sought to liberate capital movements among member states only by providing common minimum standards for implementation through national legislation to make the reform effective, which varied among those signing the Act.³⁵ Mutual recognition became the second stage of reform on the basis of those common standards.

If Asia accepts the need for change to promote market-based activity, its first step is to agree a precise intention and require national authorities to proceed with more complex mechanics. Table 2.1 contains a list of specific topics for the region's working groups to address. All the points shown in the table demand attention although their respective importance varies among the review economies. Many factors are manifested through a lack of investor confidence that is pervasive across markets. Significant commitments of time, resources and political determination will be needed for these measures to be addressed everywhere in the region. Active, integrated debt securities markets will not otherwise be seen in Asia.³⁶

³¹ Acknowledged by La Porta, Lopez-de-Silanes, Shleifer & Vishny (*ibid* p1148).

³² Allen, Qian & Qian (2002).

³³ Recognising that in Korea legislation is longer-established and has been put to far greater use.

³⁴ This may be the greatest benefit of a successful EMEAP local currency fund.

³⁵ Single European Act, 1987 OJ (L169) 1 (1987). It must be acknowledged that except in the UK, a contemporary absence of securities market legislation meant that few obstacles to harmonisation needed first to be dismantled. (Arner, 2002). Obstacles to integration continue to exist and since 2001 their removal has been the tasks of the EU's new European Securities Committee and Committee of European Securities Regulators.

³⁶ '[T]he evolution of the legal framework underlying efficient market economies was a long incremental process [...]. If the legal framework doesn't already exist or only partially exists it must be created.' North (1995) p11.

Table 2.1 Frequently observed market impediments (see section 3 for important sources)

	Obstacles	Omissions	Disparities
1. Legal	<p>The most serious legal obstacles concern the free transfer of property and other rights, and the rights of creditors in proceedings for bankruptcy or debtor restructuring.</p> <ul style="list-style-type: none"> • Barriers to true sales of real property or financial assets. • Unqualified acceptance of ownership and property rights, and limitations of such rights in relation to investor classes. • Bars to foreign ownership and associated asset transfers. • Restrictive court enforcement of local judgements. • Inability of or refusal by courts to enforce applicable foreign commercial judgements against local debtors. • Limitations on creditor collateral rights in bankruptcy or reorganisation. • Limits to enforcement against public organisations; arbitrary extension of generally accepted sovereign immunity. • Enforcement of court-sanctioned restructurings. 	<p>Legal omissions relate especially to questions of enforcement, and in penalising certain transaction types, notably asset-backed securities.</p> <ul style="list-style-type: none"> • Indeterminate title, successor rights and enforceability after transfer of creditor claims or associated collateral. • Notice requirements delaying or otherwise affecting the reliability of sales of assets. • Debtor notice requirements affecting the reliability of transfer of creditor claims. (It is common to adopt a synthetic deal structure using credit derivatives if the true sale of claims is suspect, for example in structured finance involving the sale of pools of loan assets, but it may be preferable to alter the standard form of primary loan document. This is becoming common with residential mortgage loan agreements). 	<p>Legal disparities are most common or apparent in the treatment of creditor classes and between domestic and foreign claims.</p> <ul style="list-style-type: none"> • Creditor status: uncertainty as to whether courts will enforce or dissolve contractual creditor priorities. • Unpredictable or political reviews of judicial decisions. • Risk of borrower set-off in asset sales (requiring additional credit enhancement in asset-backed issues) arising from incomplete notice requirements. • Precedence: domestic claims enjoying <i>de facto</i> priority compared to offshore claims. • Examples of practice inducing moral hazard issues: indigenous investors may perceive no difference in the relative status of government sector instruments. • Rules on usury, especially for penalties. • Imprecision or conflicts of law in disputes as to cross-border settlement and issues relating to securities custody.

/ (continued)

Table 2.1 Frequently observed market impediments (*continued*)

	Obstacles	Omissions	Disparities
1. Legal (<i>continued</i>)	<ul style="list-style-type: none"> • Incomplete recognition of special purpose vehicles (SPVs), including those registered offshore. 	<ul style="list-style-type: none"> • Recognition of International Swaps and Derivatives Association (ISDA) master agreements and definitions; permissible set-off and netting in swap contracts (see Table 2.1 part 4 <i>infra</i>). • Inadequate or unreliable creditor rights in bankruptcy or reorganisation, including failure of priority creditor rights, unpredictable rules on foreclosure and status of collateral assets, and insecure priority rights after debtor reorganisations. • Failure to recognise trusts or equivalent insubstantive entities, either onshore or offshore. 	<ul style="list-style-type: none"> • Acceptability of standard legal agreements for financial transactions when non-compulsory and not subject to regulation.

Table 2.1 Frequently observed market impediments (*continued*)

Obstacles	Omissions	Disparities
<p>2. Fiscal</p> <p>The main fiscal obstacles are taxes and duties that prohibit or severely penalise reputable financial transaction structures.</p> <ul style="list-style-type: none"> • Incidence and clarity of stamp duties and other <i>ad valorem</i> taxes. • Duties, taxes and penalties imposed upon the transfer of financial assets and claims, and associated collateral rights. • Taxes and impositions that recur within single transactions, for example, in the sale of assets or claims between SPVs. • Securities financing by repurchase or lending may be considered an outright sale for tax purposes. 	<p>Fiscal omissions are chiefly matters relating to information, especially clarity in the application of taxes, duties and allowances.</p> <ul style="list-style-type: none"> • Clarity in the imposition of taxes on asset sales or the transfer of claims. • Clarity as to permissible capital allowances. • Homogeneous treatment of interest and interest deductions. • Absence of commitments to tax neutrality. 	<p>Disparities in fiscal issues can be pronounced as between classes of creditor, obligor or financial institutions, and between local and foreign parties.</p> <ul style="list-style-type: none"> • Withholding taxes applied asymmetrically to investor groups, parties of different domiciles, classes of instrument or to classes of issuer. • Concessions for banks in comparison to other financial institutions, for example, in allowances for write-offs, interest deductions, access to double taxation treaties, and the use of offshore funding centres. • Inconsistent application of allowances under double taxation treaties; treaties with non-universal applications. • Subsidised or inequitable lending or investing incentives, for example, applied by treaty to foreign banks or conduits in selected domiciles. • Taxes on repurchase arrangements and on bond borrowing. • Specific taxes on foreign investors and professional dealers.

Table 2.1 Frequently observed market impediments (continued)

Obstacles	Omissions	Disparities
<p>3. Regulatory</p> <p>The severest regulatory obstacles are found throughout the region and concern prohibitions on local currency investment, usually by non-bank financial institutions. Issuer restrictions have tended to be directed at offshore flows in both local and major currencies. In many cases these restrictions impact inequitably upon the integrity of freely-entered contracts.</p> <ul style="list-style-type: none"> • Responsibility for market and new issue regulation divided among competing authorities. • Prohibitions and constraints on issuer classes, including corporate and foreign entities. • Restrictions on the borrower’s initial use of proceeds. • Investor constraints relating to permissible asset holdings and risks. • Specific foreign investor limitations, including prohibitions on investment by obligor or instrument. 	<p>Regulatory omissions result most frequently in markets for risks or instruments that are effectively closed to classes of investor, either deliberately or by default. These omissions reflect action or inaction by several sources, including central banks, market and investor group regulators, listing authorities and accounting regulators.</p> <ul style="list-style-type: none"> • Inadequate accounting standards compared to IOSCO³⁷ • Recommendations for best practice in accordance with IAAP or IFRS • Guidance. All 10 review economies are full IOSCO members. • Weak issuer reporting and disclosure. • Weak regulatory oversight of issuer reporting and disclosure. • Minimum requirements for new issue registration documents and prospectuses. 	<p>Differences in the treatment for regulatory purposes of conventional investor activity are a source of market distortion. The resulting lack of clarity leads to a sacrifice in investor participation.</p> <ul style="list-style-type: none"> • Disparate credit rating requirements and associated capital treatment for banks and certain other regulated investors. • Variations in requirements for new issues to be rated, and on minimum rating standards. • Non-standardised practices by national credit rating organisations, especially when linked to regulations affecting investors. • Absence of coordination among national credit rating agencies.³⁸

(continued)

³⁷ International Organisation of Securities Commissions.

³⁸ The role and regulation of national and international credit rating agencies (not only in relation to Basel II) is not exclusively an issue for Asia and is not addressed in this section. However, Asia’s regulatory authorities have as strong an interest as their OECD counterparts in discussions as to how rating agencies may properly assume self-regulatory functions, given questions of potential conflict and accountability. See remarks in Proposal III (p33 *infra*).

Table 2.1 Frequently observed market impediments (*continued*)

Obstacles	Omissions	Disparities
<p>3. Regulatory • Custody controls and directed settlement.</p> <p>(<i>continued</i>) • Effects of external capital controls on offshore borrowing. Approvals may be required for foreign currency or offshore borrowings where the approval process is variable or arbitrary.</p> <p>• Effects of capital controls on permissibility of domestic and international interest rate and currency swaps.</p> <p>• Effects of regulation on the availability of debt instruments, especially in liquidity requirements and the classification of securities eligible for rediscounting with central authorities (see Table 2.1 part 4 <i>infra</i>).</p>	<p>• Incomplete practice framework for interest rate and currency derivatives.</p> <p>• Forced illiquidity of money market instruments to non-bank financial institutions.</p> <p>• Developed rules for retail investor protection for debt securities.</p> <p>• Listing rules and prospectus requirements designed appropriately for debt issues, especially to allow for corporate debt issuance programmes or 'shelf' issues.</p> <p>• Provisions relating to investment in commercial paper.</p> <p>• Centralised reporting of bond prices and trades. This omission is closely associated with consistent use of centralised arrangements for settlement (see column 3).</p>	<p>• Variations in the application of external capital controls, permissible investments, mark-to-market valuations and liquidity requirements.</p> <p>• An issuer's domicile may by itself affect other conditions attached to a transaction, including fiscal treatment, eligibility as collateral for repurchase agreements or permissibility in regulatory reserves.</p> <p>• Requirements for corporate debt issues to be guaranteed by third party financial institutions, either for investor protection purposes or historic reasons.</p>

Table 2.1 Frequently observed market impediments (*continued*)

	Obstacles	Omissions	Disparities
4. Systemic	Systemic obstacles arise from both specific factors, not all of which are deliberate, and aspects of local debt market practice that deter institutional activity.	The most apparent and widespread systemic omission is a lack of valid market-determined yield curves for all new issue and investor benchmarking. This would ideally be a conventional risk-free government yield curve but could take other forms (fair value or derivative yield curves, for example), assuming both transparency and consistency for users, and the absence of distortions such as those caused by trading or intervention techniques. ³⁹	System disparities are manifested in encouraging an arbitrage orientation, discouraging regional institutional investment, and penalising asset classes within domestic markets. The disparities listed in this column occur between instrument classes within markets, insofar as they exist between national markets they also lessen investor confidence.
	<ul style="list-style-type: none"> • <i>De facto</i> banking sector cartels. • Securities dealing cartels and unreasonable exclusions from dealing. • Prohibitions on securities lending and short-sales. • Excessive use of money market repurchase operations by central banks (causing yield curve distortions). • Inequitable qualifications or restrictions on dealing. 	<ul style="list-style-type: none"> • Flaws in bond auction mechanisms and participation, resulting in a weakened price mechanism in primary sales, poor price visibility and a lack of consistent transparently determined interest rates. • Lack of declared government benchmark issuance programmes, and unreasonable abandonment of such programmes. 	<ul style="list-style-type: none"> • Government issue primary dealer qualifications, requirements and exclusions. • Settlement practice; settlement risks (especially a lack of book entry operations, real-time settlement and reporting). • Rules on custody and sub-custody for domestic and foreign investors. • Variations in business days practice. • Variations in interest accrual and settlement practice.

³⁹ On encouraging liquidity in government bond markets, Mohanty (2002) gives details of issues cited here as omissions or disparities.

Table 2.1 Frequently observed market impediments (*continued*)

Obstacles	Omissions	Disparities
<p>4. Systemic • The closed relationship between banks and governments in national money markets can be a distortion and moral hazard: the state issues debt largely held by the banking sector, prompted by regulatory or liquidity purposes.</p>	<ul style="list-style-type: none"> • Transparent and declared objectives for monetary policy; coordination between debt management and monetary policies. • Widespread access to a full range of local currency money market instruments; admissible in unified clearing system. • Clear rules for new issue registration and listing. • Custodian recognition and market admissibility of ISMA general master repurchase agreements. 	<ul style="list-style-type: none"> • Variations in practice for trade confirmations and execution. • Variations in settlement days. • Elective use of central depositories for settlement or custody. • Elective physical delivery of bond certificates. • Settlement by delivery against payment not applied consistently across instruments or classes of issuer. • Reliance on bond repurchases in monetary operations diminishes secondary liquidity, even though repos may facilitate trading in other ways, for example, if short selling is permitted. • Weaknesses in credit rating methodology (including data deficiencies) and applications; poor credit rating practice in structured finance.

Table 2.1 Frequently observed market impediments (*continued*)

	Obstacles	Omissions	Disparities
4. Systemic (<i>continued</i>)		<ul style="list-style-type: none"> Certain securities financing techniques may assist professional trading and improve settlement liquidity but not necessarily improve overall market liquidity or price transparency for participants at large. This can include securities lending, collateralisation using bonds or notes, and conventional repurchase agreements. It is essential that markets operate openly in order for all investors to benefit from such techniques. 	<ul style="list-style-type: none"> Fragmented issuance by central government organisations.⁴⁰ Settlement and custody practice must be compatible with acceptable securities financing techniques (repurchase, securities lending, and collateralisation using bonds or notes).
		<ul style="list-style-type: none"> Custodian recognition and market admissibility of ISDA general collateral agreements. 	

⁴⁰ Including distinctions between issue types, some deliberate, others archaic or legalistic. These will usually be inconsequential in the investor's perception of risk but lessen liquidity and introduce yield curve discontinuities. McCauley (2003) suggests the amalgamation of central government and central bank debt.

Proposal II: a collaborative regional market to encourage overall activity and hasten the reforms needed in each domestic market.

This paper's first proposal identified those legal and systemic features that most deter market activity in Asian debt securities and which are prominent in the review economies. It also anticipates a cooperative process to development and in harmonising standards throughout the region. Proposal II gathers the micro-level reforms of that analysis into a compact means of implementation. It represents as a minimum a streamlined way of addressing many of those issues of detail, by requiring governments to acknowledge and together sanction a free (but regulated) offshore market open to regional, domestic and non-Asian participants. Alternatively, the proposal could form a model for more ambitious long-term reforms leading to an integrated regional debt capital market.⁴¹ The intention in each case is to permit from an agreed date the trading and settlement of all Asian local and regional currency new issues in an established regional hub that meets agreed standards,⁴² free of withholdings, duties and capital controls, subject to common regulation and available to all investors and approved issuers.⁴³ Proposal II is thus a device to short-circuit existing arrangements, remove confusion, relieve delays and provide confidence to participants. The proposal has a long-standing precedent in the eurobond markets prior to the creation of the euro, with the critical novelty that participating countries would permit no restrictions prohibiting new issues in an obligor's home currency⁴⁴ since the intention is to meld domestic and offshore investor interests.

The model regional issue suggested in this proposal is shown graphically in figures 5 and 6.⁴⁵ From the implementation of national agreement, all new issues would be launched and will trade in the offshore centre. Domestic participants would deal through the offshore centre's systems, except for retail investors who would be expected to use domestic intermediaries for reasons of conventional investor protection. The official support needed to begin the initiative would comprise four basic undertakings:

- Participating governments would agree to lift all restrictions and regulations that may limit or prohibit investing and trading in the hub by all domestic financial institutions and intermediaries for which they are responsible.
- The host government would agree to allow the expanded offshore market to develop unhindered, and during its life not to impose restrictions or penalties on investment activity or payments other than sanctioned by the competent regulatory authority to which participating governments would subscribe. The host authorities would agree to maintain standards for financial market practice agreed by participants.

⁴¹ Favoured within the Asian Cooperation Dialogue (p2 *supra*).

⁴² Major currency bonds would not be excluded but are not the concern of this proposal and are likely to appear only as asset-backed securities. Asian issuers of major currency bonds would welcome the broader distribution that the proposal would encourage without wishing to constrain sales of their transactions to Asia.

⁴³ All Asian local currency markets except Hong Kong overtly restrict non-domestic issuers or their use of new issue proceeds.

⁴⁴ This was typically the case for French and Italian issuers in the 1970s and 1980s. France allowed the general use of its currency for capital raising only after 1989.

⁴⁵ p51 (*infra*).

- That authority shall from the project's inauguration become subject to supervisory observation by an advisory council in which all participating governments are represented, but shall itself have day-to-day oversight of settlement and sub-custody functions.
- Participating governments agree to maintain allegiance to the concept for a defined period, for example, of an initial ten years, with retroactive coverage preventing the withdrawal of applicable consents during the life of issues created during that period.⁴⁶

The first undertaking is fundamental, and would require only modest legal and regulatory changes in each domestic jurisdiction. The second requires consensus on the standards to be maintained for market practice and access, for which both international efforts and the issues identified in Table 2.1 are guides.⁴⁷ The third demands cooperation among national governments and would represent compensation for any perceived sacrifice of parochial interests among the region's competing financial centres. The final undertaking is related to market confidence and its effect on activity: this is likely also to concern regional negotiations on the trade in financial services.

The aim is for the hub to concentrate fundraising, freely assisted by the execution of currency and interest rate swaps. All local currency securities would be eligible in the hub's systems for custody, clearing and payments, in each case with transfers made free of all deductions or withholdings, and delivery against payment required on a single basis as the sole principle of settlement. The concentration of activity will also have the practical effect of acknowledging the critical role of interest rate and currency derivatives in new issues of all kinds and in so doing lead to regulation that is transparent to investors. The concept is flexible, simple to implement and operate and given political support could be made effective in a limited period of six months. Over time, it would lead to a permanent rise in market usage, indicated by the number of active investor participants as well as new issue and trading volumes.

The proposal requires national efforts, mainly in detailed aspects of law or its application, and regional agreement in sharing parochial sacrifices for the sake of Asia's overall welfare. Critically (and in comparison to the more significant architectural work needed to bring into effect Proposal III), Proposal II requires no new systems and only minor institutional arrangements. In meeting the needs identified in Proposal I, this scheme would provide a spur to a regional debt market by building upon existing local sectors and institutions without affecting them deleteriously. It presumes that choice of physical location has become unimportant for most common financial and capital market activities, given accepted regulatory and system requirements. Most trading is conducted electronically, and normal business days among EMEAP member states are virtually contiguous. Using one hub for issuance, trading and settlement would encourage a marginal increase of investor activity, mainly resulting from regional and other international funds flows that are presently neglected or deterred for want of simple infrastructure and dealing procedures. Trade flows and streams of direct or portfolio investments lead to natural demand for money market products, long-term debt instruments, hedging tools and products to assist capital asset benchmarking. Momentum for the proposal will thus arise from identified but largely untapped regional

⁴⁶ A cessation of the initial period would affect planned refinancing of maturing bonds in spite of retroactive coverage undertakings but borrowers face such irregularities at all times in current circumstances.

⁴⁷ Discussed in Goo, Arner & Zhou (2001). The hub is likely to have met the required standards when chosen.

sources rather than an increase in the core of demand now emanating from commercial banks and traders of risk, although an initial real expansion in dealing volume can be expected from domestic professional participants that trade through the hub. The plan involves no patrician losses for national governments and no sacrifice of present systems. A market said to be 'offshore' need not be taken as unregulated, demonstrated particularly in the second and third of the four founding undertakings.

Participating governments will allow contiguous trading among all domestic and offshore participants. The pre-commencement matters needing attention are:

- The nature of regulatory approvals needed for issues in the hub, embracing single transactions and formal or informal debt issuance programmes.
- The relationship between the hub's regulator with rating agencies and with exchanges that list securities.
- Settlement capacity in the clearing vehicle and for direct or indirect custody of domestic securities. Agreement as to uniform settlement conditions, including like settlement days and a common national commitment to reduce the settlement period to a minimum.⁴⁸
- All transfers from domestic borrowers will be made free and clear of withholding taxes and other impositions.
- Common minimum standards for qualification as a selected hub.
- Changes in supervision for the hub's regulatory authority, and an increase in the authority's capacity.

The hub's new issue listing requirements for stock exchange admission would be unchanged, at least as a direct product of this proposal.⁴⁹ Listings are required by custom and to provide linkage to regulatory oversight of issuer reporting and disclosure but are not associated with settlement, trading or price information. Most new issues can be expected to be listed in the hub; overseas listings would be permissible providing that they caused no dilution in the hub's regime for issuer reporting.

There need be no ceding of responsibility between national authorities: a harmonisation approach employing common standards underpins the hub concept, with approvals where necessary to be given as now. In each phase of a transaction, all operational aspects are managed in the offshore market to seek price transparency, maximise secondary liquidity by bringing together domestic and offshore trading, using the most sophisticated available systems for settlement and custody, and taking advantage of

⁴⁸ The choice of hub will determine the vehicle used for settlement and custody, although not necessarily without modification. For example, it may be advantageous to involve an established non-Asian settlement and custody organisation well accustomed to multicurrency operations, and thus lessen parochial concerns among participants. Regional settlement issues have been the subject of study by the World Bank (Akamatsu, 2004) and are of current interest to the Asian Development Bank (ADB).

⁴⁹ Except to the extent required for admission of issues originating in participating countries, for example, in relation to credit ratings or jurisdiction of incorporation.

the economies of scale present in unified wholly electronic systems.⁵⁰ Trades between counterparties in the issuer's domicile would be reported centrally and settled through the offshore market. This also removes uncertainty arising from the choice of law or jurisdiction in cross-border trading disputes by having the location of settlement and custody determine organically the law to which securities in settlement or custody are subject. The hub authorities could also adopt an appropriate international convention further to support investor confidence.⁵¹ In these respects the proposal most resembles the eurobond market of the late 1980s and early 1990s. If domestic and offshore investors buy a new issue at launch then both the funds collected and the bonds issued to investors will be fully fungible, although for convenience separate temporary 'notes' could be lodged electronically to represent domestic and offshore tranches; the size of each tranche will not remain fixed after initial settlement. The political component of credit risk is thus no different for investors to that which they accept today, except that domestic investors will assume negligible marginal risks against the hub clearing house, as with all other international settlement institutions. Legal aspects of risk flowing from the withdrawal of national concessions are unchanged.

Creditor claims will be treated no differently than today. The great majority of bond issues convey no direct collateral rights to bondholders. Providing that borrowers enter transaction agreements written under governing laws acceptable to listing authorities approved by the hub's regulator then applications for judgements or enforcement would be conducted as disparately as today. Domestic investors would thus not be prejudiced in their traditional choice of law in cases where market practice is well-established, but issuers are certain to be required to submit to non-exclusive jurisdiction in generally accepted international forums, and could expect to experience a pricing disincentive compared to 'standard' hub issues.⁵²

The singular principle of the proposal is to speed the catalogue of reforms cited in Proposal I and encourage the sum of domestic and regional liquidity. The plan will make internal domestic markets work to their limitations in trading capacity, regulatory oversight and funding constraints; and make the offshore hub market work for development, eliminating duplication in system architecture and helping to convince new participants of its effectiveness. Non-Asian issues would be permitted subject to standard regulatory guidelines as to listing eligibility and acceptable credit ratings: in each case this arrangement is similar to current provisions in the Hong Kong and Singapore local currency debt markets without long-term restrictions as to the use of issue proceeds. As a general rule, all issues could be owned directly by retail investors if they met existing investor protection requirements. The issuer's domicile by itself may not affect other conditions attached to a transaction, including a bond's fiscal treatment, eligibility as collateral for repurchase agreements or permissibility in regulatory reserves.

⁵⁰ See remarks on outsourcing clearing services in Proposal III, p30 (*infra*).

⁵¹ The leading example is the Hague Convention No. 36 on the law applicable to certain rights in respect of securities held with an intermediary, part of the Hague Conference on Private International Law. The convention was adopted in 2002 but is not yet in force. Among the review countries, China, Korea and Malaysia are members of the conference, and Hong Kong, India and Singapore have acceded to certain of its conventions.

⁵² The adequacy of enforcement of local and foreign judgements is critical in the reforms contained in Proposal I (Table 2.1 *supra*).

A more conservative model appears in figures 7 and 8, designed to accommodate government bonds and other existing high-volume domestic issues.⁵³ Compared to the main proposal, the primacy of hub trading and settlement is held by existing domestic institutions but so as to allow unhindered foreign investor participation through a single channel for settlement and custody. Later, governments may grow willing to permit their domestic sovereign issues to trade through the offshore centre. Approval may not be necessary for any offshore market to open and mature; in this case it is essential that domestic borrowers, traders, banks, brokers and investors be permitted to buy or sell offshore bonds denominated in their 'home' currency.⁵⁴

The proposal adapts formative 'liberal' euromarket experience to a regional context that is planned, agreed and facilitated. By contrast, the history of European and US international private capital flows from the late 1950s suggests that the eurocurrency debt markets emerged less through deliberate intellectual or policy planning in any market or state but rather a mass of modest factors, not all intended. National restrictions, all well-understood in a culture of fixed exchange rates and post-war capital controls, confronted mounting demand for cross-border fundraising and investment. However, one decision supported growth in international activity across all product markets: the Bank of England's permitting a wholesale market to come into being that could deploy eurocurrency (non-sterling) deposits. A market in tradable short and medium-term deposits allowed euromarket activity to develop in all its facets (money markets, fixed income and lending) and was the result of competitive product innovation. In 1966 the British authorities allowed a US bank in London to issue tradable US dollar certificates of deposit (CDs, and later medium-term floating rate FRCDs). Previously the Bank of England had only allowed brokerage with firms in London placing debt issues for foreign borrowers among non-resident funds and banks.⁵⁵

Sanctioning market-making in CDs introduced two features to London as nowhere else. First, funding grew feasible for offshore lending transactions matched in maturity to meet overseas demand for US dollars.⁵⁶ Second, funds could now be fully used offshore.⁵⁷ By contrast, today's investors in Asia have less freedom: regardless of objectives they each face a binary choice of being invested or disinvested in

⁵³ p52 *infra*.

⁵⁴ A more complex alternative would use new onshore domestic vehicles. This may be the approach adopted by EMEAP for its second Asian bond fund.

Hong Kong's post-1997 financial system became informally liquid in Chinese yuan. Its banks are now permitted to accept yuan deposits, which they must then deploy to avoid interest losses, a need that may be comparable to the first stage in the development of euromarket practice shown in figures 3 and 4 (p50 *infra*). Final yuan settlement must be made through a single bank in Hong Kong. Similarly, hub banks would accept deposits freely in all hub currencies of issue. The impact on monetary policy is minimal: deposits held offshore may lead to marginal credit creation if extended to non-banks but the availability of bonds of like currency would assist the operation of domestic monetary policy (see Einzig & Scott Quinn 1977, p104 *et seq*).

⁵⁵ Kynaston (2002) describes much of the chronology.

⁵⁶ Conventional eurocurrency loan documentation included increased costs clauses to eliminate lenders' interest rate basis risks. Taken with the wholesale CD market, banks could be confident in making lending commitments seen conventionally as mismatched.

⁵⁷ This model is shown graphically in figures 3 and 4, p50 (*infra*). With sufficient funds existing and demanded offshore, the classic euromarket issue is arranged, paid, listed and traded outside the domicile of the issuer of risk. Domestic and foreign investors alike trade through a financial hub.

their target sector. In the extreme conditions of 1997-98 investors wishing to liquidate holdings of Asian equities or direct investments were forced also to sell the corresponding host currency for lack of a conservative alternative. This proposal is not only concerned with facilitating foreign portfolio investment in a risk-averse setting that lessens contagion: participants in intra-regional capital investment would welcome more effective capital markets for information, accounting and practical motives. Early euromarket liquidity was considerably aided by the conventional money markets, one reason being that in formative days the euromarkets were as heavily reliant on bank activity as Asia today, but non-bank financial institutions were gradually drawn to using new tools for liquidity (including short and medium-term CDs and commercial paper). Although not the direct focus of this paper, the availability of short-term debt instruments would bolster and encourage market activity in long-term securities by helping broaden a trading culture, assisting in local currency hedging and by servicing the needs of non-portfolio investors.

Proposal II is an approach built on acceptance of regulatory standards of an Asian hub (embodying regionally drawn minimum standards of practice) rather than the harmonisation of the region's markets implied as the objective of Proposal I. It would allow offshore domestic issuance in a financial hub where systems are appropriate, regulation is accepted as fair and transparent, and investor attention is well-established from both foreign and domestic sources. It is a market-orientated way of dealing with obstacles, impediments and non-uniform practice to address problems of modest usage. These arrangements require a minimum of legislation or regulatory change providing that liquidity is allowed in currency swaps. They compare favourably in simplicity to alternative proposals to select a hub currency to which participating nations would align their own currencies (a hub currency would be managed in relation to a trade-weighted basket, described as a 'common loose arrangement'⁵⁸ as part of a gradualist approach to eliminating regional exchange rate volatility). This paper's proposal could represent a practical first step, not only to fundraising and market development but also in creating a framework for long-term regional stability, if that became an accepted political goal. It carries none of the unknown costs or demands of a new basket or hybrid currency, nor requires the removal of market segmentation by currency that could have a ruinous impact upon the immediate transactional future of Asian banks.⁵⁹ Nonetheless, if currency cooperation becomes an explicit policy objective then the combination of Proposal II's hub and Proposal I's long-term reforms would facilitate market integration, and contribute to the introduction of a new foreign exchange regime in the region.

⁵⁸ Frankel (2003, p44).

⁵⁹ While the early life of the euro has greatly increased issuance in the non-US dollar European corporate debt markets, the removal of entry barriers maintained by distinct legacy currency sectors allowed a huge increase in the market share of global underwriters. '[E]vidence points clearly to the fact that international competition from the larger US investment houses has been a central new feature of the post-EMU environment.' (Santos & Tsatsaronis, 2003 p14). The same study finds evidence showing that distribution resources outweigh established client relationships for banks seeking new issue transaction mandates.

This paper includes no suggestion that intermediation is intrinsically better physically located in any part of the globe. It does see the improving of standards and techniques among Asian banks to be a secondary virtue of its three main proposals.

Proposal III: a regional vehicle to encourage standardisation in credit risk transfer and facilitate securitisation through the issue of well-rated asset-backed securities on a scale not previously contemplated in Asia.

The proposal's heart is a suitably capitalised new vehicle to encourage effective risk pooling, credit risk transfer, credit rating targeting and in particular to provide a new source of external transactional credit enhancement. It includes no formal limitation on permissible source credit risk,⁶⁰ while instruments of issue might include all conventional and hybrid term debt securities, and structured money market instruments such as asset-backed commercial paper.⁶¹ This proposal is far reaching but specific in its application of resources. It requires national endorsement, regional cooperation, engagement with established credit rating agencies, and a resource commitment, partly in the form of a funded equity infusion but largely as external corporate support by means of contingent capital.⁶²

The aim is to establish a credit enhancement agency to recycle the accumulation of impaired assets in East Asia's banking systems. Except in Korea, this is Asia's greatest incomplete post-crisis task. With the endorsement of all ASEAN+3 members, this will yield a flow of new securities and bequeath a well-practiced and standardised mechanism appropriate for most aspects of credit risk transfer with structured

⁶⁰ But see Table 2.2 (p28 *infra*).

⁶¹ Securitisation is a tool of structured finance taken to be the irrevocable transfer of defined financial assets by their originator, with consideration funded by the simultaneous sale to a third party investor of new securities issued by the asset buyer. Neither asset buyer nor investor has transactional recourse to the originator. The asset buyer is most frequently an insubstantive vehicle (a company or trust). Most securitised transactions contain elements of internal or external credit enhancement to enable the securities to achieve certain credit ratings. Internal enhancement usually takes the form of over-collateralisation or the holding of a liquidity reserve; external enhancement is most commonly cash collateral, a third party financial guarantee (US standby letter of credit) or insurance. Securities are typically issued in tiers that carry different commercial terms and risks to maximise the use of assets and associated cash flows.

Except where stated, references to structured transactions do not include wholly synthetic securitised issues, notably CBOs and CLOs, which involve applying credit derivatives to asset portfolios that then remain as funded assets on the balance sheet of the originator.

The vast US federal agency bond market is generally not concerned with pure securitised structures but with pass-through arrangements under which investors acquire indirect interests in the financial assets purchased by the issuer, for example, Fannie Mae or Freddie Mac, without claims or rights of enforcement against those assets. The investor's primary risk in each case is that of the agency issuer. Similarly, investors in the European covered bond (or *pandbriefe*) markets acquire preferred interests in groups of assets (usually residential mortgages or loans for public projects) that may change in composition and which remain on the balance sheet of the originator-issuer. A market-based Asian covered bond sector would need to meet three conditions: the curbing of NPLs to internationally accepted levels; the accumulation of adequate portfolio data histories; and bank demand for regulatory capital exceeding that for true capital. None of these conditions is imminent. An Asian covered bond market could be created using the preferred creditor status of a multilateral institution, mirroring a concept now under discussion in the EU. Such support has precedents: the US federal agency and German *pandbriefe* markets were each founded with state backing and historically have received the benefit of indirect sovereign credit.

The proposed Basel II capital accord would change the definitions of risk-weighted assets accepted by participating national authorities and is relevant to this proposal in two respects. First, the accord would lessen the capital required to be set against residential mortgage loans and certain SME lending, and alter capital requirements for corporate credit (increasing for sub-investment grade risks, decreasing for others). Second, the treatment of certain higher risk (or unrated) tranches of securitised transactions and supporting liquidity facilities would demand increased capital compared to Basel I. If adopted, the new accord would have implications for some of the transactions contemplated by the proposal but not such as to make a material difference to its operations or effectiveness (see Bank for International Settlements 2003b, 2001 and 2004).

⁶² 'Contingent capital' is a third party's contractual, irrevocable commitment to fund an infusion of equity for an obligor according to pre-determined commercial criteria, applied at either transactional or corporate levels.

finance techniques, and in the long-term could assist fundraising for infrastructural development and indirectly improve the provision of credit for small and medium-scale enterprises (SMEs). In its first phase, the proposal is concerned with allowing the origination of structured transactions using real financial assets, healthy or impaired, as supporting collateral. To the extent that Asian banks have comparable needs for balance sheet and regulatory capital⁶³ and source assets include a sizeable proportion of impaired risk, wholly synthetic security transactions are not the first subject of the proposal. Nonetheless, they would be permissible under the aegis of the agency and will increase in use over time as the banking sector grows better able to create and trade credit derivatives.⁶⁴ This transition is a function of the rapidity and completeness of post-crisis bank balance sheet repair, and of the success of this proposal in providing an indirect incentive for lending to lesser-rated risks, notably SMEs.

Common to all securitised transactions is adequate enhancement of the credit risk offered to investors by the manipulation or augmentation of underlying source assets, be they a whole business, similar but unconnected assets or streams of cash. However such enhancement is achieved the process becomes manifest in one of five ways, which are the central aims of this third proposal:

- Generally, the means to make an unacceptable risk satisfactory to an investor.
- An overt or implied credit rating that betters its respective sovereign ceiling.
- The means to price unvalued pools of assets (usually to make feasible their sale).
- A method to create capital market funding where none previously existed.
- For originators, a funding source where none was available at an acceptable cost.

Applying securitisation techniques in Asia has often entailed a search for recorded assets and predictable cash flows, the usefulness of which depending on hazards such as the dependability of transferable property rights or the commercial effect of taxes.⁶⁵ Unpredictability harshly affects the economics of structured transactions.⁶⁶ The heavy marginal cost of completing an inaugural deal could be supported if it became the first of a series: too often this has proved impossible for lack of suitable material or by the obstruction of law, especially in achieving a true sale of assets to support a domestic or offshore securities issuer.

⁶³ Both the availability and deployment of regulatory (risk weighted) capital by banks relative to real capital will tend to increase with the sophistication of the banking sector (especially in risk management and product usage), the quality of supervision and the credit rating of the host economy.

⁶⁴ Few Asian banks are active as originators or traders of credit derivatives (primarily total return swaps, credit default swaps, or cash and synthetic credit-linked instruments).

⁶⁵ See Proposal I (p6 *supra*).

⁶⁶ Reporting a new issue for a Korean bank *International Financing Review* commented timelessly, 'The Asian [mortgage-backed securities] market has been plagued by a lack of [such] issues as nearly all the deals have proved to be one-offs', edition 1508, 1 November 2003, p49.

The gravity of the crisis perversely eased these limitations by making asset sales and the creation of asset-backed securities essential to bank balance sheet renovation and corporate restructuring.⁶⁷ Rating methodology in Asia grows more confident and catholic, soon making viable that certain asset pools be valued hypothetically using foreign sectoral records rather than with a wholly actuarial approach needing extensive indigenous data histories. Proposal III is a logical further step:

- To speed and expand the recycling of non-accruing or delinquent assets on a transparent basis, that when established assists the sale pricing of NPLs.⁶⁸
- Greatly to raise the number of Asia's feasible issuers, chiefly by providing banks with explicit risk support for a refinancing mechanism that will encourage competitive credit creation for medium-scale businesses and all risks of lesser quality, free of the general constraint of sovereign rating ceilings.

By facilitating structured finance on a regional scale to deal with the continuing problem of recognised, undeclared or unpriced impaired assets, Asia's governments will allow future growth in debt capital market activity and offer reliable supply of debt instruments to institutional investors. The transaction framework is well-understood by participants and regulators:

- Financial assets are sold by their originator to an insubstantive domestic trust,⁶⁹ then resold to a similar offshore vehicle that in turn funds the purchase, simultaneously or after a short period for asset accumulation, with an array of new securities enjoying direct claims of varying seniority over all or part of the pool of assets.
- Securities (typically notes, bonds or commercial paper) are issued in tranches, designed by priorities of claim and in commercial terms to meet required target credit ratings and the risk-return preferences of various classes of investor while extracting the fullest economic use of pool cash or proceeds.
- Value is first extracted from the asset pool internally; external sources then provide additional credit support such that each series of bonds meets a target initial credit rating achieved through iterative consultation with a rating agency.

⁶⁷ Most effectively with Korean lenders, to recycle impaired assets and through the creation of collateralised issues based upon the defaulted debt of Korean companies, notably the *chaebol* Daewoo. Malaysia is generally seen as similarly successful on a far smaller scale. China's need is widely accepted as paramount.

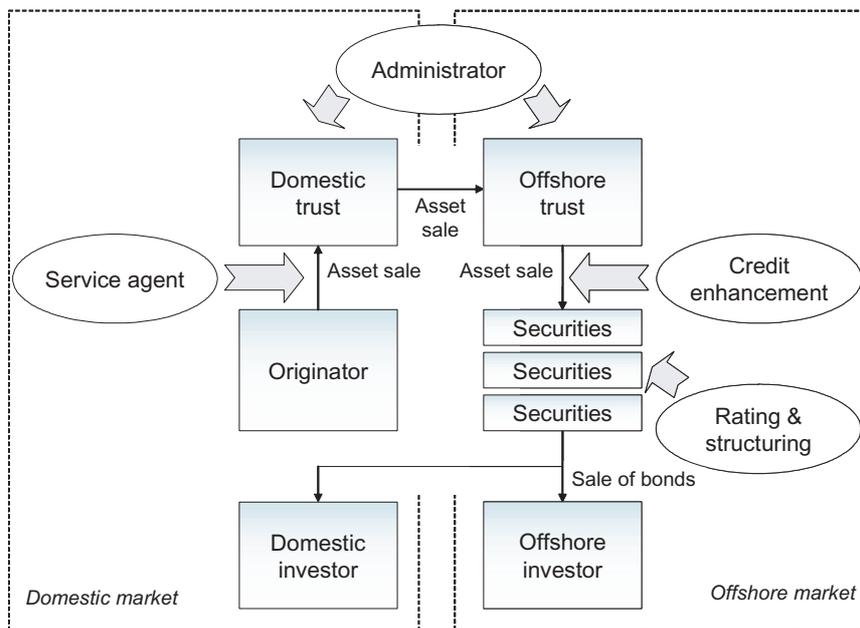
⁶⁸ Assuming increasing transaction standardisation over time, a process of reverse enquiry uses the market-clearing yields on tranches of securities to value a collateral pool and thus determine its permissible sale price.

⁶⁹ 'Trust' is used for brevity, and is synonymous with special purpose vehicle or company, denoting an insubstantive entity unconnected to the originator. Certain civil law review jurisdictions that do not ordinarily recognise trusts have legislated since the crisis to sanction SPVs in the context of structured finance, notably, Korea, Taiwan and Thailand.

- Such external backing is facilitated by a third party by means of funded or contingent capital, financial guarantee (or its equivalent) or dedicated insurance. It may cover defaults within the collateral pool or the entire transaction, including specific support to induce a counterparty to enter one or more currency swaps.
- Servicing the assets is made independent of the originator. The originator may continue to deal commercially with the ultimate debtors except in cases involving impaired assets.

Figures 1 and 2 respectively show the principles and simplified operations of the proposed vehicle.⁷⁰

Figure 1. Generic securitisation model



The main elements of the proposal and how they differ from those of past concepts or transactions are highlighted in Table 2.2 and its succeeding paragraphs. The table is a representation of the structure's commercial core rather than a guide to its legal construction or a schedule of possible participants. The parties omitted for convenience are those providing contractual financial or administrative services to one or both of the trusts (including issuing and paying agents, providers of short-term liquidity, swap counterparties, providers of support for reinvestment risks, and general or specific trustees). The agency will support deals conforming to the guidelines described in the table.

⁷⁰ Illustrations omit intermediaries taking money transmission or other pure agency roles.

Table 2.2 Features of credit enhancement agency (Proposal III)

Principles of operation	<p>Standard onshore-offshore securitisation model using two sequential domestic and offshore trusts. For consistency, transparency and technical reasons relating to achieving true sale and a neutral tax stance the basic structure will ideally apply both to local and foreign currency transactions, regardless of the domicile of initial investors.</p> <p>To avoid disruption in the relationship between lenders and clients and to encourage usage the Agency will stress the value and need for standardisation in both the documentation of underlying financial assets and in the main elements of sponsored or supported transactions.</p> <p>Qualifying assets will be governed solely by credit rating and transaction feasibility. Impaired assets, commercial mortgage loans, corporate loans and major lease receivables will be the most important subject asset categories. The proposed vehicle could accommodate other non-impaired (performing) assets such as consumer instalment credit; credit card and trade receivables but existing market resources may initially resist channelling such transactions through the Agency.</p> <p>The Agency will adopt standard market-determined commercial terms for asset-backed securities (particularly currency, listing, custody, settlement and trading qualifications).</p>
Main parties	<p>Credit enhancement will be provided by a new regional organisation incorporated in an acceptable tax neutral jurisdiction and established in a regional financial centre. Initial and future capital will be provided by founding shareholder representatives of sponsor governments, international financial organisations, and (perhaps) a small minority of private institutional supporters to give technical and advisory input to the Agency at arm's length.</p> <p>The official shareholders will form a regional supervisory body responsible for general regulatory matters. The Agency's resource mechanism and credit enhancement process will be available for use by any financial institution recognised by the regulator.</p> <p>The Agency will not itself own, manage or operate any other party in transactions to which it extends credit enhancement. Asset servicing will be managed by organisations based locally in the asset domicile. Except in cases involving pools of NPLs the service agent may be an affiliate of the originator. For transactions using impaired assets the service agent may be a national asset management company or specialist organisation, where necessary given technical assistance by the Agency.</p> <p>No other new entities are required for operations: the Agency will work with all nationally regulated originators, financial institutions and recognised credit rating agencies.</p>
Available credit enhancement	<p>Direct enhancement; by a provision of funded or contingent capital to the offshore securities issuer; direct swap counterparty; or a partial guarantee of that issuer's obligations or of specific classes of security. Contingent capital becomes funded according to predetermined triggers, such as financial or operating covenants or credit ratings.</p> <p>Indirect enhancement; by offering similar backing privately to enable a second unconnected external source to offer support to an issue, for example, a newly incorporated or existing monoline insurer.</p>

Why is this approach new? Asia has hosted many structured issues since 1997-98 but almost always supported by blanket guarantees (for example, Hong Kong Mortgage Corporation issues) or highly-rated foreign monoline insurers. Efforts to build a regional monoline insurer in Asia failed soon after the crisis: the company was inadequately vested and in alarm its shareholders failed to agree remedial action to protect its young, imbalanced portfolio.⁷¹ This new proposal differs in its permanence, in the way it approaches credit enhancement, in the generic mechanism used to ensure that complete and dependable sales of assets underpin new issues of securities, and in its ability to allow the packaging or synthetic treatment of most asset classes.⁷²

How does this proposal differ in detail from other models, and what are the associated risks and costs? Securitisation relies upon system assumptions (adequate legal, regulatory, accounting and taxation structures) and pools of assets of sufficient economic value to sustain acceptable transaction economics.⁷³ While the technique can clear financial debris in any of the review economies, this became generally feasible chiefly because the post-crisis imperative for balance sheet repair made transaction costs more tolerable. The result has been a notable recycling of assets, a growth in synthetic transactions since 1999-2000⁷⁴ and a resulting improvement in bank and corporate balance sheets in certain countries. The greatest success has been achieved in Korea, with a volume of successful securitised debt issues since 1998 greatly exceeding those elsewhere⁷⁵ but transaction growth is needed in China, India, Southeast Asia and Taiwan.⁷⁶

⁷¹ Asian Securitization & Infrastructure Assurance (Pte) Limited ('ASIA Ltd') was formed in 1996 as the region's first indigenous monoline insurer. It posted losses in its third operating year, lost its investment grade credit rating and reinsurance cover and has since been dormant with its insured portfolio being wound down.

The 1997-98 crisis may have occurred too soon after formation for ASIA Ltd to have established a diversified portfolio. The company failed less from credit losses but rather its poor capitalisation and the deleterious consequent effects on insured capacity and credit ratings. For a commercial organisation hoping to enhance credit risk ASIA Ltd carried too weak a credit rating (single-A) to meet its purpose. The ratings fell below investment grade upon the company's ceasing to write new business.

⁷² The new credit enhancement agency need not be profit-seeking but its providers of capital will demand commercial compensation, derived from guarantee fees and (ultimately) pool receipts. While the agency may permit the transfer of all financial asset classes, market practitioners may believe that existing resource economics give sufficient support to any particular transaction such that the agency need not be involved. For example, it is likely that impaired assets and corporate loans will be securitised far more often than single property commercial mortgage loans, future receipts or credit card receivables.

⁷³ Generically in structured finance, asset data must be available, reliable and relate to identifiable cash flows. Transaction structuring can achieve almost any result with the poorest of subject assets but the acceptable cost of completion through credit enhancement (over-collateralisation or external support) can be constrained.

⁷⁴ In synthetic transactions, an originator hedges risk assets using credit default swaps or guarantees in series. The swap counterparty may be a third party (insurance company or SPV) that then issues conventional securities to bond investors. Critically, assets do not leave the originator's balance sheet, making it appropriate for portfolios where loans are extended in several jurisdictions or when it may be impossible to create a reliable trust or perfect changes in title. Cross-border complications, varying legal regimes and foreign exchange issues are of little concern in the transfer of pure credit risk. Synthetic securitizations (especially CLOs) entail the transfer of only part of an underlying risk to investors through the issue of securities.

⁷⁵ When legislation first permitted asset-backed securities.

⁷⁶ As well as in Japan.

This proposal differs from conventional securitised transactions attempted in Asia in the past decade in three respects:

- The motives that encourage or compel originators to relinquish assets.
- The nature and source of external credit enhancement.
- Regional administration.

Proposal III is explicitly not concerned with providing third party guarantees for single obligor risks, especially in unique transactions. Its aims are wholly market-orientated. For the agency to commit capital to simple credit guarantee activities is to duplicate a function performed adequately in all but extreme market conditions by private sector banks and specialist financial institutions and is likely to establish an unnecessary moral hazard.⁷⁷

For cost-effectiveness, the proposed agency's undertakings will be supported in part by contingent capital provided by shareholders, committed at inception. Subsequent funded infusions to the agency could support cash calls arising under its contingent liabilities or to maintain prudential balance sheet ratios, and ultimately reflect the risk outlook for any securitised asset pool guaranteed by the agency. This technique is well-understood by regulators and credit rating organisations. The agency's shareholders will be predominantly sovereign or supranational, so its capital structure must be distinguished from transactions inherently subject to moral hazard. The terms of unfunded commitments will be subject to pre-determined commercial conditions, influenced neither individually nor collectively by shareholders. There are many precedents in commercial reinsurance practice and in the history of credit default swaps over the past decade to support this model. Triggers are standardised, typically under ISDA guidelines, and are subject to regulatory oversight and rating agency appraisal.

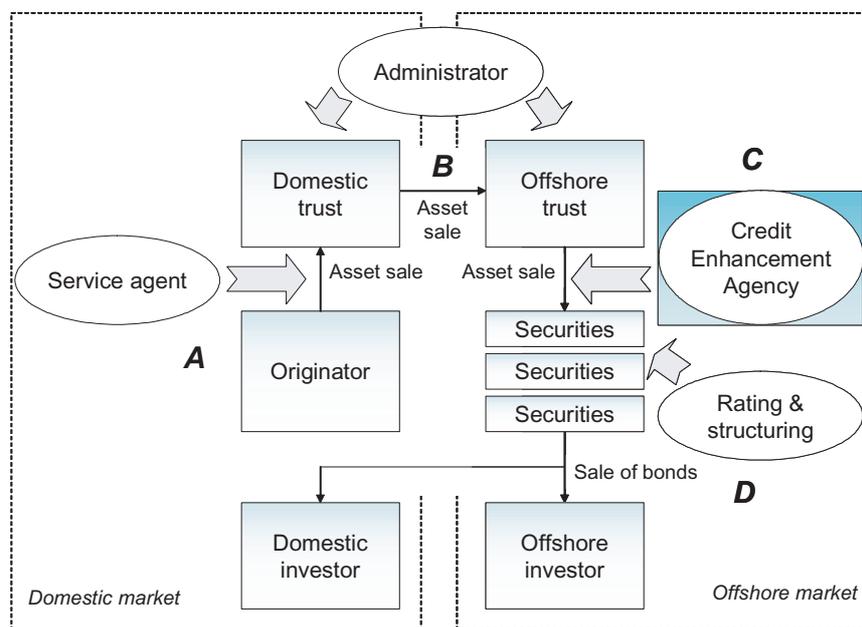
The reforms of Proposals I and II may alone generate insufficient tradable risk to meet Asia's risk management goals. Proposal III uses a conventional asset-backed security structure in a regional setting, fuelled by assets located in all parts of East Asia. Thus the scheme's motive is to facilitate a growing volume of well-rated new issues and give such continuity of supply to investors that they see structured finance as predictable rather than episodic. The agency will be sufficiently capitalised, with resources applied predominantly to the provision of transactional or programme credit enhancement, ideally with administration and risk management functions outsourced in a similar fashion to Euroclear prior to 2001, both to limit the direct influence of individual shareholders and help avoid the fate of ASIA Ltd.

⁷⁷ Ignoring cofinancing schemes, international organisations have provided single obligor guarantees in conditions of stress when credit availability was minimal. Despite intentions, in no case has the transaction created a favourable precedent. For example, in 1998 soon after the collapse of Long-Term Capital Management, Electricity Generating Authority of Thailand issued US\$300m in 10 year fixed rate bonds, with principal and one interest coupon guaranteed *inter alia* by the World Bank. In the poorest conditions, the issue was completed, selling mainly to commercial banks and has never been liquid. This deal succeeded only as a distorting novelty, offering nothing to encourage market development. International organisations may properly provide credit *in extremis* but issues such as this are costly models. (See *Euroweek* issues 570-573, September-October 1998).

These mechanics will allow for relatively high ratings so as to attract new investors to regional and major currencies issues, an accepted imperative for greater participation and activity. Not only will the agency assist in recycling impaired financial assets in high volumes, but in the long-term may become a means to encourage commercial lenders' credit support for SMEs. Smaller businesses may seldom have access to capital markets, directly or otherwise, but Asia's banks would be better able to meet their demands for loans and services were it possible for corporate risk assets to be funded or refinanced through securitisation.⁷⁸

The letters 'A-D' the following figure highlight four transaction elements inherent in the proposed structure.

Figure 2. Critical elements of credit enhancement agency



Structured finance is often a complex means to achieve the simple, in this case a supply of new debt issues at superior credit ratings. The structural skeleton of the proposal is not original, either in Asia or elsewhere⁷⁹ but two features are novel. First is the way that new (non-distressed) financial assets are volunteered for securitisation by their originator banks or finance houses; second is the cost-effectiveness and productive scope of the scheme's recommendations for external credit enhancement.⁸⁰ This proposal would offer a continuing means to generate debt securities of a credit quality acceptable to investors using hitherto unsuitable (but not distressed) assets.

⁷⁸ This also makes use of the asymmetric information frequently available to banks.

⁷⁹ Asset-backed securities appeared in 1983, with US residential mortgages used as collateral. CBOs were first issued two years later. Most Asian asset-backed bonds have been negotiated singly but in the crisis aftermath a large volume of impaired assets has been used as collateral for CBOs in Korea (Oh, Park, Park & Yang, 2003).

⁸⁰ According to Hong Kong Monetary Authority research (cited in Dalla, 2002) ASIA Ltd may originally have needed up to US\$700 million in capital and commitments to obtain AAA credit ratings. The cost was rejected, partly in the mistaken belief that the company could operate feasibly with single-A ratings. This paper's proposal assumes that the merits of active debt markets are now better understood so that the initiatives cited in section 1 (p2 *supra*) may encourage appropriate national support not possible from ASIA Ltd's heterogeneous owners.

- 'A' indicates the factors causing financial institutions to offer assets for securitisation and the associated risks. These comprise agreement on the formation of the agency, clear and uniform requirements over NPL recognition, accounting and asset disposal, more flexible sources of funding for banks, and indirect support for lesser credits, particularly SMEs.

To the extent that banking assets represent claims against entities that have (or desire) no access to a debt capital market an inducement will be needed before this type of primary resource can be pooled as collateral and transformed into usable material for debt issues attractive to domestic or offshore investors. Here, the official motive must be a combination of regulatory requirements on credit creation, particularly the full enforcement of client and sectoral prudential limits as well as general capital and liquidity demands, and a new incentive to encourage credit availability for SMEs. For example, non-discriminatory tax concessions are unlikely to breach current international trade rules.

The proposal seeks in no way to circumvent sound aspects of Asia's banking systems: it is doubtful that a flourishing Asian debt market could appear without the active participation of the region's banks. The aim is to involve the banking sector by offering solutions to ongoing portfolio problems, and additionally make banks accustomed to continual use of structured finance techniques in the refunding of non-impaired risk. A local financing link between bank and business enterprise is economically and culturally valuable but if Asia wishes to offer greater financing choice to SMEs then it is important to avoid the alternative of subsidised or directed lending, which is usually unsuccessful, unpopular and a hazardous distortion. Increased credit creation for SMEs could be made feasible by enabling banks more easily to refinance funded balance sheet risk and freely raise regulatory capital.

- 'B' draws attention to essential matters of law and practice that must be made certain for the agency to operate effectively without national constraints, and have been discussed in Proposal I. They concern the certainty of achieving a true sale of assets, the perfection of creditor claims, and eliminating duties or taxes on transfer to the extent that the use of securitisation is tax-neutral compared to a lender retaining the entirety of a claim. Onshore and offshore trusts in series are suggested to ensure the perfection of title, adhere to a standard transaction model, minimise fiscal uncertainties and where necessary facilitate the listing of securities.
- 'C' indicates issues relating to the process of credit enhancement. External credit enhancement for extant Asian asset-backed securities has generally been found in two sources: third party first loss guarantees or credit wraps⁸¹ provided by monoline insurance companies. The first is costly and the second prone to exhaustion from prudential risk limits. Assuming that third parties will support the credit demands of this proposal then the contingent capital model used by leading reinsurance groups will meet requirements for both investor credibility and cost-effectiveness in using free capital and other resources. It is further assumed that the new entity will be capitalised and maintained by subscribing governments and interested international organisations.

⁸¹ Financial guarantee support designed to correct specific credit failings.

- ‘D’ points to interplay between the credit enhancement agency and credit rating companies. The rating process for structured finance is complex, iterative and erratic, and requires the credit enhancement agency to show flexibility and considerable effort, not least because the three large international rating agencies use differing methodologies in modelling collateral applied to asset-backed securities.⁸² Credit enhancement is intended to support that process but none of the three main rating methods is best suited to the risks with which Proposal III is concerned. An actuarial method uses loss data to estimate necessary credit enhancement; appropriate for many asset-backed securities (ABSs) but unreliable when data histories and NPL accounting are poor. Cashflow modelling analysis is helpful when asset performance data is unavailable but is costly and protracted. It is likely that the new agency would explore new techniques and promote a blend of methods in consultation with the rating organisations, where possible using international sectoral data to support the performance observations of Asian originators. The proposal entails founding no additional credit rating organisations, but does envisage a dialogue on ABS rating methodology between the new entity and all recognised local and international rating agencies, as well as initiating a means for mutual acceptance of local ratings by national regulatory authorities, also assisting the reforms of Proposal I.

Rating review practice also distinguishes between conventional unsecured bonds and asset-backed securities. Public sector or corporate issue that are rated at launch will be periodically reviewed during the bond’s life and upon visible changes in credit conditions. Asset-backed securities are assigned initial ratings and then ignored unless they seem likely to default. Proposal III anticipates a change in practice such that seasoned asset-backed bonds become subject to periodic review to reflect the maturing of asset pools and the phased redemption of individual classes of security. A contingent capital structure is especially suited to this development. For each transaction given credit enhancement, a provision of funded capital would be assigned at launch, together with an unconditional commitment to supplement that funded contribution if certain external events occur and persist for a limited defined period.

The advantages of Proposal III are that it is able to deal with all financial assets and will cause a considerable increase in issuance and trading activity without disturbing the value of links between banks and SMEs. As a real comparison, the concept resembles that used to recycle defaulted or delinquent bonds and NPLs in post-crisis Korea.⁸³ Banks can be effective providers of finance for medium-scale enterprises because are accustomed to conditions of imperfect information and high initial lending costs, but often they need encouragement to lend, not only at times of generally heightened risk. An effective refinancing vehicle could provide this essential incentive while avoiding the prohibitive

⁸² This divergence mitigates concern as to rating agency influence similar to that arising from Basel II granting the agencies a fully institutional role. Too little attention has been paid to agency regulation given their predictive performance before and since the Asian crisis, or in Russia’s. Differences in agency methodology (and implied imperfections) are described succinctly by the BIS (2003a) and Raynes & Rutledge (2003).

⁸³ See especially Oh, Park, Park & Yang (*op cit*).

transaction costs of pooled debt issuance for SMEs.⁸⁴ For investors, the agency provides access to credit risk more complete and transparent than generally available in Asia. Regional settlement could take place in the same manner as Proposal II. The proposal only relates to portfolio change, not to altering the credit characteristics of single obligor risks: such transactions or derivatives based upon such risks would be left wholly to the private sector, regardless of elements of credit enhancement. The sole role for public policy in this respect is to encourage the creative participation by Asian domiciled banks.

The main considerations of the proposal are inherent costs, its need for regional cooperation, and the practical obstacles set out in Proposal I, especially in achieving price transparency in asset sales. Asset-backed securities are no less demanding than corporate bonds as to questions of accounting and law, and the proposal may not work universally with equal effect. Yet this is true of the most sophisticated markets. Last, the implementation of Basel II may lead to an increase in regulatory capital costs associated with certain securitised transactions, although this would affect few issues backed by impaired assets. Basel II's adoption could also encourage a shift in assets favoured for securitisation from residential mortgages towards loans to unrated corporate borrowers and commercial mortgages.

This paper's three proposals demand extensive cooperation among participating countries. In each case, the need for agreement upon minimum standards and therein achieve a high degree of harmonisation make it essential that both structure and requirements for use be kept as simple as possible. These proposals contain no suggestions as to issuance in composite or basket currencies: it is assumed that issuance will be in local and major currencies to match investor demand and to contain transaction costs.

Asia needs effective markets rather than passive accumulations of financial assets, and will benefit from a viable alternative to the banking sector, sufficiently transparent and liquid to provide a useful price signalling mechanism. Governments must agree to cooperate in best practices for legislative or regulatory change, and adopt new proposals that are supportive to market users, particularly institutional investors, wherever possible avoiding duplication in the creation of supporting market systems and financial architecture. They must also demand and encourage improvements in risk appraisal, financial disclosure and standards of corporate governance.

Active markets will not exist in Asia without cooperative government engagement in reform, and unless government's commitment is at all times market orientated.⁸⁵

⁸⁴ Direct public Asian SME bond issuance will remain largely infeasible for the medium-term. However, the relaxation by US administrative and judicial interpretation after 1987 of Glass-Steagall legislation, allowing commercial banks to underwrite corporate securities led initially to those banks arranging a disproportionate number of smaller issues for lesser risks and SMEs (Gande, Puri, Saunders & Walker, 1997). This was doubtless due partly to the competitive power of investment banks but may also signify the value to SMEs of their known lenders developing capital market product skills: the reform generally improved SME funding. Findings from Europe suggest that distribution skills are critical to 'local' banks retaining new issue market share against competition from global investment or universal banks (Santos & Tsatsaronis, *op cit*). See remarks in Lejot, Arner, Liu, Chan & Mays (*op cit* p11).

⁸⁵ 'Hypothetical history, which explains the past by what is simplest and commonest in the present, is in banking, as in most things, quite untrue. The real history is very different. New wants are mostly supplied by adaptation, not by creation or foundation. Something having been created to satisfy an extreme want, it is used to satisfy less pressing wants, or to supply additional conveniences.' (Bagehot, 1873, ch3).

3. Market Features and Impediments

This section indicates the more important attributes of Asia's bond markets, identifying their principal features and those that most require reform. It contains a table in ten parts illustrating conditions and activity in both domestic markets and for aspects of offshore issuance and trading, and isolates concerns to which attention is needed in the ways identified in the first proposal of section 2.⁸⁶ No attempt is made to extend beyond the key points: descriptive comprehensiveness is ephemeral and subject to continual coverage by private sector sources. The factors cited in the table also address questions arising for non-bank institutional investors in assessing any developing market.

A recurring concern is the effect on general liquidity and price transparency of government securities (and in some cases other instruments) being held by the domestic banking sector as part of an overt or indirect regulatory regime. Other common issues include:

- The scale of domestic markets in terms of available debt instruments. How freely do these securities trade and with what degree of liquidity?⁸⁷ Measures of turnover may be unreliable in unsophisticated markets but outstanding capitalisation can never be the sole criterion by which a market is assessed.
- Regulatory restrictions on issuance and external constraints on investor activity.
- How withholding taxes apply to bonds and money market instruments. Do these and other taxes differ in their impact on types of instrument or classes of investor, domestic or foreign? Are banks (domestic or offshore) or foreign investors able to lessen or offset the incidence of withholding taxes?
- The impact of exchange controls on cross-border investors and fundraising. Are there differences between the legal and practical incidence of exchange controls?
- Do domestic dealing and settlement processes differ between debt instruments? Are domestic and foreign investors offered clear unitary settlement models using delivery against payment and for custody?
- How secure and actionable is the sale of financial assets, transfer of creditor claims or of associated collateral between unconnected parties? Do taxes or duties affect such transfers so as to threaten the integrity of conventional structured finance transactions, including those for NPLs?
- Path dependence exists in the institutional development of all markets, for example, in the way

⁸⁶ p6 et seq. (*supra*).

⁸⁷ Measures of liquidity are uncontroversial but never absolute. For example, dealing (bid-offer) spreads can faithfully show competitive liquidity only if convention requires continual market-making. Relative turnover and the effect of single trades on prevailing prices are helpful indicators for less-developed markets but are clearly subjective. The most comprehensive survey of East Asian liquidity is by Mohanty (*op cit*) but covers only government securities.

that the treatment of property rights affects asset-backed securities. Rights created recently in law to facilitate privatisation programmes may not be fully appropriate for reliable ABS issues.

- Legal impediments concentrate on areas most affecting investor confidence and the structuring of ABS transactions or programmes. Circumventing these problems with complex (or synthetic) ABS transactions is not a sufficient solution.
- The quality and reliability of mandatory issuer disclosure requirements.
- The availability and price transparency of interest rate swaps and other important OTC or exchange traded derivatives and hedging products.

In the table that follows:

- References are to domestic markets for local currency debt securities unless stated. 'Outstanding market capitalisation' is as at 30 September 2003; 'net issuance' is for the 12 months to 31 December 2002 (BIS and Bank Indonesia data).
- 'Recognised domestic public issues' are those completed in 2003 and disclosed to Dealogic's Bondware database. They represent a reliable transaction-based guide to the scale of non-government sector domestic currency public issues arranged by banks and securities houses. For Hong Kong and Singapore they include a significant proportion of issues by foreign entities.
- Credit ratings are shown as at 30 April 2004.
- Legal issues include general problems and specific concerns hindering securitised transactions, notably the feasibility of true sales and creation of bankruptcy remote vehicles, risks of set-off, whether the sale of receivables is treated as secured lending to an asset originator, and matters of notice or registration that materially lessen the feasibility or simplicity of any such transaction.
- 'ADBI index' refers to HSBC's Asian dollar bond index. On 30 April 2004 this comprised 111 fixed rate US dollar denominated international issues each of US\$250 million or more with at least 12 months' remaining tenor, of which 110 were from ultimate obligors domiciled in the review countries. Of those 110 bonds, 52 per cent were regarded as liquid, 39 per cent as tradable and 9 per cent as illiquid. There are currently few outstanding non-US dollar international fixed rate Asian issues (and very few liquid floating rate issues in any currency). The 100 bonds forming the non-illiquid part of the ADBI index may be taken to be the universe of East Asia's tradable fixed rate international debt issues.
- 'Trading, settlement and custody' examines transparency for users, the degree of mandatory settlement centralisation, whether dealing or settlement is fractured by being subject to choice, variations in settlement days, the reliability of delivery against payment procedures (if extant), and systemic links between settlement and payments.

- Derivatives and bond financing is a category indicating the domestic market's product capabilities. Not considered here are offshore derivatives (mainly interest rate products) based upon non-deliverable forward contracts, intended to mimic domestic instruments that are non-existent, illiquid or unavailable to foreign counterparties. Regulators commonly prohibit some or all domestic market participants from using such OTC products in their home currency, despite their being freely traded offshore.

Table 3.1 China debt market characteristics

Substantial government and state sector issuance. Negligible trading activity. Directional, allocated market with centrally determined interest rates. Reform of all kinds under close official scrutiny. Modest illiquid foreign currency issuance (hampered by credit concerns and post 1997 defaults).

Instruments in issue	Central government issues fixed and floating rate treasury bonds and sanctions financial institution bonds on a similar scale (and state enterprise bonds in smaller amounts) most of which are bought by commercial banks for liquidity requirements. A growing non-bank financial institutional sector has a lesser passive investment role. Modest secondary dealing split between the Shanghai or Shenzhen exchanges and an interbank market: the untraded yuan bond market is thus substantial. Primary sales have been made by auction since 2002-03 but the process is closed and only part of the state's issuance plans is typically declared. Scheduled or pre-announced auctions have been cancelled at short notice. Bonds are placed or bought by direction, so the market lacks infrastructure for information purposes, open regulation, trading and settlement.
Absolute size	Outstanding market capitalisation US\$479.8bn (of which 51 per cent represents central government issues). Net issuance 2002 US\$61.8bn. US\$75.9bn treasury bonds (gross) reported issued in 2003 (2002: US\$71.6bn). Recognised domestic public issues 2003: Nil. No. of ADBI index tradable constituents: 8.
Main legal omissions	Historically, property and securities law are not comprehensive and subject to administrative rulings. New contract (1999) and trust laws (2001) provide for true sale and allow single transactions, but property rights, effectiveness of transfer, and the creation of bankruptcy remote vehicles for ABS issues require further reform and refinement (hence offshore ABS structures have been preferred to date). Quantitative constraints on corporate issuers now prevent the use of onshore SPVs for structured transactions. Enforcement uncertainties are common and may vary between provinces. Four asset management companies were set up after 1997 to dispose of bank impaired assets: foreign participation in such sales has been minimal despite great interest, partly due to pending legal and regulatory uncertainties. These problems are acknowledged by government and its main regulators.

/ (continued)

Table 3.1 China debt market characteristics (continued)

Taxation questions	Withholding taxes on interest payable offshore and to domestic non-bank investors.
Rating agencies	None. Under regulatory study.
Long-term credit ratings	BBB+/Not rated (S&P domestic currency sovereign bond rating). A2 (Moody's domestic currency ceiling). BBB+/A2 (S&P & Moody's foreign currency sovereign bond ratings).
Securitisation	Since 2003 several domestic or foreign currency issues completed using NPLs but only with full or partial recourse to the asset seller, or enhanced with well-performing assets. China Banking Regulatory Commission (CBRC) is said to be drafting ABS regulations. Many more transactions planned or announced.
Derivatives & bond financing	Bond repurchases allowed since 2003. Draft derivative regulations issued by CBRC in 2004 clarify counterparties for onshore foreign currency trades. Not yet known what yuan products will be permitted, nor who may use derivatives and for what purposes.
Trading, settlement & custody	No mandatory central securities depository. Limited provision for delivery against payment settlement. Trading days vary between instruments, and if bonds are listed.
Announced reform	World Trade Organisation commitments suggest liberalisation will occur but many reforms are political. China's State Council gave a commitment to debt market reform in early 2004. Many reforms have been mooted or announced for markets and to deal with NPLs. Approval for non-bank money market funds was announced in 2003, which could assist liquidity. It is likely that government issuance will become market-orientated in stages, allowing interest rates to cease being centrally determined.
Regulatory issues	Unclear division of responsibilities among securities, banking and insurance regulators, and historically between the central bank, finance ministry and National Development and Reform Commission. There is strong recognition of the need for regulatory clarity among all central authorities. Offshore borrowing and investment is tightly controlled.

Table 3.2 Hong Kong debt market characteristics

Sophisticated, potentially substantial but underused market. Non-bank investors often lack confidence.

Instruments in issue	<p>Government has issued debt sporadically. The Hong Kong Monetary Authority regularly issues Exchange Fund notes (12 months or less) and bonds (10 years or less), the main use for which is as liquidity regulation instruments through a discount window, and to provide the private debt market with a benchmark yield curve. Open auction used for these quasi-government securities with a declared issuance programme. The amounts in issue have traditionally been limited by Hong Kong's quasi-currency board structure but this restriction could be overcome if agreed. Statutory bodies issue medium-term bonds regularly but never prolifically.</p> <p>In each case, secondary markets can be liquid, but conducted largely by banks: non-bank institutional investors have little continual access to paper. Non-government sector bonds follow eurobond market issue and trading practice: issuers are mainly supranational organisations (for tax reasons), banks in Hong Kong. Local and foreign corporates are far less active. A liquid market for commercial paper existed in the early 1990s until crowded out by the Exchange Fund notes. Hub for medium-term note (MTN) issuance based on semi-liquid derivatives market. Retail targeted debt issues popular since 2002 due to low nominal interest rates. Since 1997, government agency Hong Kong Mortgage Corporation encourages banks to securitise residential mortgage loans and is itself an issuer in local and core currencies. Sporadic core currency public issuance by major corporates.</p>
Absolute size	<p>Outstanding market capitalisation US\$45.5bn (of which 34 per cent represents government issues).</p> <p>Net issuance 2002 US\$1.7bn.</p> <p>Recognised domestic public issues 2003: US\$12.4bn (512). Excludes unlisted MTNs.</p> <p>No of ADBI index tradable constituents: 21.</p>
Main legal omissions	<p>Common law framework generally amenable to securities markets.</p> <p>Delayed reform of law on administration and bankruptcy.</p> <p>Listing rules may deter non-Chinese foreign companies.</p>
Taxation questions	<p>No withholding taxes but corporate debt issues costs are treated unequally for profits tax purposes compared to banks, public sector and supranational issuers: this has historically deterred both local and foreign corporate issuance. Non-bank traders and investors may be similarly disfavoured, although this anomaly was lessened in 2003.</p>
Rating agencies	<p>None. International agencies active.</p>
Long-term credit ratings	<p>AA-/Aa3 (S&P & Moody's domestic currency sovereign bond rating).</p> <p>Aa1 (Moody's domestic currency ceiling).</p> <p>A+/A1 (S&P & Moody's foreign currency sovereign bond ratings).</p>
Securitisation	<p>No substantial omissions or anomalies.</p>
Derivatives & bond financing	<p>OTC hedging instruments (especially interest rate swaps and options) are well traded. The exchange based market in interest rate products is more limited.</p>
Trading, settlement & custody	<p>Integrated, well established systems and bridges to overseas clearing houses. Central securities depository is linked to payments system for HK and US dollar securities.</p>
Announced reform	<p>Approval for real estate investment trusts (REITS) and retail orientated debt issues has yet to take full market effect.</p>
Regulatory issues	<p>Issuer disclosure and reporting is a concern for many investors. Unclear relationship between securities regulators.</p>

Table 3.3 India debt market characteristics

Structurally flawed market with substantial government issuance. Investable assets are scarce, especially for non-bank investors. Generally highly regulated. Reform is desired but slow in implementation.

Instruments in issue	Market dominated by government sector (central and government and public corporations) as issuers; banks (and the central bank) as investors. Government sector needs reform to consolidate debt issues. No fully open auction or declared issuance programme for government primary issues (but short-term issues are announced semi-annually). Little general liquidity in government issues due to liquidity requirements and historic legal constraints on issuance. Central government auctions treasury bills (up to 12 months), and notes of up to 10 years; state government securities can be similar. Central and state governments also guarantee bonds (up to 15 years) to assist infrastructural financing. Corporate bonds and commercial paper are bought by banks and (bonds) to a limited extent by domestic retail investors. In a first rupee issue for a foreign borrower in February 2004, the ADB raised US\$110m equivalent in 10 year notes, 60 per cent bought by commercial banks, the remainder by non-bank institutions. Foreign borrowing and outward investment very closely regulated.
Absolute size	Outstanding market capitalisation US\$192.5bn (of which 99 per cent represents government issues). Net issuance 2002 US\$24.9bn. Recognised domestic public issues 2003: US\$4.6bn (129). No of ADBI index tradable constituents: 2.
Main legal omissions	The transfer of receivables is valid but real property rights may be constrained or subject to delay in transfer. Limits to foreign ownership of domestic companies.
Taxation questions	Withholding tax is typically 20 per cent of interest due to non-resident investors. A tax treaty with Mauritius has been used by non-resident Indians and domestic borrowers to eliminate withholdings. Government has sought unsuccessfully to impose capital gains taxes in lieu of withholdings taxes. Stamp duty applies to CDs which limits money market trading. <i>Ad valorem</i> stamp duties apply to the transfer of receivables.
Rating agencies	Listed corporate issues must be rated (at investment grade) by two local agencies.
Long-term credit ratings	BB+Ba2 (S&P & Moody's domestic currency sovereign bond rating). Aa3 (Moody's domestic currency ceiling). BB/Baa3 (S&P & Moody's foreign currency sovereign bond ratings).
Securitisation	Recently enacted securitisation law, not yet tested.
Derivatives & bond financing	Restrictions on short sales, bond futures and bond options. Negotiated, semi-liquid OTC interest rate derivative market.
Trading, settlement & custody	No central securities depository for all instruments. Central government issues settle through an automated system operated by the central bank, which also acts as a depository. Limited provision for delivery against payment settlement. Settlement trading days vary by instrument. Physical delivery persists in some cases.
Announced reform	Securitisation, related issues of taxation and stamp duty have been under discussion since 1999. Existing offshore borrowing controls were tightened in November 2003 to encourage domestic borrowing.
Regulatory issues	There is no unambiguous regulation of debt securities issuance. Bank liquidity requirements are comparatively high, which depresses market liquidity.

Table 3.4 Indonesia debt market characteristics

Modest market that grew after the Asian crisis due to government funding needs connected to banking sector recapitalisation. Limited corporate debt market.

Instruments available	<p>Money markets are liquid and well established, with government and public sector bills and commercial paper held or traded prior to the Asian crisis, mainly due to central bank issuing short-term notes (SBIs) for funding and liquidity management, and state companies borrowing for longer periods. Commercial bank demand for SBIs is governed by regulatory requirements. Several very large medium-term government debt issues arranged after 1998-99, mainly to support the recapitalisation of the public sector and newly nationalised banking sector. Currently, an open auction exists for new government securities but there is no issuance programme or guidance: a firm institutional framework for issuance is lacking. Legislation enacted in 2002 is intended to give a formal setting for government issuance, and will be tested when the outstanding post-1999 transactions are refunded.</p> <p>Medium-term corporate debt issues have begun to increase in number since 2001-02, following legislation encouraging mutual fund investment in debt securities.</p>
Absolute size	<p>Outstanding market capitalisation US\$5.4bn. Recognised domestic public issues 2003: US\$2.7bn (52). No of ADBI index tradable constituents: 3.</p>
Main legal omissions	<p>Legal system is less accommodative to market-based securities than Asian common law systems, and may require comprehensive legislation of the kind introduced by Korea after the Asian crisis. There is uncertainty in the enforcement of foreign and domestic judgements, and in the acceptance by the courts of the choice of foreign law for contracts or collateral deeds. Current receivables may be transferred by assignment but there are doubts as to necessary notices and consents. Law permitting ABS issues was enacted in 1997 but domestic SPVs cannot issue without a trading record. Law allowing the transfer of receivables to an onshore vehicle passed in 1998. Unclear that courts respect contractual priorities among secured creditors in restructuring, but secured creditors have retained rights over collateral. Further uncertainty exists in respect of new bankruptcy law.</p>
Taxation questions	<p>Withholding tax applies to interest from debt securities but with differing domestic and foreign exemptions. Foreign investors may be subject to taxes on capital gains. A limited number of tax treaties only lessen minimum effective rates of deduction. Stamp duty applies to the transfer of collateral assets (this has led to unnecessarily complex structures to create reliable ABS issues).</p>
Rating agencies	<p>Ratings are mandatory for public corporate issues. The established rating agency has ties to a sister agency in Malaysia and technical assistance agreement with an international agency.</p>
Long-term credit ratings	<p>B+/B2 (S&P & Moody's domestic currency sovereign bond rating). Ba1 (Moody's domestic currency ceiling). B/B2 (S&P & Moody's foreign currency sovereign bond ratings).</p>
Securitisation	<p>Handful of single transactions since 1996-97 supported by foreign monoline cover. Legal framework for onshore transactions in need of correction (except those using credit card receivables). Acute enforcement problems have made conventional ABS expansion hazardous for domestic investors and almost impossible for offshore transactions.</p>
Derivatives & bond financing	<p>Securities financing and short sales permitted but little used. No onshore market in interest rate swaps; no exchange traded interest rate contracts.</p>
Trading, settlement & custody	<p>Use of central securities depository is not mandatory for all instruments. Limited delivery against payment settlement. Settlement trading days vary.</p>
Announced reform	<p>General intention to support capital market reform with further legislation. Rules announced in 2003 for more comprehensive disclosure by issuers. General intention to create a new unified regulatory authority.</p>

Table 3.5 Korea debt market characteristics

Sizeable market made resourceful and sophisticated since 1999 by considerable legal and regulatory innovation. High corporate and ABS issuance. Risks of systemic volatility may threaten usage.

Instruments available	Market size and activity overstated before 1998, since when reforms have fed growth in government, corporate and ABS volumes and usage, much of the expansion assisting post-crisis financial reconstruction. Government issues traditionally account for a relatively small share of total market capitalisation. Despite the scale of the overall market, non-bank investors often find acceptable instruments scarce, in part because Korea has a comparatively large insurance sector. Central government issues several security types (including treasury, monetary stabilisation and foreign exchange stabilisation bonds) in maturities of up to 10 years, and historically guaranteed other public sector borrowers, producing an unnecessarily fractured market and benchmark yield curve. Coupled with bank regulatory requirements, such fragmentation greatly lessening liquidity. Open auction for government securities and declared issuance programme. ABS growth sourced successively from banks, finance companies and corporates. Foreign issuers not generally permitted despite the Won market's size. Overseas core currency issuance by Korean borrowers is sizeable and generally well-traded.
Absolute size	Outstanding market capitalisation US\$432.1bn (of which 26 per cent represented by government issues). Net issuance 2002 US\$53.5bn. Recognised domestic public issues 2003: US\$38.1bn (631). No of ADBI index tradable constituents: 26.
Main legal omissions	Korea appears a model for successful civil law financial reform but long-term impact on activity cannot yet be judged. Strong controls remain on all Korean issuers and largely prohibit non-Korean Won issues. Despite ABS growth it is unclear whether originators may service loans, but this has not been disputed. True sales are allowed under ABS legislation but SPVs are often placed offshore to safeguard true sales.
Taxation questions	General 25 per cent withholding tax on interest. Banks actively use foreign tax treaties.
Rating agencies	Three agencies, each with an international link. Ratings mandatory for public issues.
Long-term credit ratings	A+/A3 (S&P & Moody's domestic currency sovereign bond rating). Aa3 (Moody's domestic currency ceiling). A-/A3 (S&P & Moody's foreign currency sovereign bond ratings).
Securitisation	New laws in 1998-99 permit ABS and mortgage-backed issues by help create a simple means of transfer and public notification. As a result the government's NPL recycling body (KAMCO) has been highly effective since 2000 in assisting the financial and corporate sectors in disposing of impaired and restructured assets, financed with ABS issues. All KAMCO assets were acquired with recourse. Overseas ABS issues have been generally successful, relying on monoline credit wrap support becoming more freely available with Korea's credit rating recovery after 1998. Primary (non-synthetic) CLOs and MBS issues successfully completed since 1999-2000.
Derivatives & bond financing	Limits on bond repurchases. Interest rate and currency derivatives generally permitted and the domestic swap market has been encouraged recently by the authorities. Domestic investor demand likely to increase the use of structured products.
Trading, settlement & custody	Centralised settlement and custody but not mandatory. Delivery against payment settlement since 1999 but not universal.
Announced reform	Separation of ownership and financing.
Regulatory issues	The regulatory environment developed since the Asian crisis has clear divisions of roles but future reform may concentrate on questions of corporate disclosure and reporting. As a primary CLO market expands (probably based upon SME loans and finance company receivables) then the regulatory treatment of interest rate and credit derivatives will need clarification and be made consistent with capital regulation. Unclear also that all public intervention has been market-driven, for example, in 2001 state bodies were encouraged to assist in engineering a recovery in the market for corporate bonds.

Table 3.6 Malaysia debt market characteristics

Effective but under-used market, the product of significant systemic innovations.

Instruments available	Despite improvements in systems and a long history of market initiatives, Malaysia's domestic bond markets suffer illiquidity and a lack of issuer usage. Government and public sector instruments take many forms, while the core of outstanding central government issues is compulsorily acquired and held by public sector provident funds. Government issues securities directly (with open auctions and a declared issuance programme) and through the central bank, and include guaranteed Islamic notes of up to 10 years. Liquidity requirements for financial institutions further constrain trading in Government of Malaysia treasury bills and bonds. The government has long recognised the problem, and caused federal agencies to issue securities that domestic investors would regard as government risk: Cagamas founded in 1986 as a national mortgage agency, and Khazanah Nasional, a state investment company since 1993 that issues state guaranteed notes that serve to provide a benchmark zero coupon yield curve. Market innovation is healthy and money market activity is liquid. The corporate debt market is effective but modest (there is a history of bank-guaranteed corporate issues). Foreign investors have also been deterred by capital controls (1998-2000). Bar to issuance by foreign borrowers.
Absolute size	Outstanding market capitalisation US\$92.5bn (41 per cent government issues). Net issuance 2002 US\$0.4n. Recognised domestic public issues 2003: US\$1.7bn (14). No of ADBI index tradable constituents: 14.
Main legal omissions	The legal framework generally does not hinder market development but post-crisis enforcement has been questioned.
Taxation questions	15-20% withholding tax imposed on investments for all non-bank investors, but some instruments are tax exempt, including Government treasury bills, zero coupon bonds and identified rated corporate bonds. Investors often use a Labuan conduit to avoid or lessen domestic taxes (Labuan investors generally buy domestic instruments free of tax).
Rating agencies	Two private domestic agencies have external ties to the ADB and Standard & Poor's Corp. Ratings mandatory for all public issues.
Long-term credit ratings	A+/A3 (S&P & Moody's domestic currency sovereign bond rating). Aa2 (Moody's domestic currency ceiling). A-/Baa1 (S&P & Moody's foreign currency sovereign bond ratings).
Securitisation	Cagamas issues pass-through securities to fund mortgage purchases. Two public entities (Danaharta Nasional and Danamodal Nasional) were established after the Asian crisis, respectively to acquire and recycle NPLs, and to assist bank re-capitalisation. 1999 securitisation guidelines led to a new law governing ABS issues in 2001 but this has been little used, perhaps due to regulatory caution as to the originator's control or influence over a new SPV.
Derivatives & bond financing	Bond repurchases permitted. Short selling and securities lending barred. Bond options market permitted from 2004. Semi-liquid onshore market in interest rate swaps. Onshore synthetic instruments and credit derivatives are growing but may become subject to new central bank regulation.
Trading, settlement & custody	Central settlement and depositary mandatory for government, Cagamas and Khazanah bonds, but feasible for all listed debt securities, as is delivery against payment settlement. Settlement trading days may vary.
Announced reform	A 'master plan' for reform adopted in 2001 aims to improve the use and functioning of all capital markets by 2010. Most of the systemic reforms are in place. Regulatory changes affecting banks and investors being are progressively introduced, including greater freedom for state provident funds: this may eventually cause market activity to expand to its potential.

Table 3.7 Philippines debt market characteristics

Financial sector dominated by government funding needs and a strong banking sector. No traditional of non-governmental debt issuance except in money market instruments.

Instruments available	Government issues dominate the debt and money markets. Recurrent public sector fiscal deficits have led to heavy government issuance. Government auctions notes and bills, and has issued up to 25 year bonds through underwritten transactions, but most have tenors of up to 1-3 years. Except in short-term bills, liquidity is slight as most issues are held to maturity. Liquidity in government bond markets heavily constrained by bank liquidity requirements. Open auction for government securities through a relatively large group of primary dealers but there is no declared issuance programme, and retail issue methods are ineffectual. Structural weaknesses in the long-term domestic debt market have historically made the state equally dependent on foreign currency debt. There is no tradition of domestic corporate debt other than in very short maturities. No real attempt to create a long-term market, although pending ABS legislation may lead to constructive change. Credit concerns prevent the development of a market for public sector risk similar to the US municipal bond market despite announced intentions. Government sector foreign borrowing erratic and coloured by rescheduling history since 1980s, but foreign borrowing has been essential due to domestic market shortcomings.
Absolute size	Outstanding market capitalisation US\$25.3bn (96 per cent government issues). Net issuance 2002 US\$0.9bn. Recognised domestic public issues 2003: Nil. No of ADBI index tradable constituents: 16.
Main legal omissions	Several efforts since the 1990s to enact securities, regulatory and financial sector reform have suffered extensive political delay. Securitisation impossible despite central bank having introduced transaction guidelines in 1998. A new enabling act currently awaits presidential ratification. True sale may be treated as a secured loan to a seller of assets. Unclear how courts treat contractual and other priorities among secured creditors and with unsecured creditors. Controversy as to court enforcement of regulatory compliance matters.
Taxation questions	Stamp duty levied on trades in non-government securities. The withholding tax regime is complex and deters inward portfolio investment.
Rating agencies	Domestic agency concerned mainly with short-term corporate commercial paper.
Long-term credit ratings	BBB/Ba2 (S&P & Moody's domestic currency sovereign bond rating). A1 (Moody's domestic currency ceiling). BB/Ba2 (S&P & Moody's foreign currency sovereign bond ratings).
Securitisation	Guidelines 1998. Never effective. Most announced offshore transactions have never been completed, often due to contractual or legal problems.
Derivatives & bond financing	Bond and note repurchases subject to capital charge. Foreign banks trade money market based OTC derivatives.
Trading, settlement & custody	Generally fragmented. Use of central securities depositary is not mandatory for all instruments. No delivery against payment settlement. It is common for securities to be transferred by serial assignment to avoid stamp duties, making ownership unreliable. Settlement trading days varies. Certain settlement rules for government securities are inconsistent (for example, same day settlement conflicts with transfer mechanism).
Announced reform	Securitisation act became law in March 2004 but is untested.
Regulatory issues	Financial sector legal and administrative reform have been characterised by delay. No clear regulatory regime for debt securities. All securitisation, corporate issuance and foreign borrowing is tightly controlled, needing central bank approval.

Table 3.8 Singapore debt market characteristics

Post-1998 policy changes led to a considerable increase in all market activity; this has not been sustained. New applications and greater foreign interest may be needed. Highly effective systems.

Instruments available	Money markets have been liquid for some years but the medium-term debt market was shallow and illiquid until 1999 (except for equity-linked issues favoured by local corporates). Government debt was modest and simply absorbed in the state-sponsored provident fund. In a series of 1998-99 reforms, government began an appreciable increase in bond issuance and secondary activity with an enlarged government debt programme, the relaxation of controls on foreign issuers and with targeted incentives to participants. Central government overfunding produced a substantial growth in outstanding (tradable) government bonds, raising liquidity and giving an effective term benchmark yield curve for the first time, and encouraged domestic and foreign corporate new issues, some of which have been sizeable. Foreign issuance has been more diverse than in Hong Kong. Open auction for government securities. Declared 12 months issuance programme but subject to variation. Foreign issuance encouraged, although there are restrictions on the use of proceeds. The market has strongly supported commercial property securitisations and bank regulatory capital transactions. However, market growth has now stalled and may need to be stimulated with further more modest reform: for example, foreign (especially regional) participation could be encouraged. Singapore could become a source of regulatory capital for ASEAN banks. The domestic market would be further helped by new instruments (CLOs) to assist SME finance and adjustments to the working of the mandatory provident scheme.
Absolute size	Outstanding market capitalisation US\$56.4bn (63 per cent government issues). Net issuance 2002 US\$0.6bn. Recognised domestic public issues 2003: US\$3.6bn (58). No of ADBI index tradable constituents: 6.
Main legal omissions	Singapore's common law framework is generally amenable to securities markets.
Taxation questions	Offshore withholding tax exemption on 'qualified debt securities'
Rating agencies	None. International agencies active.
Long-term credit ratings	AAA/Aaa (S&P & Moody's domestic currency sovereign bond rating). Aaa (Moody's domestic currency ceiling). AAA/Aaa (S&P & Moody's foreign currency sovereign bond ratings).
Securitisation	Central bank maintains comprehensive regulatory guidelines. Commercial property securitisation popular since 1998.
Derivatives & bond financing	Free use except securities lending. Strong exchange traded derivatives. Local interest rate swap market not consistently liquid (which dissuades foreign issuers) but has received central bank support.
Trading, settlement & custody	Effective central securities depository linked to domestic payments system.
Announced reform	Further changes to listing and corporate disclosure rules.
Regulatory issues	Restrictions on the overseas use of Singapore dollars and on domestic fundraising by foreign financial institutions.

Table 3.9 Taiwan debt market characteristics

Dominant domestic banking sector has led to a semi-active, closely regulated debt market with little true liquidity. Reform has now allowed ABS transactions but the speed of all such change is slow.

Instruments available	Highly regulated government debt market and the financial system is dominated by banks. Closed auction for government securities (since 1992). Issuance programme announced irregularly and at short notice. No reliable benchmark yield curve due to general lack of liquidity. Government bonds and notes important in bank and financial institution liquidity requirements; heavy emphasis on repurchase trading, partly for tax reasons. Government bonds issued in maturities of up to 20 years, a majority for either 5 or 10 years. For an open, active government market to grow and encourage a transparent corporate debt market, there may need to be changes in the focus and importance of the banking sector. A limited number of supranational borrowers have issued fixed rate bonds in the domestic market. Corporate fundraising orientated to banks and equity markets.
Absolute size	Outstanding market capitalisation US\$156.3bn (49 per cent government issues). Net issuance 2002 US\$15.7bn. Recognised domestic public issues 2003: US\$12.0bn (177).
Main legal omissions	No of ADBI index tradable constituents: Nil (overseas issues largely equity-linked). Non-equity markets have been undergoing deregulation at a slow rate for more than 10 years but the legal background needs reform for debt market activity to improve significantly. Securitisation legislation enacted in 2002 is the first such example: so far it is little used and may not be fully effective in tax implications and perfection of title. Legislation to allow real estate investment trusts was proposed in 1998 but not enacted.
Taxation questions	Transaction tax is a continuing deterrent to market growth. A punitive 20 per cent withholding tax and differentials in tax treatment distort trading activity and lessen active involvement by non-bank investors.
Rating agencies	Established domestic agency. Ratings are mandatory for public issues.
Long-term credit ratings	AA-/Aa3 (S&P & Moody's domestic currency sovereign bond rating). Aa3 (Moody's domestic currency ceiling). AA-/Aa3 (S&P & Moody's foreign currency sovereign bond ratings).
Securitisation	ABS provisions enacted in 2002. The law is little tested but may now be effective. Since April 2003, non-bank investors permitted to invest in listed ABS issues.
Derivatives & bond financing	Restrictions on securities lending, short sales, bond futures and bond options. Bond repurchases limited by transaction tax on corporate issues. Limited exchange traded products and illiquid OTC derivatives.
Trading, settlement & custody	Use of central securities depository is not mandatory for all instruments. Limited delivery against payment settlement. Settlement trading days varies.
Announced reform	ABS law became effective in 2003.
Regulatory issues	Full effects not yet seen of financial holding company legislation in 2001, separating bank shareholding in related companies from lending decisions. History of restrictions on portfolio inflows. Disclosure requirements needing attention. SEC must approve all domestic issues; offshore borrowing is tightly controlled.

Table 3.10 Thailand debt market characteristics

Expanding corporate debt market including active private placement issuance. Growing but irregular government and public sector issuance. All activity constrained by close regulatory control.

Instruments available	All issuance has grown markedly since the recovery from Asian crisis due to investor demand, disintermediation from banking sector and high state funding requirements and for bank recapitalisation. Irregular (but sizeable) government issuance except short-term instruments. Hence despite growing demand for government and corporate issues, there is no reliable benchmark yield curve and the corporate debt market has a bias to private issues and short maturities (3-5 years). Government issues or sponsors a variety of bills, bonds and public sector instruments that would benefit from consolidation. Open auction for government securities and issuance programme disclosed but not consistent other than for bills. Generally excess demand for government issues for liquidity purposes and from public sector provident schemes.
Absolute size	Outstanding market capitalisation US\$54.8bn (58 per cent government issues). Net issuance 2002 US\$10.5bn. Recognised domestic public issues 2003: US\$5.1bn (45). No of ADBI index tradable constituents: 4.
Main legal omissions	Weak rules covering corporate new issue disclosure and documentation, based largely on 1992 legislative framework that initiated a market regulatory environment. Provisions relating to transfer are unclear in some respects despite ABS legislation, including notice requirements and the unwinding of sales. Market confidence not assisted by the frequent use of decrees compared to changes in primary legislation. Uncertainty as to principles adopted by the central bankruptcy court in adjudicating settlements. Other aspects of enforcement have been unreliable. Effects of external capital controls on all offshore borrowing is tightly controlled.
Taxation questions	Withholding taxes on interest and imposts on asset transfer are generally complex, affecting confidence and investor costs. Withholdings on public sector issues will be waived under 2004 decrees and the waiver may be extended to a variety of issues to assist activity.
Rating agencies	Well-established agency has limited resources. Ratings mandatory for public issues since 2000.
Long-term credit ratings	A/Baa1 (S&P & Moody's domestic currency sovereign bond rating). A1 (Moody's domestic currency rating ceiling). BBB/Baa1 (S&P & Moody's foreign currency sovereign bond ratings).
Securitisation	Single ABS transactions completed since 1999 (using car loans, credit card receivables and mortgage loans) but all have been highly structured. 1997 ABS legislation allows onshore SPVs but is ambiguous as to notice requirements in transfer. Central agency created 1998 to recycle banking sector assets.
Derivatives & bond financing	Restrictions on short sales by non-banks. No exchange traded bond option or futures markets. Limited domestic market in interest rate swaps and other OTC hedging instruments.
Trading, settlement & custody	Use of central securities depository not mandatory for all instruments. Partial use of delivery against payment settlement.
Announced reform	Caution in all post-crisis reform has slowed development.
Regulatory issues	Foreign (initially supranational) issues to be permitted subject to ceilings 2004. Government has a promising outlook on reform but has yet to improve disclosure. Government bond consolidation is vital. Close informal control by finance ministry of most aspects of financial market activity, including transactional approvals and investment policy. Thai Bond Dealers' Centre is unusual in Asia as a self-regulatory organisation representing securities houses and regulating trading, but its core authority is unclear, and competition exists among other regulatory bodies. Controls on outward investment and portfolio inflows.

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Appendix. Illustrations relating to Proposal II

The following diagrams illustrate three simplified deal structures, in each case for clarity omitting banks and other parties that are non-discretionary intermediaries or execute pure transmission functions, and showing flows of funds at the time of initial and periodic payments. 'Investor' is ubiquitous, standing for all types of principal. Each form of issue may be listed on an exchange.

First, 'offshore' bond issues are similar to the model euromarket transaction of the 1970s. Regardless of listing or regulatory domiciles, all trades are settled outside the domicile of the issuer of risk. A domestic investor may freely buy or sell such issues subject to any local official or regulatory constraints, seen commonly when bonds are denominated in its home currency.

Figure 3. Offshore issue, initial payments

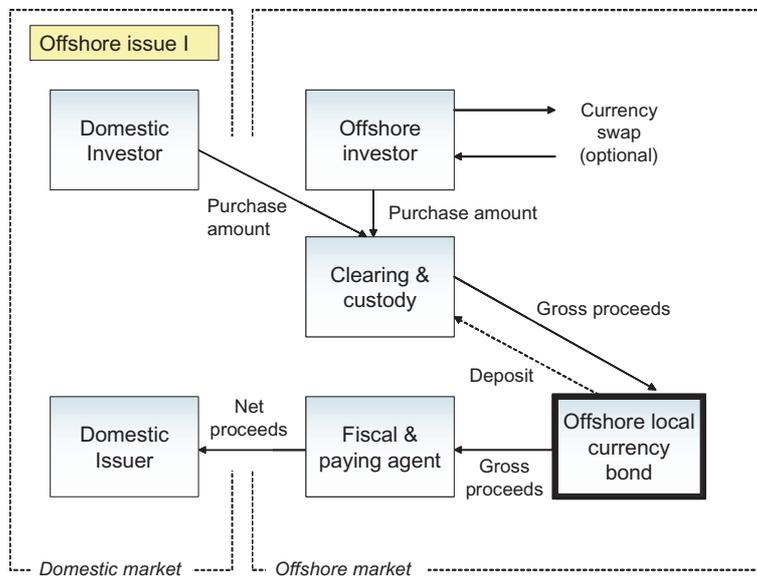
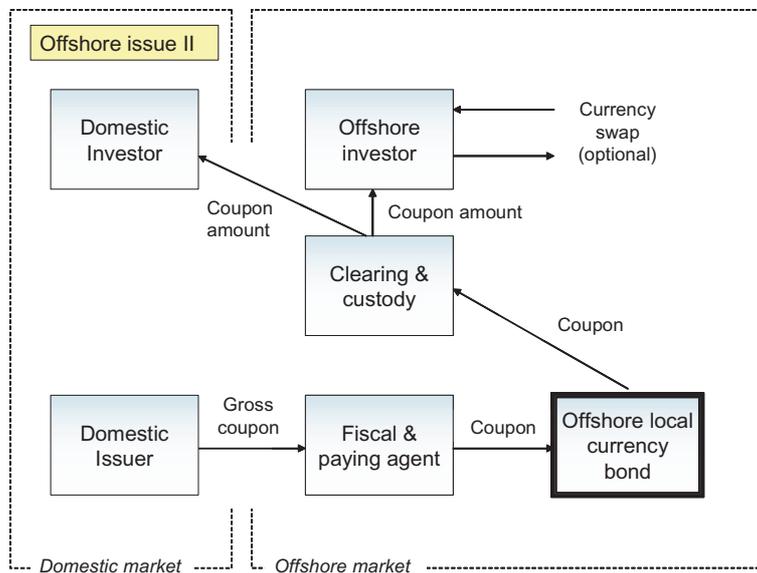


Figure 4. Offshore issue, periodic payments



Second, 'regional' issues represent the core of Proposal II, in which a regional hub becomes the transaction's primary place of settlement, probable listing and repository of information. In this case a domestic investor may elect to effect or settle a sale or purchase offshore, subject to local official or regulatory constraints.

Figure 5. Regional issue, initial payments

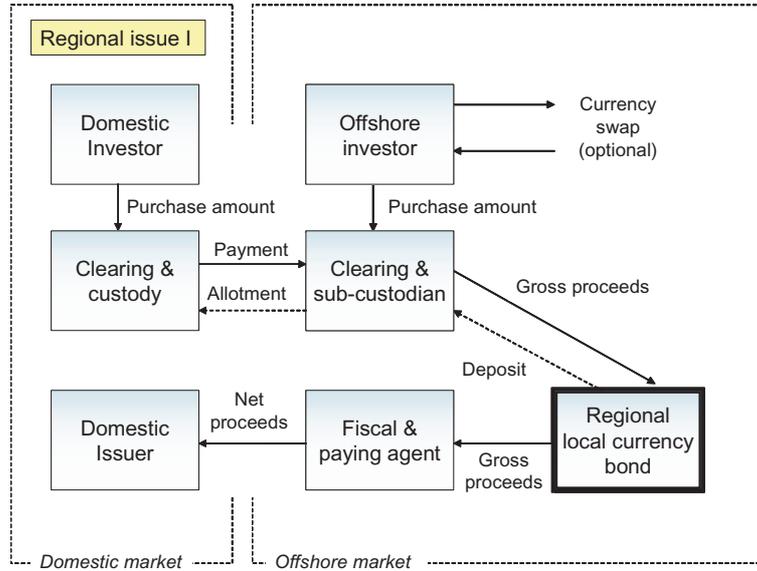
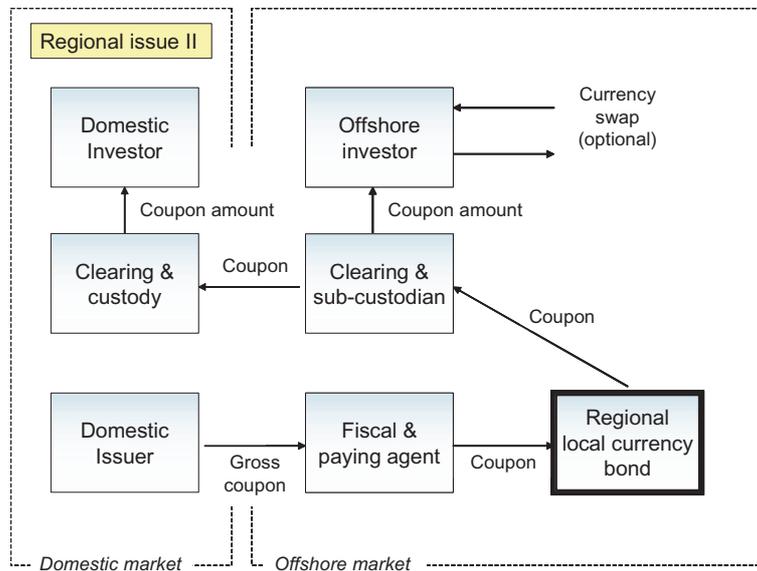


Figure 6. Regional issue, periodic payments



Last, the ‘domestic freely-traded’ issue is a model for those for which the primacy of a regional hub may be impractical or impolitic. This may be appropriate for domestic issue classes that exist today in considerable volume, most notably government and central bank notes or bonds, for which domestic settlement and other aspects of system architecture exist in most of the review economies, whether or not begging reform. The bridge to the regional hub is intended to promote information flows and encourage cross-border investment activity, and may later encourage the standardisation of dealing, settlement and custody.

Figure 7. Domestic freely-traded issue, initial payments

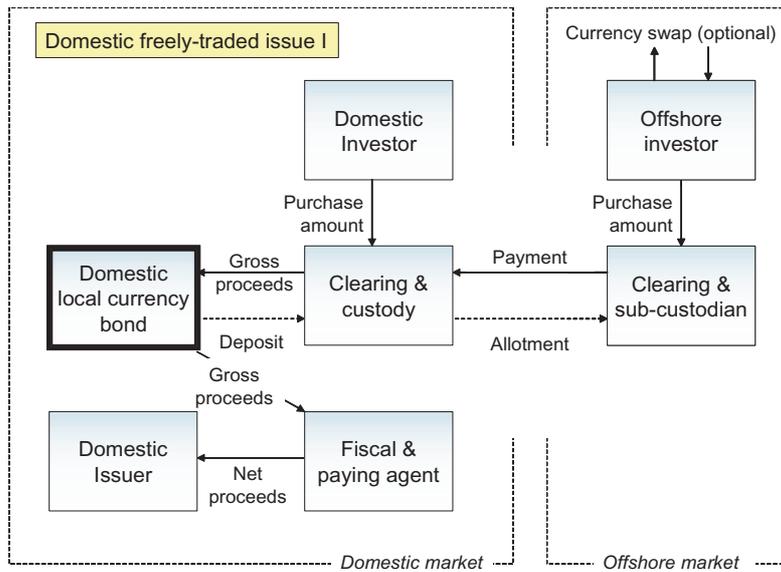


Figure 8. Domestic freely-traded issue, periodic payments

