Fostering the Development of an Asian Bond Market

Takayuki Urade

I. Background

The currency crisis of 1997 triggered a severe recession in East Asia. However, the region has since recovered, demonstrating just how robust its economic potential still is. In order to avoid another currency crisis, however, the countries of the region will have to rethink what is generally regarded as the root cause of the 1997 crisis—how best to raise the funds they need.

Before the crisis the commonest source of long-term funding (e.g., for property development), in the absence of well developed capital markets, was short-term foreign currency loans funded by local savings and recycled by local financial institutions via Western banks. The withdrawal of funds that followed the collapse of the Thai baht highlighted the double mismatch (of currency and maturity) that existed between the sources and applications of these funds, and made a bad situation even worse.

Once the crisis of 1997 was over, Japan proposed the creation of an Asian Monetary Fund (AMF) along the lines of the International Monetary Fund (IMF), but this was rejected not only by the IMF itself but also by the United States, which was concerned about losing its political and economic influence in the region, and by China, which did not want to let Japan take the initiative. A few years later, in 2000, Japan, China, South Korea and the 10 members of ASEAN (ASEAN+3) signed a currency swap agreement to enable a signatory experiencing difficulty in obtaining liquidities to receive emergency liquidities from other signatories.

However, this mechanism was only intended to deal with crises. More fundamental is the need for countries in the region to rethink how they obtain the funds they need so as to avoid such crises altogether. One of the proposals for achieving this and thereby ensuring that the economies of the region enjoy stable growth is to foster bond markets in Asia.

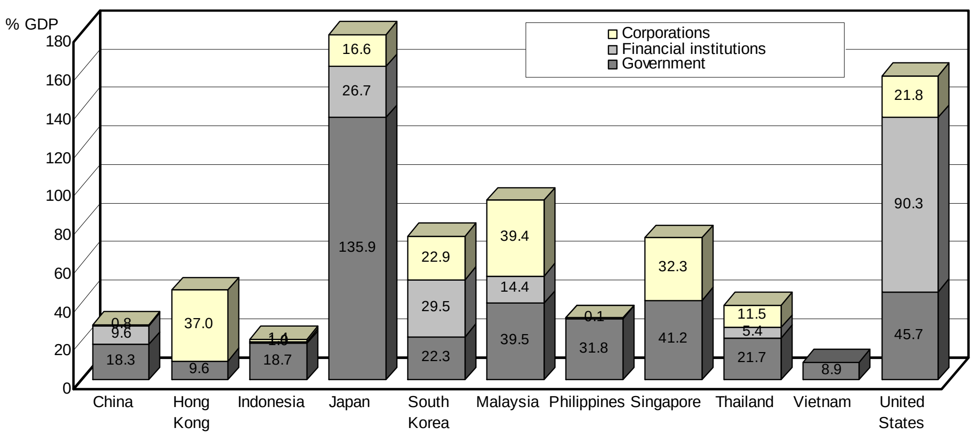
The various initiatives that have been taken towards this goal should be seen in this light. The idea of fostering national bond markets in the region was to help find a means of channeling the region's surplus savings into long-term local currency investments, while the idea of forming a regional bond market is an extension of this.

The need for developing bond markets was recognized even before the currency crisis of 1997 and was the subject of a number of studies (e.g., by the World Bank).[1] However, it took the crisis for these studies to be acted on within the framework of financial cooperation in the region.

This process saw countries such as the United States, themselves members of the Asia-Pacific Economic Cooperation (APEC) forum, voice their concern by calling for this organization to be more effective and the 13 ASEAN+3 countries vie for pole position within that forum. The debate has since taken many turns, with calls, for example, to do more to involve Australia, India and Islamic money. However, as we shall see below, the real debate has taken place as part of the Asian Bond Markets Initiative (ABMI), led by the finance ministers of ASEAN+3, and the Asian Bond Fund (ABF) initiative, led by the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP).

This report therefore describes the aims and activities of both ABMI and ABF to date, including the role of private-sector financial institutions, and likely future developments. At the end of the report readers will find an appendix summarizing the initiatives to date.

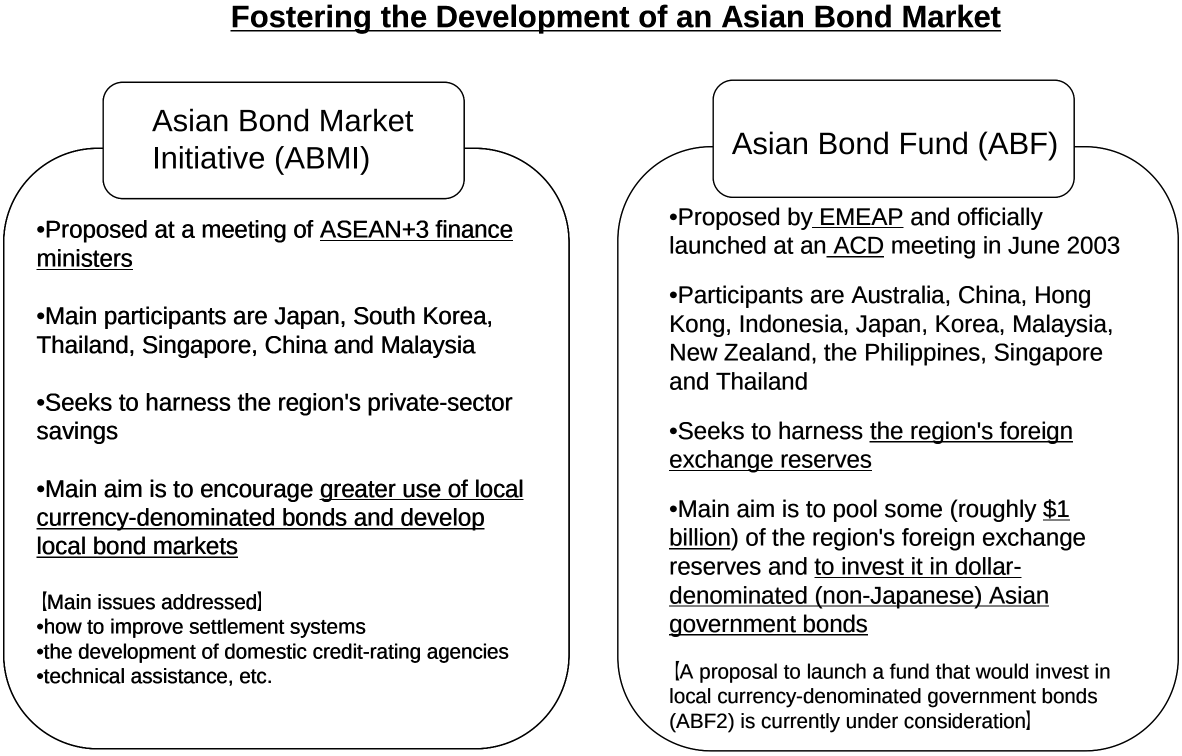
Figure 1 Outstanding Local Currency Bonds as a Percentage of GDP



Source: Asian Development Bank, Asian Bonds Online (http://asianbondsonline.adb.org).

[1] See, for example, World Bank, The Emerging Asian Bond Market, Vol. 1, 1995.

Figure 2 Comparison of Asian Bond Market Initiative (ABMI) and Asian Bond Fund (ABF)



Source: Ministry of Finance's website (http://www.mof.go.jp/jouhou/kokkin/ABMI-ABF.pdf).

II. Asian Bond Markets Initiative

1. Outline

As was mentioned earlier, ABMI was proposed at an unofficial meeting of ASEAN+3 in December 2002 as a means of channeling the region's surplus savings into medium- to long-term local currency investments.

The goals of ABMI were "to lay the foundations for bond markets in Asia that would enable private-sector businesses to issue bonds denominated in local currencies for channeling the region's savings into long-term fixed capital formation and investment" and "to create a liquid bond market that is convenient for both issuers and investors by ensuring that there is a proper infrastructure (e.g., with credit guarantees and credit rating agencies) and a large issuance in a wide range of maturities and currencies."[2] In order to ensure that these objectives are achieved, six working groups (Figure 3) were set up within the framework of the ASEAN+3 finance ministers meeting, where all the issues involved have been discussed and the opinions of

[2] See the Ministry of Finance's website at http://www.mof.go.jp/jouhou/kokkin/asia_initiative.htm

multilateral development banks (MDBs), government agencies, private-sector credit guarantee companies and market participants have been sought.

Figure 3 AMBI's Six Working Groups

Name of group		Chair
I	New securitized debt instruments	Thailand
II	Credit guarantee and investment mechanisms	South Korea, China
III	Foreign exchange transactions and settlement issues	Malaysia
IV	Issuance of bonds denominated in local currencies by multilateral development banks, foreign government agencies, and Asian multinational corporations	China
V	Rating systems	Singapore, Japan
VI	Technical assistance coordination	Indonesia(deputy chairs: Philippines, Malaysia)

Source: Ministry of Finance's website.

The issues listed in Figure 4 range from those that need to be addressed as soon as possible to medium- and longer-term issues, and the discussions have taken into account the situation in each country. Also, following the meeting of the ASEAN+3 finance ministers in May 2005 (in Istanbul), the number of working groups has been reduced to four.[3]

[3] (1) New securitized debt instruments (chair: Thailand), (2) credit guarantee and investment mechanisms (chair: Korea and China), (3) foreign exchange transactions and settlement issues (chair: Malaysia), and (4) rating systems for Asian bond markets (chair: Singapore and Japan). For further details see http://www.mof.go.jp/jouhou/kokkin/ABMI_road_map.pdf

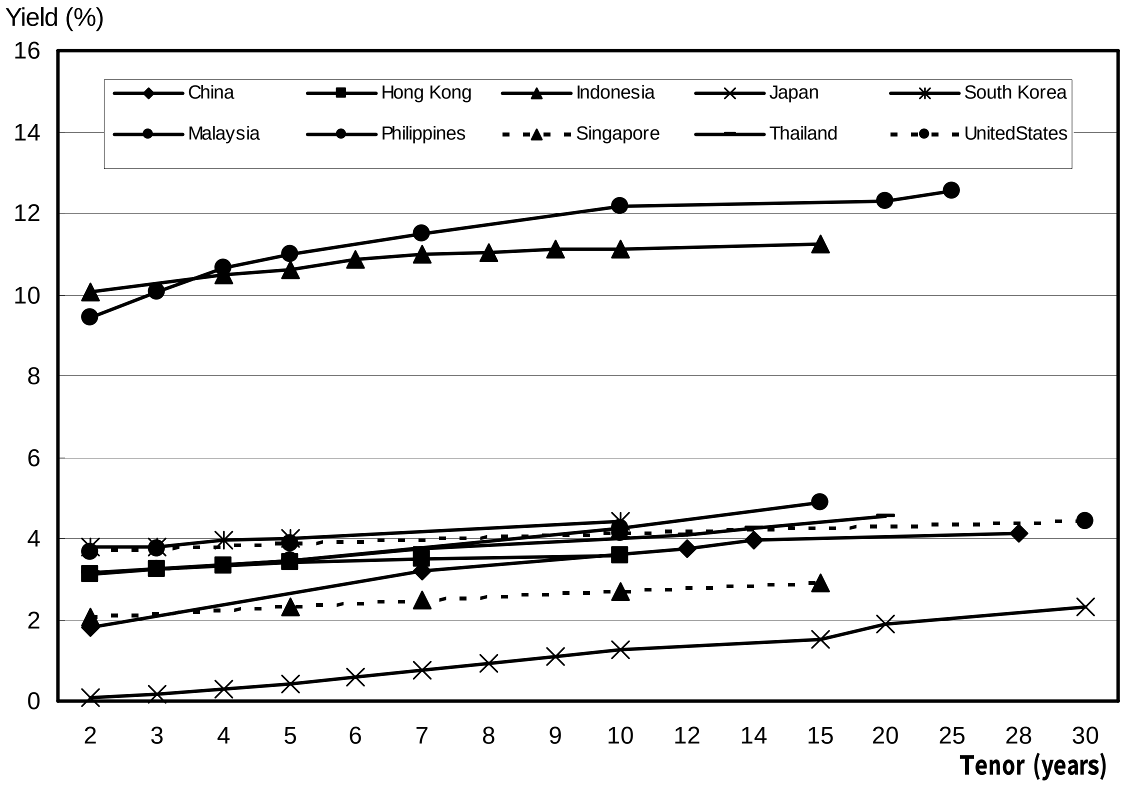
Figure 4 Main Issues Addressed by ABMI

Facilitating access to the market through a wider variety of issuers and currencies
This could be achieved by encouraging: 1) sovereign bond issuance by Asian governments to establish benchmarks; 2) Asian governments and government financial institutions to issue bonds to meet their financing requirements and to lend the proceeds to the private sector; 3) the creation of asset-backed securities markets and the greater use of guarantees in order to make it easier for small businesses to raise funds in the bond market; 4) bond issuance in the region by multilateral development banks and government agencies; 5) bond issuance in the region for funding foreign direct investment in Asian countries; and 6) greater issuance of local currency-denominated bonds and the introduction of currency basket-denominated bonds.
Enhancing market infrastructure to foster bond markets in Asia
This could be achieved by: 7) providing credit guarantees through the active use of existing guarantors, and possibly establishing an Asian Regional Guarantee Facility; 8) strengthening the rating system by enhancing the role of domestic rating agencies, as well as considering the possible establishment of an Asian Credit Rating Board; 9) establishing a mechanism for disseminating information on leading companies and the socioeconomic situation in the region; 10) addressing settlement issues concerning cross-border transactions; and 11) providing technical assistance in order to identify and remove impediments to developing bond markets, and to enhance capacity building.

Source: Ministry of Finance website.

In order to establish a benchmark yield in the early stages of a national bond market, a large amount of government bonds is needed in terms of both issuance and maturity. (Figure 5 shows the present yield curves of each of the national bond markets concerned.) The governments and government agencies involved have therefore considered ways of lending the proceeds of the bonds issued to private companies that are unable to tap the market and of issuing securities backed by loans to small businesses. It would also be a good idea to encourage companies that are trying to make inroads into other markets in the region to make use of the local bond market and to encourage multilateral institutions to issue bonds in local currencies as such measures would make maximum use of each country's savings. Consideration has also been given to diversifying bond issues by issuing bonds denominated in a basket of regional currencies as a means of increasing liquidity by mitigating currency risk and appealing to a wider range of investors.

Figure 5 Local Currency Bond Benchmark Yield Curve



Source: Asian Development Bank, Asian Bonds Online (http://asianbondsonline.adb.org).

As part of the process of fostering such developments, consideration has also been given to helping small businesses in the region by guaranteeing bond issues, offering them loans, or taking equity stakes in them as well as making full use of credit guarantees by existing donors such as ADB and the Japan Bank for International Cooperation (JBIC). Similarly, consideration has been given to matters such as clearing and settlement systems and credit rating agencies as well as impediments such as market regulations.

We shall now take a closer look at those main issues on which action has already been taken.

2. Action taken on particular issues

1) Bonds issued in local currencies by multilateral and development institutions

Since ABMI was announced, there have been numerous discussions of and actual issues of bonds by multilateral institutions such as the World Bank, the International Finance Corporation (IFC), and the Asian Development Bank (ADB).

The first of these was an issue in Indian rupees by ADB in February 2004 (amount: 5 billion rupees, or roughly ¥12.5 billion). This was followed in November 2004 by an issue in Malaysian ringgit (amount: 400 million ringgit; maturity: five years; coupon: 3.94%, 0.02 percentage point lower than the coupon on the five-year benchmark Malaysian government bond)—the first such issue by an international agency. This May the Bank was also the first non-resident to issue a bond in Thai baht (amount: 4 billion baht; maturity: five years; coupon: 3.87%, 0.17 percentage point higher than that on five-year Thai government bonds).

As for the World Bank Group, in December 2004 IFC became the first multilateral body to issue ringgit bonds that conform to Islamic principles (amount: 500 million ringgit; maturity: three years; coupon: 2.88%), while in April 2005 the World Bank issued its first ringgit bond (amount: 760 million ringgit; maturity: five years; coupon: 3.58%), which became the largest ringgit issue by any multilateral development bank and the third ringgit issue after those by ADB and IFC. The Malaysian government has also welcomed the issue for responding to the needs of investors and widening the range of financial instruments that conform to Islamic principles. Among the bilateral aid agencies, JBIC issued in September 2005 a baht-denominated bond in the amount of 3 billion baht and with a maturity of five years (coupon: 3.78%, 0.28 percentage point higher than that on five-year Thai government bonds). JBIC has also announced its intention to issue bonds in renminbi.

2) Support for bond issues from multilateral and government agencies

As well as issuing bonds in their own capacity, development institutions have provided support for private-sector bond issues throughout the region.

In June 2004 JBIC provided a secondary guarantee for a 3.5 billion baht bond issue by Tri Petch Isuzu Sales Co., Ltd. (TIS), a joint venture by Mitsubishi Corporation and Isuzu Motors in Thailand.[4] Japanese companies operating in the region would like to mitigate currency risk by raising capital in the local currency, but issuing a bond can sometimes be problematic if they are not well known in the country concerned. As well as making it easier for them to do this, credit enhancement by JBIC can help to increase issuance in the bond markets of these countries (Figure 6).

In February 2004, as a further measure to help Japanese companies' local subsidiaries in the region issue bonds in local currencies, the Ministry of Economy, Trade and Industry (METI) established a new guarantee system using Nippon Export and Investment Insurance (NEXI). Under the new system, Japanese companies sign an insurance agreement with the Japanese bank guaranteeing the local currency bond issue, and the bank effectively transfers the default risk via NEXI to METI by paying

[4] Under this arrangement, JBIC provided a secondary guarantee on the principal amount for a primary guarantee by Mitsubishi Corporation on the principal and interest amount. This enabled the issue to obtain a "AAA" rating.

NEXI a premium equivalent to a percentage of the nominal issue amount. The existing trade insurance system will therefore serve as a "stopgap" until a new debt guarantee agency, currently under discussion by the region's ministers of finance, is established.[5]

The 13 members of ASEAN+3 are studying the possibility that governments and companies in the region might issue new types of bonds. One such example is a "reverse dual currency (RDC) bond." One of the advantages of such a bond would be to mitigate currency risk by paying interest in a local currency but the principal in yen and thereby attract more Japanese investors.

3) Securitization

Although securitization, as part of the process of fostering the development of Asian bond markets, was originally used mainly by larger companies, it has recently become easier for smaller businesses, which are an important driving force in the regional economy, to use securitization as a means of raising capital. The first such deal, based on an agreement between the Japanese and South Korean governments, was concluded in December 2004 and involved the origination of a ¥7.7 billion collateralized bond obligation (CBO) backed by private placements by 46 small South Korean businesses. The principal was guaranteed by JBIC, and the bonds were sold to institutional investors, mainly in Japan (Figure 7).[6] Japan's Ministry of Finance took this as an opportunity to amend the rules governing guarantees by JBIC in order to enable it to guarantee bonds properly structured in the region and with a credit enhancement. More such issues, this time with other members of ASEAN+3, can be expected.

One of the challenges facing the countries in the region in issuing CBOs is the need to develop a secondary bond market and to provide information on small businesses. In this regard, Malaysia and Thailand have recently made significant progress. During the past four years Malaysia has issued over ¥300 billion, and Thailand some ¥110 billion, in CBOs. Just under 40% of recent issues in Thailand, however, have been in the form of CDOs, and some issues have been backed by credit card receivables.[7] In addition, more needs to be done to ensure transparency of pricing,

---

5 Asahi Shimbun, 5 February 2004.

6 Under the deal, 46 small Korean businesses issued privately placed notes in Korea, the full amount of which was underwritten by Daishin Securities of Korea. Daishin then sold the entire amount to a Korean special purpose vehicle, which obtained credit enhancement from the Industrial Bank of Korea (IBK) and issued senior debt backed by the notes. Finally, a separate, Singaporean special purpose vehicle purchased the full amount of this senior debt and issued yen-denominated collateralized bond obligations guaranteed by JBIC. The use of two special purpose vehicles and the dual guarantee from IBK and JBIC enabled the debt to be packaged in a way that made it attractive to investors. The collateralized debt obligations were three-year floating-rate notes, and were purchased by institutional investors in Japan and other Asian countries. The arranger was Nomura Singapore. (Nihon Keizai Shimbun, 14 December 2004.)

7 Nihon Keizai Shimbun, 19 January 2005.

improve liquidity in swap markets, provide credit enhancement, widen the investor base, and improve the rules on taxation and accounting.[8]

4) Other schemes

A number of other initiatives are also under separate consideration. We shall take a closer look at one of these: a proposal, currently before the Asia-Europe Meeting (ASEM), an organization that aims to increase cooperation between the two continents, to issue bonds denominated in a basket of currencies. This proposal, which was made by a group of experts (the ASEM Task Force) at the ASEM Summit in October 2004, would involve issuing bonds denominated in a basket including yen, euros and dollars. The proposal also involves establishing a "YES Fund" (named after the initial letters of the first two currencies (Yen and Euro) and the symbol for the dollar ($)), which would provide the three currencies required for these YES bonds. One proposal is that the weight of each currency in the basket could be based on the trade volumes in these currencies.[9]

Also, and independently of these developments, it has been reported that a number of countries in the region, including Japan, South Korea and Thailand, are considering introducing a basket of bonds that would consist of a certain percentage of each country's government bonds managed using a consistent approach.[10]

5) Sharing information on regional markets, economies and companies

In June 2004 a new, publicly accessible website ("Asian Bonds Online"),[11] managed by ADB, was launched as a source of information on the region's national bond markets. The website covers a wide range of information (e.g., on taxation, regulations, bond indices, benchmarks, credit ratings, and settlement systems as well as data on new issues and secondary market trading) designed to foster the development of secondary bond markets in the region, enable analysts and others involved in these markets to do their job more thoroughly, and make it easier for institutional investors from both the region as a whole as well as each country to invest in these bonds.

6) Progress in developing national bond markets

In parallel to (or in preparation for) the above-mentioned regional initiatives, deregulation of primary and secondary bond markets is taking place at a national level.

---

8 Nihon Keizai Shimbun, 21 June 2004.

9 Nihon Keizai Shimbun, 4 October 2004. The ECU was a basket consisting only of member currencies—partly because trade with each other accounted for a high proportion of member countries' trade, and partly because it was hoped that this would offset some of the effect of dollar depreciation. However, a basket containing both the dollar and the euro was considered more appropriate for Asian countries as trade with the United States and Europe still accounts for a large proportion of their trade.

10 Tokyo Yomiuri Shimbun, 11 July 2004.

11 See Asian Bonds Online's website at http://asianbondsonline.adb.org/

In November 2003 the Thai government announced that interest payments on baht-denominated bonds would be exempted from tax, while in 2004 it drew up guidelines for issuing baht-denominated bonds and allowed multilateral financial institutions, foreign governments and foreign government agencies to issue such bonds. During the first year, a number of institutions, including the World Bank, ADB and JBIC, took advantage of this opportunity within an overall issue limit of 15.0 billion baht (roughly ¥40 billion). At the same time, the Bank of Thailand relaxed some of the capital controls it had introduced to combat currency speculation,[12] while the government announced that it would grant non-resident investors withholding tax (15%) exemption for income from investing in baht-denominated government bonds and, in most cases, government-guaranteed bonds in the domestic market.

Similarly, in Malaysia multilateral institutions have been allowed to issue ringgit-denominated bonds since September 2004, while in the Philippines the country's first electronic trading platform for bonds ("Bond Exchange") was set up by the Bankers Association of the Philippines to attract investment by retail investors, who have traditionally favored equities.

In March of this year the Chinese government, hoping to interest multilateral institutions, published regulations governing the issuance of renminbi-denominated bonds by non-residents, and the World Bank, ADB and JBIC are currently vying to bring the first such issue to market. However, the fact that four government departments are involved and that there are restrictions on both issuance and the use of the proceeds means that there is likely to be a delay before the first issue takes place. Although there have been loans of more than $1 billion, issuers face considerable obstacles in that, for example, they have to provide financial information in conformance with Chinese accounting standards and may only use the proceeds for domestic construction projects.[13]

In parallel to these deregulatory developments, the range of issuers and types of issues on national bond markets have become more diversified. Although most issues still have a maturity of 10 years or less, Singapore and Malaysia have considered issuing or have actually issued bonds with maturities of 20-30 years in order to foster the development of a market in bonds with maturities of more than 10 years,[14] while Thailand and Malaysia are in the process of amending their securities legislation to allow the introduction of exchange-traded bond funds. Asset-backed securities are also becoming commoner. Last October the Malaysian national mortgage agency Cagamas Nasional Bhd. issued the country's first-ever residential mortgage-backed

---

[12] The 50 million baht limit on baht-denominated loans by domestic banks to non-residents was abolished, as was the limit on purchases by local banks of baht-denominated bonds issued by non-residents.

[13] Nihon Keizai Shimbun, 2 March 2005.

[14] In Singapore, in June 2003, the Land Transport Authority, issued the country's first 20-year bond. Previously, the longest-dated issue was a 15-year bond. The country's state-owned investment arm, Temasek Holdings, has indicated that it is considering issuing a 25-year to 30-year bond.

securities, while in Thailand there have also been a number of mortgage-backed security issues, and a 24 billion baht (roughly ¥65 billion) lease-backed securitization to provide funding for a new government office development is due to take place.

III. Asian Bond Fund

While the Asian Bond Market Initiative may be said to address the need to develop the supply side of the region's bond markets, the Asian Bond Fund (ABF) project is an attempt to address the demand side. The organization behind the project is the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP).[15] The project launched its first fund (ABF1) in June 2003, and this was followed in May of this year by a second fund (ABF2). The following is a description of the two funds based on EMEAP press releases.

1. Asian Bond Fund 1 (ABF1)

ABF1 was launched in June 2003 to facilitate the channeling of a small portion of the very sizeable official reserves held by Asian economies back into the region and to provide a useful means for Asian central banks to diversify their investments beyond the more traditional reserve assets and to enhance their returns. In order to ensure adequate liquidity and compatibility with the central banks' reserves, however, it was decided to limit investment to a basket of US dollar-denominated bonds issued by Asian sovereign and quasi-sovereign issuers. Although this fell short of achieving the project's ultimate objective (namely, to resolve the double mismatch of currency and maturity in the region's bond markets), it marked an important step forward in that it enabled the 11 central banks and monetary authorities to cooperate more closely. The main features of the fund are shown in Figure 8.

2. Asian Bond Fund 2 (ABF2)

In December 2004 EMEAP announced that it would be launching a new bond fund (ABF2) which would extend the coverage of ABF1 by investing in bonds denominated in local currencies and thereby deal with the double mismatch problem.

ABF2 comprises two components: a Pan-Asian Bond Index Fund (PAIF), which invests in domestic currency-denominated bonds issued in the eight EMEAP markets, and a Fund of Bond Funds (FoBF), which is a two-layered structure with a parent fund investing in eight sub-funds, each of which invests in domestic currency-denominated bonds issued in the respective markets of the eight EMEAP economies.

[15] The 11 EMEAP central banks and monetary authorities are the Reserve Bank of Australia, People’s Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore and Bank of Thailand. See EMEAP's website at http://www.emeap.org

The PAIF and eight sub-funds are both managed passively by private-sector fund managers.

EMEAP members' investment in the ABF2 was finally fixed at around $2 billion (half being allocated to the PAIF and half to the FoBF, with the Bank of Japan contributing about $200 million). This was in order that it should be neither so large that it would crowd out private-sector investors nor so small that it could not benefit from economies of scale. In May 2005 EMEAP announced that it had appointed managers, a master custodian and an index provider for the fund and that the funding of $2 billion had been completed, while the International Index Company (IIC, formerly known as iBoxx) launched the family of indices (iBoxx ABF).[16] It also announced that the respective fund managers of the ABF2 would be working closely with the relevant authorities to seek authorization to offer the funds to other public and private investors, where appropriate through listing, in the following months. The main features of each of the funds are shown in Figure 10.

In the near term, ABF2 is expected to help raise investor awareness of Asian bonds, while, in the long term, it should serve to broaden and deepen national and regional bond markets by (1) offering a new asset class to investors wishing to invest in local currency-denominated bonds, (2) ensuring transparency and credibility, and improving market infrastructure (e.g., through the use of replicable bond indices), and (3) accelerating tax and regulatory reform to facilitate cross-border investment.[17] Also, the fact that country weights are periodically reviewed according to the size of the local market, the turnover ratio in that market, the sovereign credit rating and market openness means that "there is a built-in preference for bonds favored by the market" (Bank of Japan's International Bureau) and that there is an incentive for member countries to further reduce impediments in their own local bond markets. It is also expected that at some time in the future a fund will be launched that invests in private-sector bonds as well as sovereign and quasi-sovereign issues.

[16] In constructing the iBoxx ABF Indices, IIC consulted with a number of international and domestic market participants, through its Asian Index Committee and Asian Oversight Committee, as a means to help ensure credibility and market acceptance of the indices. Details of the specifications of the indices are available on IIC's website at http://www.indexco.com. The indices can be used as they stand by private-sector fund managers as a benchmark for their fixed-income products, customized or used to develop derivatives.

[17] For example, PAIF was the first non-Chinese institutional investor to be granted access to China's interbank market. Similarly, in April 2005, the Malaysian government relaxed its foreign exchange controls. Prior to that, however, it allowed multilateral financial institutions to issue bonds on the domestic market and granted non-resident investors withholding tax exemption for income from investing in ringgit-denominated bonds, while Thailand has granted non-resident investors withholding tax exemption for income from investing in baht-denominated government bonds and, in most cases, government-guaranteed bonds in the domestic market since 7 January 2005. In addition, member countries have been bringing in legislation, where necessary, to allow bond funds and exchange-traded bond funds to be listed.

3. The response of the private sector to ABF

Private-sector financial institutions have also responded to EMEAP's initiatives. For instance, JP Morgan Fleming Asset Management, Merrill Lynch Investment Managers and Schroder Investment Management[18] are either planning to or have already started to market investment products that include Asian bonds. However, a number of issues have still to be addressed, including (1) the high cost of investing in Asian bonds that results from the absence of the kind of cross-border clearance and settlement systems found in Europe, and (2) the investor anxiety that results from a lack of credit-rating agencies with local expertise and a lack of credit guarantee agencies.

It was mentioned above that ICC had developed benchmark indices for ABF. However, a number of other potential benchmarks have been developed, including HSBC's Asian Local Bond Index (ALBI), which actually appeared in 2002 and therefore predates the iBoxx ABF family,[19] and the DBS-PALS (Pan-Asian Local Sovereign) Bond Index,[20] which covers local currency-denominated bonds from eight Asian countries.

---

[18] In March of this year Nomura Securities began to market in Japan the Schroder fund focusing on Asian bonds. The initial subscription limit was ¥100 billion. The fund, which is offered to Japanese investors with or without a currency overlay, reports quarterly. It seeks to achieve an absolute return by investing mainly in local currency-denominated bonds issued by governments, government agencies and corporate borrowers from the following 14 Asian countries and regions (excluding Japan): Hong Kong, China, the Philippines, Malaysia, South Korea, Singapore, Taiwan, Thailand, Indonesia, India, Vietnam, Pakistan, Sri Lanka and Kazakhstan. The fund is managed as a family of funds and invests in the Luxembourg-based Schroder ISF Asian Bond (the mother fund). The initial sales charge is set by the distributor but capped at 2.1%. The (annual) expense ratio will depend on the fund's net asset value but will be in the range 1.659-1.5015% per annum. The administration fee is 0.3%, and the trustee is UFJ Trust Bank.

[19] ALBI covers both government and corporate bonds, and takes into account factors such as market capitalization and liquidity. As a result, its geographical breakdown is: South Korea (35.5%), Hong Kong (15.8%), Singapore (10.7%), and China (0%, because of the bond market's low liquidity).

[20] The DBS-PALS Bond Index consists of 86 local currency-denominated government and quasi-government bonds from eight countries and regions: China, South Korea, Singapore, Malaysia, Indonesia, the Philippines and Hong Kong. As well as sub-indices for each country or region, there is a basket index covering all eight sub-indices and adjusted for market capitalization, liquidity and sovereign rating. The highest country weights are those of South Korea (23.9%), followed by Singapore (22.2%), China (6.7%) and Hong Kong (5.5%). What is distinctive about the index is the fact that it does not cover corporate bonds but does cover China, while Singapore has a higher weight than in HSBC's ALBI. The index is updated daily; country weights are reviewed every quarter; and the list of bonds is updated monthly. When it launched the index, DBS hoped that it would encourage fund managers to launch funds linked to the index. (Nihon Keizai Shimbun, 21 June 2004)

IV. Future Developments

Before concluding this report, a few words perhaps need to be said about two important aspects of how the region's bond markets are likely to develop: the political aspects and the technical aspects.

1. The political aspects

In addition to the ABMI and ABF initiatives described in this report, a number of other approaches have been discussed at various forums, including APEC, which has been trying to develop national bond markets in the region ever since the crisis of 1997, and the Asia Cooperation Dialogue (ACD), which has been led by Prime Minister Thaksin Shinawatra of Thailand. However, whatever the merits or effectiveness of these approaches, such meetings have tended to be highly political events (marked, for example, by leadership contests and disagreements over the composition of the participating countries). In addition, they have still to display the kind of commitment and ability to put words into action that have characterized both ABMI and ABF.

As far as cooperation on ABMI within the framework of ASEAN+3 is concerned, the sheer economic power of China, Japan and South Korea perhaps makes it unrealistic for ASEAN to continue to lead the debate, even though it has indicated its concern that its influence in the forum may be waning. Also, it looked at one stage (e.g., when the United States, which, like ASEAN, was concerned that its influence in the region might be waning, proposed that APEC be given greater powers) as though ABMI might go the same way as Japan's proposal for an Asian Monetary Fund. However, China's apparently firm commitment to both ABMI and ABF would suggest that ASEAN+3 and EMEAP are likely to remain the two main forums for fostering the development of the region's bond markets.

Another item of political interest is the East Asian Summit which is due to be held in Kuala Lumpur in December and which India, Australia and New Zealand are expected to attend. Finally, it will also be interesting to see to what extent and in what way the above efforts to develop the region's bond markets can attract Islamic money.

2. The technical aspects

As we have seen, various measures have been taken in recent years to remove the impediments to the development of a regional bond market, and more local currency-denominated bonds can be expected to be issued if market conditions permit. However, a number of impediments still need to be removed if these developments are to take hold.

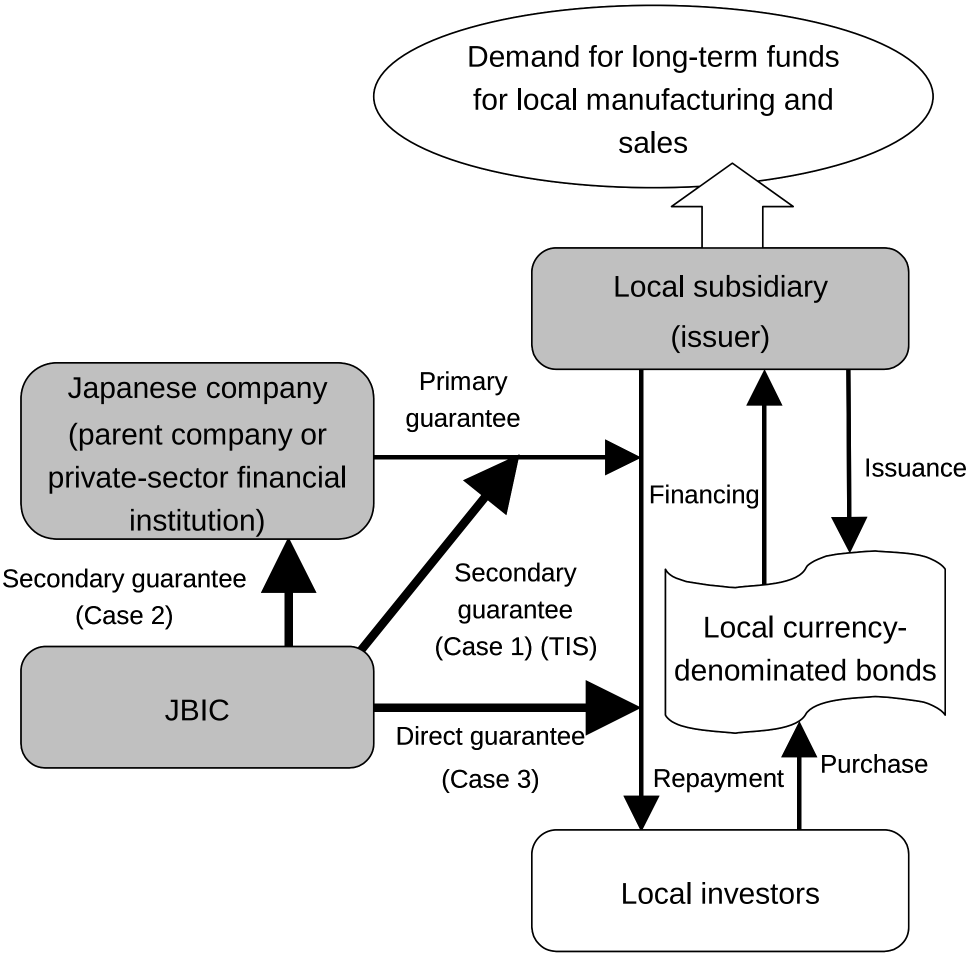
The ultimate objectives of ABMI and ABF are to achieve a smooth transition from a public-sector-oriented financing structure to a private-sector-oriented structure, and to encourage the development of cross-border investment by the private sector in the region. However, more may need to be done to monitor risks to local currency-denominated bonds (such as that from foreign speculators) if the regulatory framework these ultimate objectives require (e.g., the easing of controls on cross-border portfolio investment) is not to deter foreign investors.

At the same time, however, there is no denying the need to induce sophisticated foreign investors to invest in the region in order to increase market liquidity and encourage local investors to become familiar with more sophisticated techniques. However, there are still some foreign fund managers, especially in Europe and the US, who, in spite of their desire to invest in Asia, see no reason why they should buy local currency-denominated bonds in order to diversify their portfolios when they can buy easily swappable US dollar-denominated bonds with sufficient liquidity and yield. It remains to be seen whether the various initiatives and private-sector schemes described above will be able to attract enough investment to offset this.

Another important issue, if the region's savings are to be used effectively, is the growing need in the region to train people who will be able to work as fund managers for institutional investors such as pension funds and asset management companies. Sophisticated financial centers in the region such as Hong Kong and Singapore have attracted asset management companies from all over the world. The challenge for the countries of the region will be to produce professionals with the expertise (i.e., investment and administrative skills, and the ability to select fund managers) needed to channel these savings in the most appropriate way.

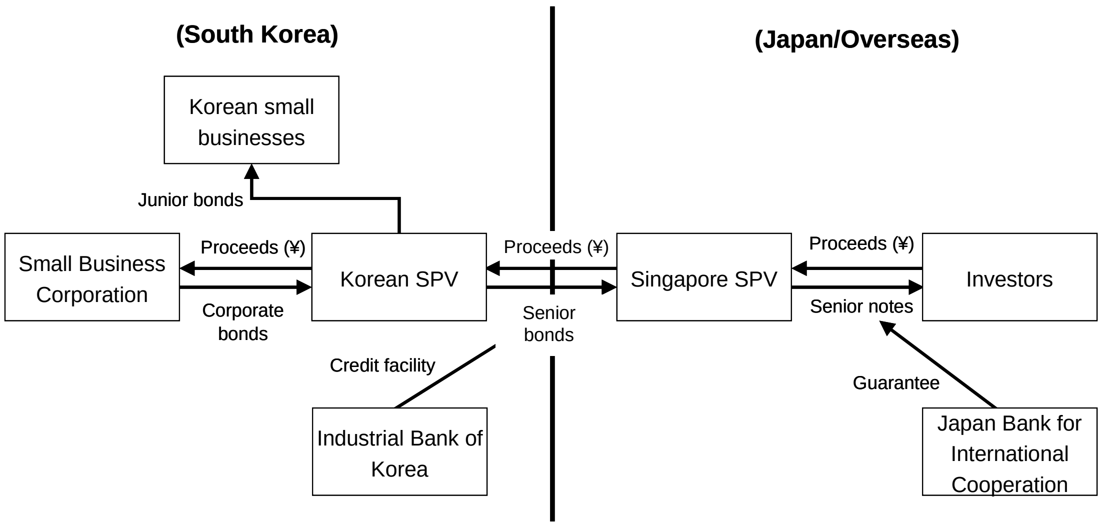
However, the volatility of the region's currencies, which may correlate closely, could more than offset the yields on investment products containing local currency-denominated bonds. It is therefore reasonable, given the current state of development of the region's bond market infrastructure, that investors are likely to be more interested in these bonds as a currency play than on account of their yield and to favor liquid bonds with short maturities. Whether or not these bonds can appeal to investors, both local and foreign, will ultimately depend on how long it takes for each country's market infrastructure (i.e., regulations and systems for taxation, clearing, settlement, and disclosure) to mature and to offer investors a wide range of investment opportunities. In the longer term, much will also depend on whether denominating bonds in a basket of currencies proves only a stepping stone to currency reform along the lines of the kind of single currency adopted by members of the European Union.

Figure 6 JBIC's Guarantee Facility for Local Currency-Denominated Corporate Bonds Issued by Japanese Local Subsidiaries



Note: Case 3 applies only if the issuer is a wholly owned subsidiary.
Source: JBIC's website.

Figure 7 Korean Collateralized Bond Obligation Deal



Source: JBIC's website.

Figure 8 Key Features of ABF1

Initial fund size	Around US$1 billion
Fund structure	Unlisted open-ended fund
Investors	EMEAP central banks only
Qualifying assets	US dollar-denominated bonds issued by Asian sovereign and quasi-sovereign issuers in EMEAP economies (China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand)
Currency denomination	US dollar
Manager	Bank for International Settlements (BIS)
Investment style	Passively managed against a designated benchmark index
Benchmark index	Not available
Monitoring	EMEAP Oversight Committee

Source: Bank of Japan's website.

Figure 9 Key Features of ABF2

【Key Features of Pan-Asian Bond Index Fund (PAIF)】

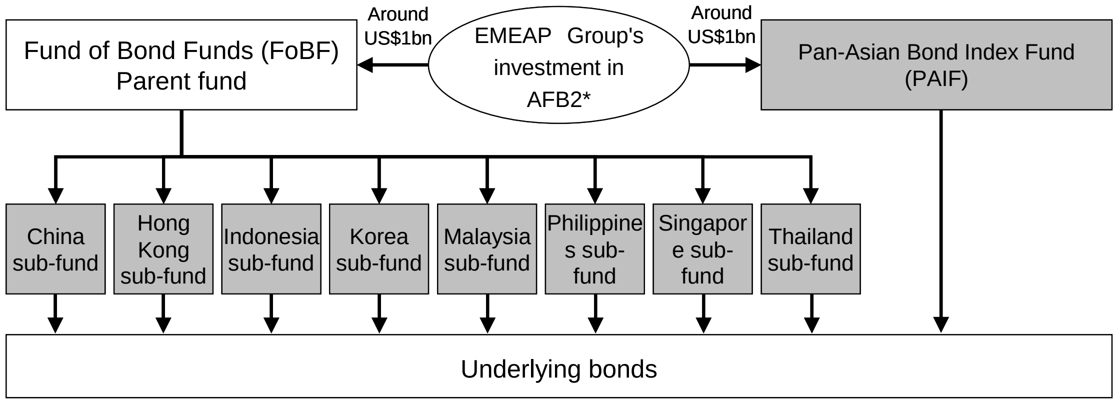
Initial fund size	Around US$1 billion
Fund structure	Phase 1 : unlisted open-ended fund Phase 2 : listed open-ended fund
Investors	Phase 1 : EMEAP central banks only Phase 2 : EMEAP central banks and other public and private sector investors
Qualifying assets	Domestic currency bonds issued by sovereign and quasi-sovereign issuers in eight EMEAP economies (China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand)
Currency denomination	US dollar
Manager	State Street Global Advisors Singapore Limited (SSgA)
Investment style	Passively managed against a designated benchmark index. The fund manager is required to conduct periodic rebalancing of the portfolio when the country allocations and the constituent bonds in the benchmark index change over time.
Benchmark index	Pan-Asia Index of the iBoxx Asian Bond Indices to be provided by International Index Company (formerly known as iBoxx)
Master custodian	Hong Kong & Shanghai Banking Corporation Ltd.
Place of domicile	Singapore
Place of listing	Hong Kong Stock Exchange (additional listings on other stock exchanges will be considered at a later stage)

【Key Features of FoBF Sub-Funds】

Initial fund size	Around US$1 billion to be allocated to the eight FoBF sub-funds
Phase 2 fund structure	● China sub-fund: Listed open-ended fund (if appropriate) ● Hong Kong sub-fund: ETF (exchange-traded fund) ● Indonesia sub-fund: listed open-ended fund (if appropriate) ● Korea sub-fund: listed open-ended fund, possibly ETF ● Malaysia sub-fund: listed open-ended fund, possibly ETF ● Philippines sub-fund: listed open-ended fund ● Singapore sub-fund: ETF ● Thailand sub-fund: listed open-ended fund, possibly ETF
Investors	Phase 1 : EMEAP central banks only Phase 2 : EMEAP central banks and other public and private sector investors
Qualifying assets	Domestic currency bonds issued by sovereign and quasi-sovereign issuers in the respective EMEAP markets
Currency denomination	Domestic currency of the respective EMEAP markets
Managers	● China sub-fund: China Asset Management Corporation Ltd. ● Hong Kong sub-fund: HSBC Investments (Hong Kong) Ltd. ● Indonesia sub-fund: PT Bahana TCW Investment Management ● Korea sub-fund: Samsung Investment Trust Management Co., Ltd. ● Malaysia sub-fund: AmInvestment Management Sdn. Bhd. ● Philippines sub-fund: Bank of the Philippine Islands ● Singapore sub-fund: DBS Asset Management Ltd. ● Thailand sub-fund: Kasikorn Asset Management Co., Ltd.
Investment style	Passively managed against a designated benchmark index. The fund manager is required to conduct periodic rebalancing of the portfolio when the country allocations and the constituent bonds in the benchmark index change over time.
Benchmark index	Respective market sub-indices of the iBoxx Asian Bond Indices to be provided by International Index Company (formerly known as iBoxx)
Master custodian	Hong Kong & Shanghai Banking Corporation Ltd.
Place of domicile	Respective jurisdictions of fund investment
Place of listing	Stock exchanges in the respective jurisdictions of fund investment, where appropriate

Source: Bank of Japan's website.

Figure 10 ABF2 Framework



* BIS will act as the fund administrator for EMEAP Group's investment in AFB2.

Components that will be open to investment by other public- and private-sector investors.

Source: Bank of Japan's website.

(Appendix) Important Events in the Development of Asian Bond Markets

	Asian Bond Market Initiative (ABMI)	Asian Bond Fund (ABF)	Other events
1997			7 Asian currency crisis occurs.
1998			
1999			
2000	5 ASEAN+3 finance ministers agree to promote the Chiang Mai Initiative to create a network of bilateral swap arrangements.		
2001			9 September 11 attacks take place in the United States. Malaysian Securities Commission issues guidelines on securitization.
2002	12 Japan proposes Asian Bond Market Initiative (ABMI) at an informal session of ASEAN+3 deputy finance ministers in Chiang Mai		3 HSBC announces development of Asian Local Bond Index (ALBI). 6 Asia Cooperation Dialogue is established. A number of countries, including Singapore, Thailand, and Malaysia, begin to switch some of their foreign exchange reserves into euros.
2003	2 Two working groups are set up at an informal session of ASEAN+3 deputy finance ministers held in Tokyo to discuss the development of Asia's bond markets: a Working Group on Creating New Securitized Debt Instruments (chaired by Thailand) and a Working Group on Credit Guarantee Mechanisms (chaired by South Korea). 4 The first joint meeting of the above two working groups is held in Seoul. 6 A meeting of all six working groups and an ASEAN+3 finance ministers' meeting on guarantees are held in Tokyo. 8 An ASEAN+3 finance ministers' meeting is held in Manila. A press statement is issued on the progress and future steps to be taken concerning the ABMI. 10 A meeting of the Working Groups on Foreign Exchange Transactions and Settlement Issues, Local and Regional Rating Agencies, and Technical Assistance Coordination is held in Kuala Lumpur. 11 A symposium on the issuance of local currency-denominated bonds by multilateral development banks, government agencies and Asian multinational corporations (MNCs), and a meeting of the corresponding working group are held in Beijing, while a joint meeting of the Working Group on New Securitized Debt Instruments and the Working Group on Credit Guarantee Mechanisms is held in Seoul.	6 The EMEAP (Executives' Meeting of East Asia and Pacific Central Banks) Group announces the establishment of the Asian Bond Fund (ABF). US dollar ABF (ABF1) is launched.	6 Singapore's Land Transport Authority issues the country's first 20-year bond.
2004	3 Meetings of the Working Group on Rating Systems and Dissemination of Information on Asian Bond Markets and the Working Group on Credit Guarantee Mechanisms as well as the first meeting of the Focal Group of ASEAN+3 ABMI are held in Manila, while a meeting of the Working Group on Foreign Exchange Transactions and Settlement Issues and the Working Group on Technical Assistance Coordination is held in Kuala Lumpur. 5 An ASEAN+3 finance ministers' meeting and a seminar on domestic credit rating agencies in Asia ("Roles, Issues, and Challenges") are held in Jeju (Korea), while a meeting of the Working Group on Technical Assistance Coordination is held in Bali.	2 Prime Minister Thaksin Shinawatra of Thailand indicates the possibility of an ABF3 in the near future. 4 The EMEAP Group announces the framework for ABF2.	1 Osaka Securities Exchange announces that it is strengthening its ties with stock exchanges in other Asian countries. 2 Asian Development Bank issues rupee-denominated bond in India (amount: 5 billion rupees, or roughly ¥12.5 billion) and considers possibility of issuing bonds denominated in baht and renminbi. The Ministry of Economy, Trade and Industry (METI) announces a new system of guaranteeing local currency bonds issued by local subsidiaries of Japanese companies. The financial authorities of Japan, China and South Korea hold a meeting to discuss ways of stabilizing government bond issuance and facilitating debt management. 3 Bangkok's city government obtains a credit rating with a view to issuing municipal bonds.

	Asian Bond Market Initiative (ABMI)	Asian Bond Fund (ABF)	Other events
2004	6 ADB launches its Asian Bonds Online website as a source of information on bond markets in the region. In Thailand, JBIC issues a baht-denominated bond and provides a secondary guarantee for the issue of a baht-denominated bond by Tri Petch Isuzu Sales Co., Ltd. 7 A number of countries, including Japan, South Korea and Thailand, consider issuing bonds denominated in a basket of currencies. 8 An ASEAN+3 ABMI seminar on local currency bond issuance by foreign multinational corporations is held in Shanghai. 9 JBIC announces that it will lend the proceeds of local currency-denominated bond issues to Japanese companies setting up operations in the region. 10 A Meeting of the Working Group on Technical Assistance Coordination is held in Kuala Lumpur, while an ad-hoc forum on credit ratings in Asia ("The Role of Credit Rating Agencies in the Development of Structured Markets in Asia") is held in Singapore. 11 ASEAN+3 ABMI Focal Group and Working Group meetings are held in Tokyo. 12 A Working Group meeting is held in Singapore. At the ASEM V Summit in Hanoi the Task Force for Closer Economic Partnership between Asia and Europe recommends the creation of an ASEM "YES" Bond Market and an ASEM "YES" Bond Fund, based on a basket currency incorporating the yen, the euro and the US dollar. Nomura Seoul Ltd. arranges a Korean collateralized bond obligation the principal of which is guaranteed by JBIC.	12 The EMEAP Group announces the launch of ABF2.	4 Thai government allows multilateral financial institutions to issue baht-denominated bonds. ACD holds an unofficial meeting to discuss how to foster the development of an Asian bond market. 6 DBS Bank (Singapore) announces the development of its DBS-PALS (Pan-Asian Local Sovereign) Bond Index. Malaysia allows multilateral institutions to issue ringgit-denominated bonds. 10 The Malaysian national mortgage agency Cagamas Nasional Bhd. issues the country's first-ever residential mortgage-backed securities. ADB issues its first ringgit-denominated bonds. The Thai government announces that it will grant non-resident investors who purchase baht-denominated government bonds favorable tax treatment. 12 Singapore's state-owned investment arm, Temasek Holdings, obtains a credit rating and indicates that it may issue a 25-year to 30-year bond. The United States calls for the Asia-Pacific Economic Cooperation (APEC) forum to be more effective. The ASEAN+3 Summit agrees to hold the East Asian Summit in Kuala Lumpur in December 2005.
2005	3 ASEAN+3 and ADB agree to cooperate in assisting governments and corporate issuers of bonds from member countries 5 An ASEAN+3 finance ministers' meeting is held in Istanbul. The ministers agree to build on the achievements of the Chiang Mai Initiative and to adopt the following additional measures as part of the ABMI: to conduct regular self-assessment by member countries; to gather and share information on bond market development in an integrated manner; to explore the possible issuance of Asian currency-basket bonds; and to explore the development of international bond markets in Asia.	5 The EMEAP Group announces the appointment of fund managers and the adoption of a family of indices for ABF2.	3 The Chinese government, hoping to interest multilateral institutions, publishes regulations governing the issuance of renminbi-denominated bonds by non-residents. Schroder Investment Management (Japan) Limited begins to market its Schroder Asian Bond Fund, composed of local currency-denominated bonds from 14 Asian countries (excluding Japan), in Japan. Summer JP Morgan Fleming Asset Management (Japan) launches an Asian Bond Fund.
2006	ASEAN+3 finance ministers will reiterate their commitment to attracting investment in Asian bond markets.		
2007			
2008			
2009			South Korea and ASEAN are due to conclude a Free Trade Agreement

Source: NICMR.