DEVELOPING AN ACTIVE ASIAN BOND MARKET – LESSONS FROM THAILAND

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Background and Rationale

Whilst much has been achieved in Europe and USA in capital market development the position in Asia has been woefully inadequate. (Refer Table 1)

Table 1

	% of Global Population	Funds under Management
Asia	60%	13%
USA	7%	52%

Pension coverage in the USA and Europe exceeds 80% and 60% respectively, whilst in Asia not surprisingly only 15%.
This issue is further exacerbated when you consider that Asia's population is ageing and in the next two decades the ageing population is expected to grow by over 20%.
Notwithstanding above the case for strengthening Asian Bond Markets is strong given the following factors.

1. Large Savings Pools and economies of scale
2. Potential for increasing investor choice and diversification – intra asia and globally
3. Retention of fund management jobs and expertise within asia

2.0 State of Asian Markets today

In the wake of the 1997 Asian financial crisis, regional policymakers and international organizations recognized the importance of developing the bond market in Asian economies to increase the efficiency of the financial system and promote regional growth.

2.1 Some causes for the crisis were:

- Lack of a regulatory framework for the banking sector with poor standards of governance and accountability.

- Over-reliance on bank borrowing
- Funding of domestic long term projects through short term foreign currency denominated loans which created currency and maturity mismatches.

Since then and propelled by the global sub-prime crisis in 2008, progress has also been made on a regulatory level with many developing nations adopting the Basel Capital Accord.

The benefits of promoting an efficient bond market were to:

- Reduce currency risk and maturity risk
- Diversify sources of borrowing and reduce counterparty risk
- Provide alternative channels of financing private and public investments
- Increase investor confidence and product choice

Whereas emerging Asian equity markets are well established and have been dominating the global market in performance over the last few years, the level of development of the bond markets still vary significantly from one jurisdiction to the other. This is mainly due to the different stages of economic development and unique features of each country's financial structure.

A number of initiatives have been made by international organizations to promote the Asian bond market by developing the government and corporate bond sectors together with the banking system. Some of these collaborations have been highlighted below.

A. The Asia Pacific Economic Cooperation (APEC)

A project which APEC began in 1998 with the assistance of the World Bank and the Asian Development Bank aimed at developing a bond market for APEC member countries was intensified in 2002 with the development of securitization and credit guarantee markets with efforts further intensified in 2003 by increasing cross-border talks and bi-lateral cooperation.

APEC members include Australia, Brunei Darussalam, Canada, Chile, China, Hong Kong, Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Republic of Korea, Russia, Singapore, Taipei, Thailand, United States and Vietnam.

B. The Association of South East Asian Nations + China, Japan and Korea (ASEAN+3)

The Asian Bond Markets Initiative (ABMI) launched in 2002 by members of ASEAN+3 and strongly supported by the Asian Development Bank, had the primary aim of developing efficient and liquid bond markets in the region with a better utilization of "Asian savings for Asian investments". The establishment of a Credit Guarantee and Investment Facility (CGIF) fund to extend credit for the issuance of corporate bonds in the Asian region was one of the objectives of this program with the intention of spearheading market activity in the primary corporate bond segment.

Further Milestones:

In 2005 the ABMI roadmap proposed a new framework which collated and shared information on bond market development, promoting self-assessment by member countries based on feedback from market participants and the launch of a study on an Asian currency basket bond.

These initiatives were further enhanced in 2007 by exploring new debt instruments, promoting the securitization of loan credits and receivables and the promotion of an Asian Medium Term Note (MTN) program.

In 2008 the roadmap was to include promoting the issuance and facilitating the demand of local currency denominated bonds, improving the regulatory framework and infrastructure for the bonds markets.

ASEAN+3 member countries include Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam plus China, Japan and Korea.

C. The Executives' Meeting of East Asia and Pacific (EMEAP)

Another initiative to develop financial markets was the establishment of bond funds by the EMEAP to facilitate the introduction of investment trusts.

2.2 Asian Bond Fund (ABF1 and ABF2)

The Asian Bond launched by the central bank forum EMEAP comprising of 11 member countries is managed by BIS (Bank of International Settlement). It was the first bond fund to be launched in Asia (2003) promoting cooperation between regional central banks and encouraging the bond market development of EMEAP member states.

EMEAP Members: China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand. Additional Members: Australia, New Zealand and Japan.

ABF1

The original ABF referred to as ABF1 was denominated in US dollars with seed money of $1bn received from the 11 EMEAP member central banks. The fund invested in dollar bonds issued by eight governments and quasi-government organizations of the member countries.

The second stage of the Asian Bond Fund (ABF2) was launched in 2005 with an initial capital of $2bn and invested in local currency bonds also issued by governments and quasi-government organizations of the eight EMEAP member countries mentioned above. Under the ABF2 umbrella nine separate bond funds were formed.

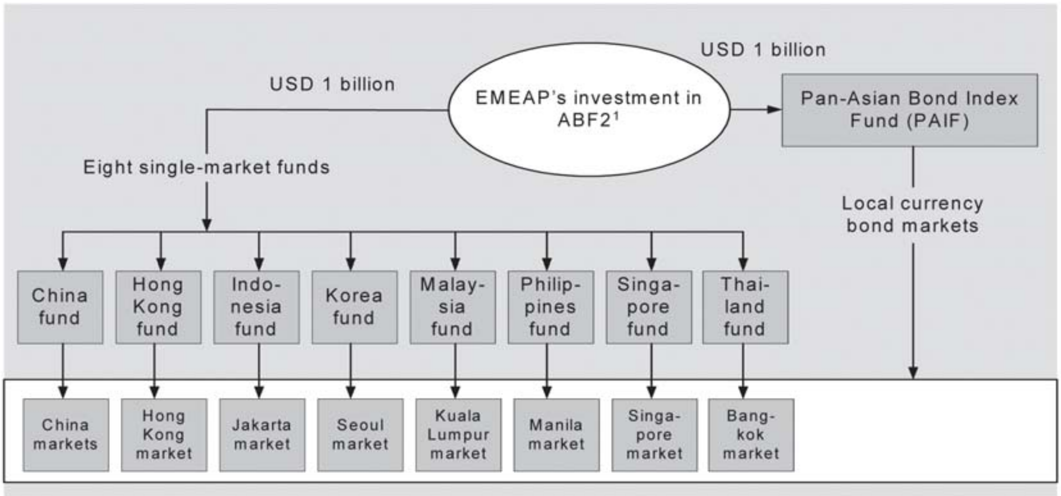
ABF2

The structure of the ABF2 as illustrated in Figure 1 consists of:

- The Pan Asia Bond Index Fund (PAIF)
- Eight single market bond index funds

The PAIF fund manager is State Street Global Advisors and custodian bank is HSBC.

Figure 1 ABF 2



Source: BIS

As a result of these collaborative efforts Asian Bond markets have developed considerably in the past 10 years but still lags behind the developed markets. More progress is needed especially in the development of the Asian corporate bond market which is still at an infancy stage or non-existent in some emerging countries.

Building blocks, critical success factors and issues for the development of an Asian bond market

- Efficiency and further liberalization of emerging markets
- Improved regulatory standards and corporate governance
- Policies promoting liquidity, tax reforms for investors
- Long term capital flows to emerging economies from the developed Asian countries
- An internationally recognized clearing system
- Vulnerability of Asian equity markets and currencies to global market volatility
- Increased market literacy and broader investor base
- Financial integration in regional markets
- Greater responsibility of emerging economies in growth of global economy

3.0 The development of an Asian funds passport

A report published by State Street Global Advisors estimates the growth capacity of Asia's $3.9 trillion (2009) in collective fund assets to be over 10% in 2014 for selected emerging markets and as much as 15.3% for regional giants such as China. In spite of the lack of a common Asian currency or regional authority such as the European Union, the consensus is that financial innovations with a solid regulatory framework such as the EU funds passport vehicle score high on investor confidence and developing a passport scheme for Asian funds would provide international investors with a wider array of off-shore products in otherwise inaccessible markets. Such a scheme would also increase cooperation between Asian regulators, facilitate cross-border marketing of local products and lead to integration of the fast growing emerging Asian economies into the regional framework. The Australian government has also shown its growing interest in the establishment of an Asia region funds passport scheme to support its expansion plans into global markets.

In order for the asset management industry to grow however, efficient and diversified equity and bond markets are pre-requisites. So promoting the development of these markets is key to the development of the asset management industry in the emerging economies.

3.1 The benefits:

- Fast growing emerging economies would have access to cheaper capital to fund their expansion plans, diversification of savings and investments from pension funds can fund demand
- Cross border products would allow asset managers to access a larger pool of investors and achieve economies of scale
- Investors would have a broader and cheaper array of financial products to choose from, giving them access to smaller markets and local expertise
- Growth in the asset management industry would lead to more job opportunities and retain expertise and talent in Asia

3.2 Critical factors:

- Setting up a level playing field promoting less developed Asian markets
- A solid regulatory framework
- Cross border cooperation in the development of fund products which focus on Asia rather than just the domestic market
- Increase investor awareness and dissemination of information
- Developing technology tools to facilitate product implementation

Case study – Thailand

The decision to select Thailand as our country case study is to highlight the development of

Thailand's financial sector being a story of growth with unprecedented initiatives for change in the midst of adversity following the aftermath of the 1997 Asian financial crisis. The case study also provides an overview of Thailand's regulatory policy known as the Financial Sector Master Plan (FSMP) which highlights the country's ability to manage economic and market shocks effectively.

4.0 Background

With the influx of Japanese capital in the late 1980s and early 1990s, Thailand had a manufacturing-led economic growth supported by inexpensive labour, liberalized foreign investment policies and developments in the private sector. During this period commercial banks played an important role in mobilizing funds though bank deposits with little activity seen in the domestic bond market.

Following the Asian crisis in 1997 with investor confidence at a low, the country's financial system went through a major restructuring program to reform the local regulatory framework, strengthening corporate governance of banks and implementing initiatives to reduce reliance on banks and external sources of funding.

In the midst of extensive political unrest, Thailand enjoyed a solid export driven growth from 2000 to 2007 only to be severely hit by the global economic crisis in 2008 cutting exports drastically in most sectors. In 2010 exports rebounded and the country's GDP growth of 7.6% during the year made it one of the fastest growing economies in Asia. Despite the polarized political situation, business and investor sentiment remained positive and the stock market continued to grow. The historic floods in 2011 that inundated more than two-thirds of the country's 77 provinces, disrupting supply chains on a global scale also highlight the major role played by Thailand in the world economy.

In spite of these setbacks, the projected economic growth rate for the country in 2012 and 2013 are 5.5% and 7.5% respectively (Bank of Thailand, April 2012). The short-term outlook for the country is favourable however significant risks still remain due to the uncertainties of the world economy.

Regulatory and policy decisions

1999 - 2003	Emergency measures which included closing down insolvent companies, recapitalizing viable companies and introducing debt restructuring mechanisms. Building blocks for formation of the Financial Sector Master Plan.
2004 - 2014	Financial Sector Master Plan (FSMP) - A medium term development and reform program to create a more transparent and internationally competitive financial market.

Phase I (2004-2009) involved increasing efficiency of the financial sector by

- Restructuring the licensing system of commercial banks (prior to this multiple types of licenses were issued to financial institutions).
- Limiting operations of foreign banks and number of new entrants to the banking sector.
- Bank of Thailand (BOT) empowered as the sole regulator and supervisor of financial institutions.
- Establishment of a committee to promote micro financing, with government owned special institutions (SFIs) to play a greater role in lending to the underserved sectors.
- Increasing access to financial services amongst the unbanked and for small enterprises by providing incentives to banks on the risk weights assigned for certain types of loans when determining their capital requirements thus freeing funds for the extension of credit to the undeveloped sectors.
- Improving consumer protection through formation of the Deposit Protection Act (DPA). The aim is to replace the blanket deposit guarantee system with a limited deposit guarantee, increasing the responsibility of banks and reducing the public cost of the deposit insurance system.
- Banks required to update deposit and lending interest rates on their websites, on a daily basis and submit this information to BOT. Consumers can then compare rates across banks by accessing the BOT website.

Phase II (2010-2014) to concentrate on:

- Reducing system-wide operating costs caused by distressed assets arising from the 1997 financial crisis
- On improving financial competitiveness of banks by allowing them to expand their product lines and branch into other business areas such as mutual funds and venture capital management.
- New and existing foreign bank subsidiaries will be allowed to open up to 20 branches from 2012 with the aim of increasing competitiveness of domestic commercial banks.
- Strengthening of risk management practices in financial institutions

5.0 Stage of development of Financial Markets

5.1 Bond Market

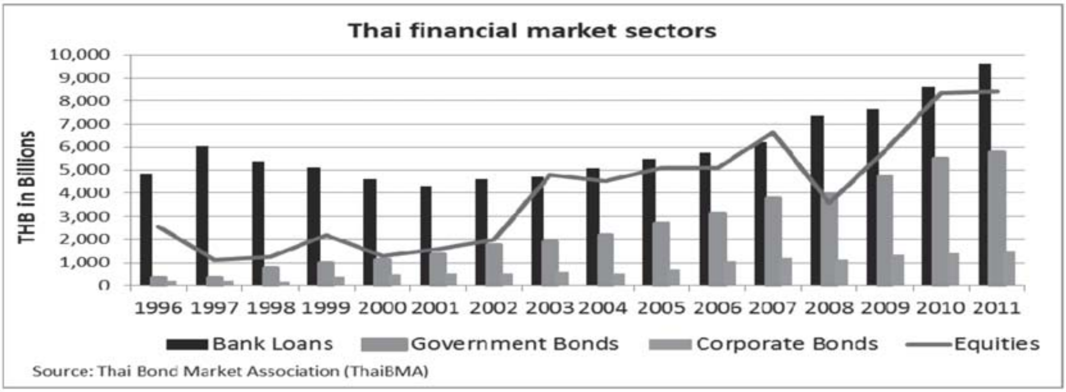
Thailand's capital markets have come a long way. In 1994 the "Bond Dealers Club" (BDC) was set up to promote the secondary market for debt securities and introduced an electronic bond trading system for the first time in the Thai bond market. After receiving the Bond Exchange license from the SEC, BDC was renamed in 1998 as The Thai Bond Dealing Centre (ThaiBDC). A major reform by the ThaiBDC in 2005 was to centralize the trading platform at the Stock Exchange of Thailand (SET) providing trading information, bond data, reference yields and market and regulatory news on both the primary and secondary market through its websites.

To strengthen its role as a self-regulated organization and information center, the ThaiBDC changed its status in 2005 to a licensed securities related association under the SEC Act and was named the Thai Bond Market Association (ThaiBMA).

As part of its commitment to promote best practices and assist in the development of the bond market, the ThaiBMA developed several key financials such as government bond yield curves and benchmark bonds. It has also initiated additional data techniques such as zero calculations, credit spreads, bond analysis and Value-at-Risk (VaR) for bond investment and portfolio management.

The Thai bond market can be categorized into three segments: government securities, corporate bonds and foreign bonds. The proportion of foreign bonds is very small and around 1% of the total domestic bond market. The corporate sector began issuing bonds in 1992 with approval required from the SEC prior to a corporate bond issuance and with credit ratings being a pre-requisite for all bond offerings with some exceptions. (Refer graph 1)

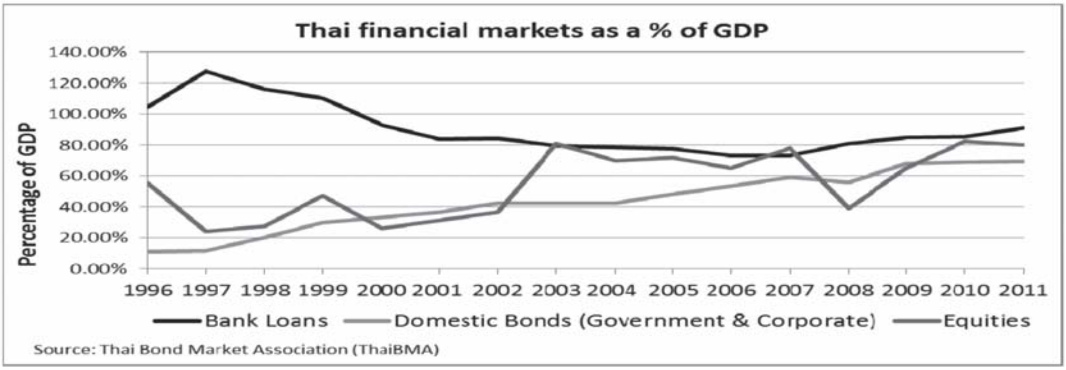
(Graph 1)



Following the 1997 economic crisis, the Thai government successively issued treasury bonds to finance the resulting budget deficit increasing the value of the bond market from THB 547 billion in 1997 to THB 1,883 billion at the end of 2001. Trading on the secondary market also increased substantially in the same period contributing to a robust bond market. The domestic bond market (government and corporate) at the end of 2011 was THB 7,327 billion.

The ratio of Thai domestic bonds to GDP shows an increasing trend since the 1997 crisis although the issuance of corporate bonds remains relatively small. In 2011 government securities made up around 80% and corporate bonds around 20% of the domestic bond market. The ratio of the value of the bond market to GDP was 70% at the end of 2011, whereas the value of corporate issuance was only 14% and still needs developing. (Refer graph 2)

(Graph 2)



Local currency denominated foreign bonds made their debut in 2005 when the Asian Development Bank issued domestic bonds to the value of 4 billion Baht. In the same year under the Asian Bond Market Initiative (ABMI), the Japan Bank for International Cooperation issued a 5 year Thai bond for 3 billion Baht, the first bond to be issued by a foreign government on the Thai capital market with the aim of financing business operations of Japanese companies in Thailand.

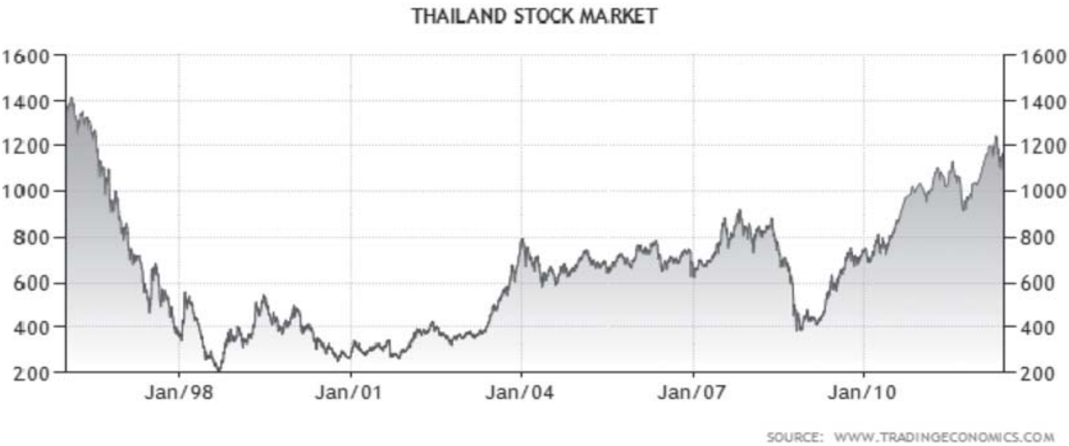
5.2 Equity Market

The stock markets is one of the most important sources for companies to raise capital for business development. The liquidity that a stock exchange provides gives investors the confidence and ability to buy and sell securities with relative ease compared to other investments such as real estate or bonds.

The capital markets in Thailand developed in two stages. The privately owned stock market known as the Bangkok Stock Exchange (BSE) began operating in 1962. Activity at the BSE was rather poor and stocks performed badly. The BSE finally ceased operations in the early 1970s. The general view is that the BSE did not succeed because of limited investor understanding of the equity market and also due to a lack of official support.

In 1974 the Securities Exchange of Thailand was formed and started trading in 1975. In 1991 its name was changed to the Stock Exchange of Thailand (SET). In 1997, in line with other regulatory reforms carried out after the crisis, the SET implemented new cap and floor price limits for trading and also introduced a circuit breaker system to reduce unusual volatility in the market which might cause investor panic. In addition to the SET index and sub-indices, the SET also calculates industry and sector indices. (Refer graph 3)

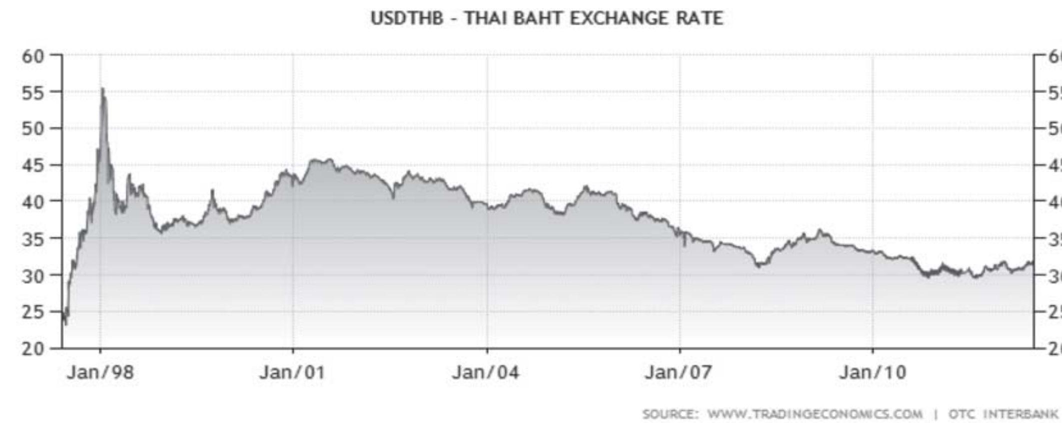
(Graph 3)



Historically from June 1997 to June 2012, the USDTHB reached an all time high of 55.50 in January 1998 and a record low of 23.15 in June 1997. The current exchange rate is approx. THB 31.87 to the USD (June 25th 2012). Most significant is that despite the collapse of its currency in 1997, Thailand's economy remained sound. (Refer graph 4)

6.0 Development of Investment Funds

(Graph 4)



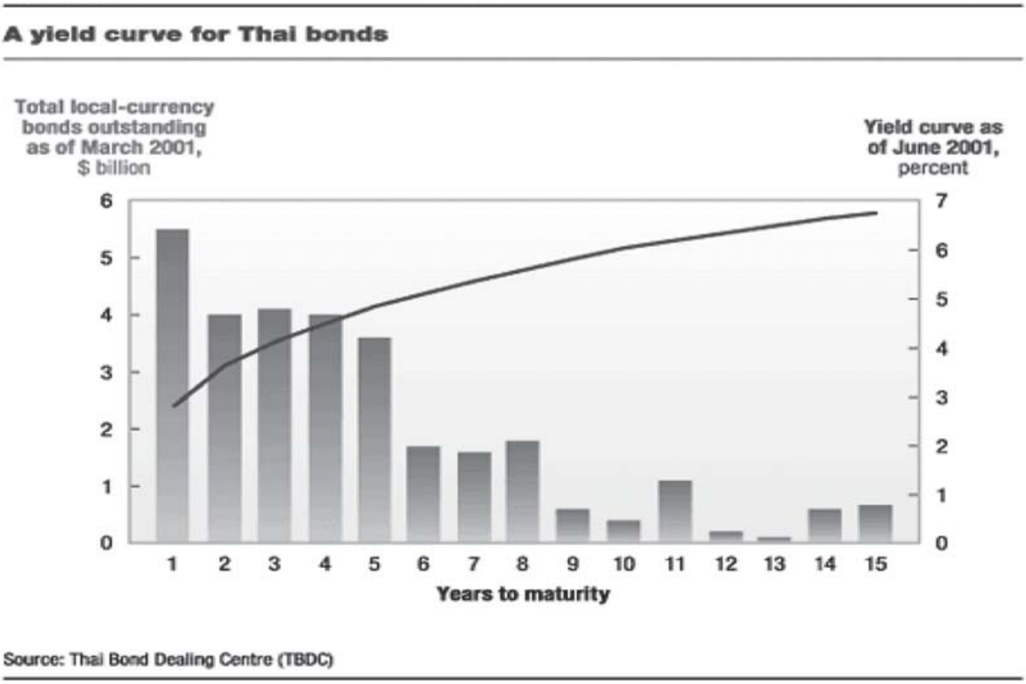
The development of the Thai asset management industry began in 1975 by the formation of the Mutual Fund Company which was controlled by the Thai Government and the International Finance Corporation (IFC). In 1992 the mutual fund industry was liberalized leading to a rapid increase in the number of funds available. In 2002, there were 346 funds under management, in 2011 the number increased to 1,265 funds. Assets also grew substantially from THB 435 billion in 2002 to THB 2,846 billion in 2011.

Today mutual funds dominate the market, followed by a smaller proportion of investments in private and provident funds. The major types of mutual funds offered in Thailand are fixed income, equity, balanced and property funds. Fixed income funds have the largest amount of assets under management at THB 1.23 trillion in 2010 in comparison to equity funds with assets of 261 billion under the same period. The local demand is for short-term money market funds, domestic fixed income and a growing interest for foreign debt from Asian countries like Korea and to some extent from China. (Refer graph 5,6 and 7)

(Graph 5)

(Graph 6)

(Graph 7)



6.1 Challenges

- Less variety of locally developed investment funds, more sophisticated funds offered by foreign-owned asset managers
- Need for one regulator (Bank of Thailand, Thai Bond Dealing Centre and SEC regulations tend to impinge on each other)
- Mutual fund products more short term and offered as alternative to deposits leading to insufficient wealth at retirement
- Banks distribution channels limited to marketing of own investment funds
- Standard regulatory requirements for retail and high net worth individuals hamper potential to generate more income
- Government to build gaps in yield curve and build strong repo market, liberalise hedging instruments

6.2 Derivative Trading

The Thailand Futures Exchange (TFEX) formed in 2003 allows the trade of derivatives such as futures, options and options on futures on permitted underlying assets as approved by the SEC.

7.0 Key Learnings

- ***Promote liquidity in bond market and establishment of a secondary market***
  The Thai government issued a significant amount of debt instruments following the 1997 Asian financial crisis promoting liquidity and reducing reliance on banks and external sources of funding. At the end of 2011, the outstanding value of domestic bonds totaled THB 7,327 billion of which around 80% were government bonds.
  The secondary market takes place through the OTC market or through the Bond Electronic Exchange (BEX), the latter is used for retail trading activities. Liquidity is provided by authorized dealers.

- ***Maintain stable currency***
  Thailand adopted a floating exchange rate policy in 1997, with market forces and economic data determining the value of the Baht. However in the case of extreme currency volatility in the market, the Bank of Thailand will intervene to stabilize the Baht. The Bank also maintained a policy to control excessive foreign exchange outflows which was relaxed to allow direct investment and portfolio investment abroad within permitted limits.

- ***Improve standards in corporate governance and risk management***
  Thailand has significantly improved the financial viability of its banks by addressing non-performing loans (NPLs) and implemented Basel II with effect from January 2009. Thai banks are required to maintain a minimum CAR of 8.5% under Pillar 1. Pillar 2 was implemented in 2009 with banks required to develop an internal capital adequacy assessment process (ICAAP) by the end of 2010. The BOT started the supervisory review and evaluation process (SREP) in 2011. Information is disclosed by banks since 2009 for Pillar 3. The Bank of Thailand has already indicated plans to implement the Basel III regime in 2013.

  The Securities and Exchange Commission (SEC) and the Stock Exchange of Thailand (SET) have become more proactive in enforcing regulations, protecting the rights of minority shareholders and enhancing rights of shareholderss. In 2002, the SET established a Corporate Governance Centre to offer advisory services to listed companies and in order to improve investor confidence in Thai capital markets.

- ***Establish effective market trading systems***
  The Thai Securities Depository Company, a subsidiary of the Stock Exchange of Thailand (SET) has implemented systems to provide the following services to its members: securities and fund registrations, securities depository, security clearing and settlement and back office services. The trading platform implement by the Thai Bond Market Association (ThaiBMA) at the SET provides trading information, bond data, reference yields and news on both the primary and secondary markets.

- ***Increase market literacy***
  The SEC and the SET publish information on their web sites in order to educate investors about financial investments. They also provide training courses with the objective of familiarizing local investors with new products. The Financial Consumer Protection Centre (FCC) opened in 2012 by the Bank of Thailand plays an educational role, creating consumer financial awareness and understanding of their rights and responsibilities. It is also geared at addressing consumer complaints about the services of financial institutions.

- ***Broaden investor and issuer base***
  Regulatory developments allow non-residents to issue debt securities (Thai local currency bonds) and qualified local institutional investors to invest in foreign securities. Furthermore non-residents can invest in government bonds without any restrictions regarding repatriation of investment and return.

8.0 Conclusions and Recommendations

Asian economies need to take a lead role in the establishment of regional cross border products providing foreign and local investors with a broader range of financial products which will contribute to the development of their local financial markets and spearhead regional economic integration.

Thailand's success story in developing an active capital market despite many obstacles (natural disasters and economic setbacks) is a good case study of 'evolution' and 'growing pains' for other Asian nations.

Although it seems feasible to promote a funds passport for the more developed Asian countries where stable equity and bond markets exists, for the emerging economies with small treasury markets and non-existent corporate bond markets, development initiatives should be first on the agenda. The work done so far to promote Asian bond markets needs to continue and be intensified with promotion of bond markets in the non-member countries of these initiating organizations. Also governments together with asset managers need to look at ways of growing and promoting the local fund management industry. Countries which have a product structure in place need to promote bi-lateral talks with other smaller nations providing them with technical assistance to develop local and cross border products. Regional Trade Bodies such as APEC, SAARC a can play an important role by initiating the dialogues for the Asian region in collaboration with governments of its member countries.

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