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Discussion Paper

First High-Level Follow-up Dialogue on Financing for Development in Asia and the Pacific

Incheon, Republic of Korea

30-31 March 2016

# CORPORATE BOND MARKET IN ASIA AND THE PACIFIC AND ITS ROLE IN FINANCING FOR DEVELOPMENT

DP/06

March 2016

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UNITED NATIONS ESCAP

Economic and Social Commission for Asia and the Pacific

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**Discussion Papers**

Macroeconomic Policy and Financing for Development Division

# Corporate bond market in Asia and the Pacific and its role in financing for development

by

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March 2016



## Abstract

The role of the local corporate bond market is very important in obtaining stable long-term fund for private sector. Many countries in Asia and the Pacific still heavily rely on banking sector to meet with the demand for funding from company side. However, as highlighted from previous crises, heavy dependence on bank loans is likely to undermine an economy's steady growth because the risk in the economy concentrates on banking sector. An economy with balanced funding sources, including banks and capital markets, is more robust to financial crisis, and thus is more likely to stably maintain its economic growth. This paper investigates the current status of corporate bond markets in Asia and the Pacific, and analyzes corporate bond market development in Korea as a case study. Based on the analysis, it provides strategies for local corporate bond market development in the region.

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# I. Introduction

The role of the local corporate bond market is very important in obtaining stable long-term fund for private sector. Many countries in Asia and the Pacific still heavily rely on banking sector to meet with the demand for funding from company side. However, as highlighted from previous crises, heavy dependence on bank loans is likely to undermine economy's steady growth because the risk in the economy concentrates on banking sector. An economy with balanced funding source including banks and capital markets is more robust to financial crisis, and thus is more likely to maintain its economic growth in stable manner.

Since the Asian financial crisis in 1997, policymakers in Asia and the Pacific have tried to nurture the local currency corporate bond markets along with government bond markets. Nonetheless, the development of corporate bond markets is rather sluggish in general. It takes typically long time to improve bond market, especially one for corporate sector. When the industry base is still shaky, this becomes even more challenging. However, it is necessary for policymakers to continue their efforts to advance the corporate bond markets along with other bond market sectors.

In this paper, I investigate the current status of corporate bond markets in Asia and the Pacific. And then I analyze corporate bond market development in Korea as a case study. Based on the analysis, I provide strategies for the local corporate bond market development in the region.

# II. The Role of Corporate Bond Market

## A. Roles of corporate bond market

Bonds refer to fixed income securities that have principal and interest payments returned according to a predefined schedule. Because bonds are in general fixed-term securities whose principal and interest are paid on predefined dates, a bond default occurs whenever its issuer fails to meet the payment schedule.

A bond market serves diverse functions and roles for issuers, investors, intermediaries, and market infrastructure. For issuers, bonds enable them to raise large-scale, long-term capital via capital markets. Bond issuers such as a nation state, municipalities, state enterprises, financial institutions, and businesses can issue and sell bonds to investors in the capital markets for large-scale financing in a longer term. Especially, issuers with high credit ratings can tap into a bond market for financing at relatively low costs. Issuers with relatively lower credit ratings can also raise capital in larger amount if they are willing to pay premiums.

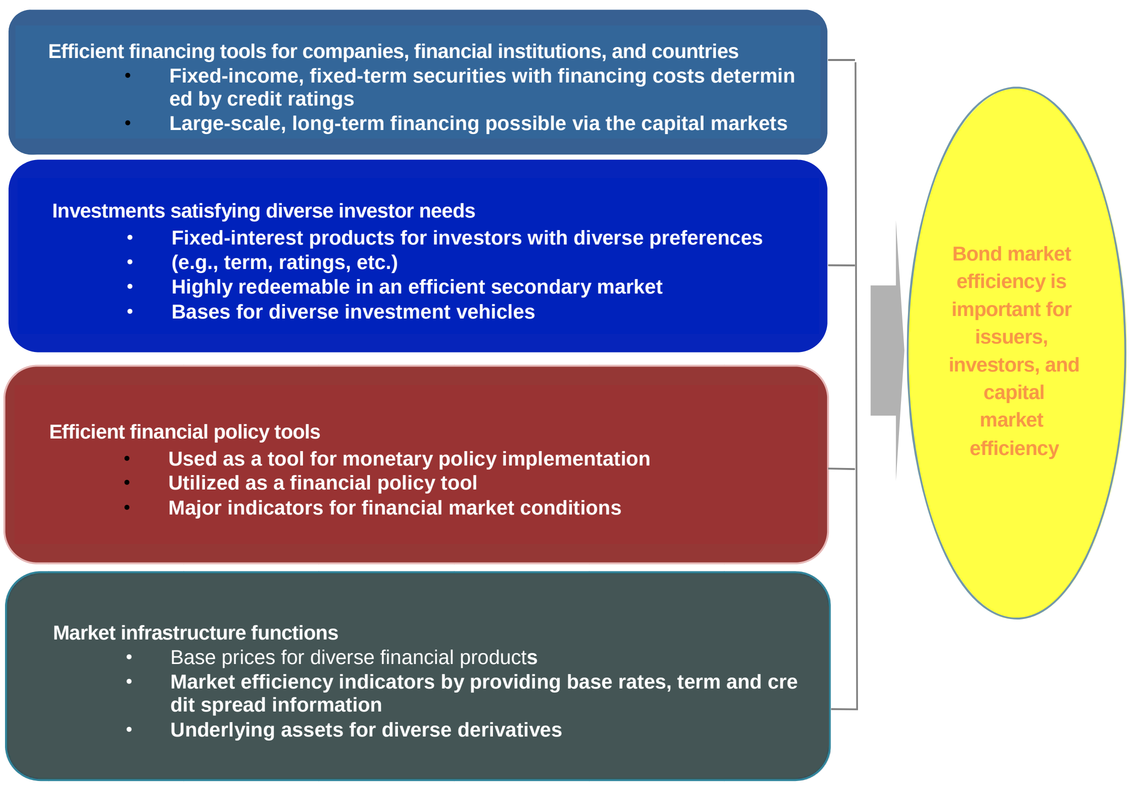
A bond market also offers benefits for bond investors with diverse products that meet demands as from investors diverse as investment terms, credit ratings, etc. In general, major investors include financial institutions, pension funds, and investing public. Investor bases vary depending on a stage that a nation's bond market development is placed. In a well-developed bond market, a wide array of institutional and ordinary investors invests in bonds. Such market enables bond investors to sell and liquidate their bonds immediately if necessary. But bond redeem-ability in that high level is achievable only with a developed secondary market and investor pools with diversity.

Bond brokers can benefit from revenue-generation opportunities in bond issuance and trading services while securities firms can raise bond-related revenues by designing products that would meet bond investors' demand; analyzing bond-related risk, disseminating the information to the market; underwriting newly issued bonds and underlying risk to distribute it to the market via diverse product structures.

Furthermore, a bond market is utilized as a tool of monetary policy by a central bank, and as a tool of financial policy by financial authorities. Specifically in Korea, the central bank issues monetary stabilization securities to directly adjust its monetary supply, and financial authorities use the bond market as a policy tool. Another benefit is usage as a set of key indicators via bond yields and maturity structures. Diverse groups of stakeholders use it to better understand market situations and carry out appropriate policy actions and implement strategies.

Infrastructures and intermediary functions are regarded as important as well. Bond market infrastructure includes mark-to-market; credit assessment; securities deposit systems often used as ingredients for innovative financial products such as repos; and interest rate futures. Accordingly, building an efficient bond market is an essential precondition to development of financial market, and serves as an important factor for an efficient primary market for issuers and a well-functioning secondary market for bond investors.

**Figure 1. Roles and functions of bond market**




*Source:* AsianBondsOnline.

Corporate bond market provides long-term finance to companies and financial institutions, offers investment products meeting diverse risk profiles to investors, and gives opportunities to raise revenue for financial intermediaries by commercialization based on assessment on creditworthiness of issuers. A well-developed credit market can trigger introduction and development of various credit derivatives, and carry out its role as a major indicator for creditworthiness of the entire market and risk management in the entire market.

From the issuers' point of view, corporate bonds help issuers raise capital based on their creditworthiness. A company would need various forms of financing depending on its development stage because for investors, risks and information uncertainties are different in each stage of business growth. At the beginning stage, policy financing and angel investments make up a central financing tool. In the early growth stage, venture capital kicks in to play a role as a major capital source.

As businesses expand and grow to their full potential, their demand financing increases. Accordingly, variety of financing tools such as equity and debt financing are used. When they finally enter their stage of full growth, they access capital markets for large-scale financing tools as well as bank loans. As business ownership is distributed throughout capital markets, this often invites professional management. In particular, corporate bonds are suitable for large-scale debt financing once they reach their stage of full growth. Because bonds are invested by a great number of investors in capital markets, it is important for issuers to provide transparent information on their creditworthiness at the time of and after issuance. Because this involves many stakeholders, it is not easy to make changes in bond debentures.

Because of massive scale, any event such as default will leave a grave impact on economy. And in such case, rate of debt collection remains relatively low due to insecurity of bonds. Furthermore, because corporate bonds are traded in a form of securities borrowing, efficiency of secondary market should be high. Thus corporate bond issuers are required to provide information related to their credit for market confidence, and credit assessment to play more important roles and functions to regularly assess issuers' creditworthiness. To this extent, major issuers of corporate bonds are normally businesses with high creditworthiness and large business size.

Corporate bond investors range as diverse as professional investors and investing publics. But in general, primary investors are professional investors who have knowledge about various types of structures of corporate bond. In this regard, major investors include banks, insurers, pension funds, and asset managers. In order to facilitate a corporate bond market, it is necessary to nurture professional investors with diverse risk preferences.

Corporate bonds are sold to investors after the first underwriting a securities firm. In other words, a financial intermediary first assesses an issuer's demand for financing and designs a product structure accordingly, and engages in firm commitment or stand-by underwriting. Therefore, a corporate bond market is a major revenue-generating area for securities firms, and level of growth of market is a key to securities firms' drive for building foundations for investment banking.

What is important for an active corporate bond market is function of credit assessment and efficiency of pricing. Credit rating agencies (CRAs) analyze creditworthiness of bonds or issuers and then share information with the market while bond pricing agencies evaluate market prices of corporate bonds traded in the market. What is also necessary for facilitating corporate bond market is a regulatory framework governing rules of posting, registration, and listing of bonds. Regarding corporate bond issuance, it is essential to introduce a system that regulates requirements for issuers that are relevant for individual types of products, including regulation on qualified issuers. Further, it is requisite to establish systems are related to registration and posting of issuers and bonds. Because corporate bonds are invested by a large number of investing publics, it is important to ensure protection of investors by providing adequate information related to issuance in a timely manner, and by creating securities deposit and bond registration systems.

## B. Preconditions for corporate bond market development

### 1. Legal basis and issuance process

It is critical to formulate legal basis and relevant regulatory framework related to bond issuance in order to promote corporate bond market. Legal basis of issuance of bond refers to definition of qualified corporate bond issuers; institutional arrangements for types of corporate bonds and quality of products; and institutional frameworks for primary and secondary markets. Specifically, the former clearly defines qualified issuers of corporate bonds, types of corporate bonds that can be issued, and other legal processes and requirements for investor protection. By formulating concrete requirements for corporate bonds and issuers that are differentiated from bank loans, this would provide legal and institutional foundations for investors to invest in corporate bonds, and for the market to issue and trade corporate bonds, and for regulators to build market transparency and relevant infrastructure. Thus this constitutes an important base for a fair, efficient market.

What is also quintessential is devising regulatory framework related to corporate bond issuance and trading. In particular, it is necessary to build up corporate bond issuance process and rule of disclosure. With regard to issuance, a regulatory framework should be created to oversee disclosure system, deposit procedure, issuance procedure, and investor protection scheme. On top of this, it is critical to formulate a regulatory framework for credit assessment to evaluate corporate bonds' creditworthiness and thus