



**COLLECTIVE GROWTH OF
THE ASIAN BOND MARKETS**

JOHN T. W. CHU
CHAIRMAN
AIG INVESTMENTS, ASIA

FOR THE

CAPITAL MARKETS COMPETITIVENESS SESSION
WORLD ECONOMIC FORUM
DALIAN, PEOPLES REPUBLIC OF CHINA
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I am honored to have been invited by the World Economic Forum to participate in the Capital Markets Competitiveness session as a discussion leader. This topic is of great importance to me as an active participant of Asia's capital markets. Over the past ten years, Asian governments and companies have embarked on growth strategies, requiring financing. The Asian debt market has and will continue to offer borrowers a viable alternative source of funds, apart from traditional means such as equity financing and bank loans. Asian securities regulators and central banks have made concerted efforts to develop their local bond markets. In a few markets, bond conventions and market practices are beginning to align with international best practice. This development has benefited long term institutional investors such as life insurers and pension managers who need quality assets to match their long-tailed liabilities.

I will make a few observations:

1. The first is that despite ebbs and flows of liquidity and changes to the preferred borrowing method, Asian capital markets are becoming popular among global investors, both individual and institutional, seeking to lend to high growth Asian companies and nations. Investors are attracted to relative macroeconomic stability and high growth potential. Since the Asian financial crisis, the Asian US\$ bond market has been growing fast, in size as well as in diversity. Today, the Asian US\$ bond market is around US\$170bn in size with issuers from 14 economies.

Asian bonds have fast become an asset class of its own. Global managers have introduced Asian bonds into their portfolios in an effort to diversify risks away from their traditional OECD markets. Coupled with high domestic liquidity, the Asian bid has resulted in Asian bonds outperforming their OECD counterparts. Spreads on the Lehman NJA USD Investment Grade Credit Index have since 2005 been convincingly tighter than the Lehman US Corporate Investment grade index. Similarly in the high yield sector, we have seen tighter spreads in Asia vs High yield US corporates.

The attractiveness of Asia stems from its strong economic fundamentals. Asian economies to varying degrees display high levels of economic growth, strong FDI flows, strong exports, high foreign exchange reserves, high savings rate, moderate inflation, fiscal discipline, and stable currencies. All of these have contributed to the improving credit strength of Asian corporate and sovereign issuers thereby attracting global investors to the region.

An interesting point to highlight is that the current global financial market instability emanates from the US, the most developed market, rather than from Asia. While all markets are affected by the current sub-prime lending crisis, credit spread widening has been less severe in Asia than in the US.

2. A second is the accelerated disintermediation in Asia - the process by which the traditional role of banks as the intermediary between big borrowers and the ultimate investors gradually breaks down. In the US and Europe, this disintermediation process is well advanced. In Asia, there is still some way to go, although direct access has increasingly become common. Bonds outstripped loans as a source of debt in Western Europe in 1991; loans are still dominant in

the Asia Pacific, but the gap is closing. For example, in China, domestic-currency bonds accounted for 6% of total domestic financing at the end of 1995, whereas bank credits accounted for 88%. These figures had changed to 20% vs. 61% by the end of 2006. In Singapore, bonds accounted for 10% of all domestic financing while bank credits accounted for 27% in 1995. By the end of last year, bonds and bank financing were almost equal at 15% and 17%, respectively.

The investor base is also becoming larger and more diversified, with rapid growth of the insurance industry and pension programs. More and more corporate treasurers in the region have recognized the traditional sources of funding, i.e. short-term bank loans and equities may not be the most effective capital structures and that medium to long term borrowings could provide for a more efficient capital structure. Asian banks have also accessed the debt market first by issuing subordinated debt to replenish their capital bases, then undated perpetuals to manage their cost of capital more efficiently.

However, the vast potential for future growth is yet to be released. To use an example, China's corporate bond market equates to only around 3% of the nation's gross domestic product, whereas corporate bond markets in most other Asian countries account for around 16-17% of GDP, while Japan and South Korea are around 50%, and in the US it is over 100%. The most recent developments in Asia include the evolution of the high yield market. Prior to 2000, Asian high yield issuers were restricted to sovereigns such as the Philippines and Indonesia and very few prime corporates in these countries. Gradually, the market began to expand and today, we have a wide range of high yield issuers from a variety of industries and countries.

3. According to figures from the Asian Development Bank, emerging East Asian bond markets expanded rapidly in the second half of 2006, lifting full-year growth to 32.4%, well above the rates for both 2004 and 2005. Total bonds outstanding jumped from US\$2.1 trillion at year-end 2005 to US\$2.8 trillion at the end of 2006. Government bond markets grew 30% during 2006, with net issuance strongest in China. The major issuer is the People's Bank of China, which continues to issue bonds to absorb excess liquidity in the RMB market. It was by far the largest issuer, raising twice as much in bonds as the central government. Nevertheless, the corporate sector is where we witnessed the fastest growth. Corporate bonds outstanding surged 36%. Again, growth was the strongest in China at a stunning 66%, which also accounted for 60% of the total emerging East Asian markets' new corporate bond issuance. This is largely a result of encouraging quasi-government corporations such as state-affiliated enterprises to issue corporate bonds to finance infrastructure or other capital needs. Last month, the China Securities Regulatory Commission (CSRC) began allowing listed firms to issue corporate bonds. We welcome this move and believe that corporate bonds will gradually increase in significance to the total bond market composition.

During the first quarter of 2007, economic growth in Asia remained strong. Inflation remained subdued and bond yields stayed low overall. Over the past few months during which the global credit markets have experienced significant volatility we have seen divergent behavior across Asian credit markets. In several

economies, including Japan, China, India, South Korea, and Hong Kong, a “flight to safety” phenomenon has emerged, as in Europe and the US, where sovereign bond yields have fallen sharply since the sub-prime problem emerged. However, in the Philippines, Malaysia, Thailand and Indonesia, yields have risen sharply, suggesting credit concerns are front and center in investors’ minds. This divergence reflects the market complexity across the region.

One key characteristic of the Asian domestic bond market is the appreciation of Asian currencies overall. Asian governments have consistently intervened in order to slow the appreciation pressures on their currencies. Led by the Chinese government’s decision to allow the RMB to gradually appreciate in 2005, more Asian governments have followed suit in allowing their currencies to appreciate against the US dollar. This will make the absolute return of the dollar based investor even more attractive. Domestic bond markets, therefore, have opened a new asset class to foreign investors.

4. In terms of liquidity, my observation is that the market will be impacted by large opportunistic pools of liquidity from time to time. However domestic bids will eventually be the key drivers of demand, particularly for investment grade paper. In Asia, government bonds are in general more liquid than corporate bonds. Turnover ratios varied across markets in 2006, but are still relatively low compared to developed markets. We believe that liquidity would increase as long as certain issues could be addressed. On the supply side, there are not enough investment grade corporate issuers. High-grade corporates normally have healthy balance sheets, stable earnings and cashflow and/or easy access to equity, and are still not seeing the debt market as a primary source of financing. This leaves the market with a lot of sub-investment grade issuances that are below minimum credit thresholds of quality large institutional investors such as insurance companies and pension funds. One potential solution to this issue is to introduce credit guarantees provided by financial insurers.

On the demand side, there are 2 trends which have impeded the development of a large secondary market, which is crucial to providing liquidity. These include the “buy and hold” mentality and large banks keeping government bonds as reserves. Most Asian economies still boast impressively high domestic savings. China, Singapore, Malaysia, for example, all have savings rates close to 50%, while Hong Kong, South Korea, Thailand and Vietnam are at about 30%. These savings could be channeled from the banking system or from outside of the banking system into the capital markets. Retail investors are beginning to diversify away from a traditional equity and real estate focused portfolio to include fixed-income securities in order to achieve a better balance. This trend will become more obvious in the lower-risk sovereign debt and high-grade sector when the stock and real estate markets start showing signs of weakness. This was evidenced by the recent capital flight from equities to bonds in several Asian markets as European and US credit market concerns spilled into the region. Despite the housing market turmoil in the US, Asian households will continue to purchase more homes and seek to finance them with long-term fixed-interest mortgages, which lenders could securitize and pass through to the bond market. They need to do this with caution based on sound credit risk analysis, of course. Furthermore, large infrastructure projects in Asia are increasingly being financed

by debt instruments. The potential domestic demand is conducive to enhancing liquidity, which will further compress Asian spreads, especially the highly sought-after high quality bonds.

As far as foreign liquidity is concerned, Asian countries would have to liberalize their capital accounts, which could expose their financial markets to external shocks if their financial infrastructures are not yet fully established and resilient. Whether Asian countries will eventually choose to re-open their capital accounts and the sequence and timing of so doing would be another discussion. Once the capital account is liberalized, there are then the issues of exchange rate risks, repatriation risks, and cross-border taxation, etc. Nevertheless, international investments are crucial to increasing market depth and liquidity.

5. An efficient bond market would usually exhibit the following characteristics:
 - **Stable Macroeconomic environment:** A stable and predictable macroeconomic environment, principally low inflation and stable interest rates, is conducive to bond market development.
 - **Regular government issuance** to establish benchmarks and reliable yield curves. There should also be an efficient auction process for these issuances and a large network of primary dealers and underwriters as market makers.
 - **Development of legal and regulatory infrastructure:** Hong Kong and Singapore, for example, have the most efficient and dependable legal and regulatory frameworks. Accordingly, their bond markets are also the most developed. They both have government yield curves extending up to fifteen years, higher secondary market liquidity, liberal tax treatment, diverse issuer profiles, and openness to foreign investors with minimum restrictions. In most markets, much has been done on standardizing and streamlining the issuing procedures, as well as improving transparency.
 - **Established clearing and settlement systems for perfecting financial liens and claims as well as a reliable and prompt dispute resolution mechanism:** A bond is a contract to exchange cash today with a claim of future cash flows with an agreed-upon interest. The longer the lag between handover of cash and the complete payment, the higher the risks involved. Relevant rules would have to be created to guarantee and protect the investor's rights and claims throughout the life of the contract in case of its dissolution. Speedy enforcement of these rules is equally important as creating them.
 - **Appropriate protections for capital repatriation and currency conversion:** Many Chinese firms had used their listed units in Hong Kong to issue high yield bonds in the US market to finance their operations, as the implementation of strict regulations on remitting money back to China made it a complicated and inefficient process. These firms are gradually tapping the local market. The same goes for foreign investors in the Asian bond markets. One of their major concerns is the ease with which capital can be moved in and out of a country.

- **Reasonable and predictable tax regime**, for example, no withholding tax provisions; China, Hong Kong, Malaysia and Thailand provide income tax-exempt status to sovereign bonds. Profits on government bond transactions are not taxed in Hong Kong, Singapore, Taiwan, Malaysia, Vietnam and the Philippines.
- **Accounting practices, rating conventions, and an enforceable commercial code**: Bond investors demand more information and disclosure from issuers compared to equity investors. Equity holders have unlimited upside, whereas bond holders have no upside and unlimited downside. Bond investors need to know what they are getting into. What the risks are and how they can be mitigated.

6. Looking ahead, Asian economies will be even more voracious users of funds to finance the more capital intensive era of their economic development. With their economies growing at a record pace, Asian economies have huge infrastructure needs for telecommunications, power, and transportation to name a few. The ADB estimates that Asia requires US\$300 billion worth of infrastructure investments a year to keep pace with their socio-economic growth. Traditionally, most infrastructure projects in Asia were debt financed through bank loans, but this caused tenor mismatches. Much of the infrastructure demand in Asia is for green field projects that require high sunk costs and produce no immediate cash flows until several years into operation. Bank loans usually carry shorter maturity and expose these projects to refinancing risks. Large volume of policy lending also exposes policy banks, and ultimately, the government, to heavy contingent liability fiscal burdens. In contrast, infrastructure projects in the US have been financed by municipal bonds or federal project bonds.

Capital market debt financing of infrastructure is based on project bonds backed by the future cash flows of the project. This will separate the project investor from operator and free infrastructure companies from carrying project financials on their own balance sheets, and thus allowing them to undertake projects exceeding their financial capacities. Also, the bond market could expose investment opportunities to funding sources in addition to banks, such as insurance companies, pension funds, and retail investors. Project bonds could also carry longer maturities than bank loans, better matching the lifespan of the projects and reducing their refinancing risks. Asian countries are increasingly tapping into this market to meet their infrastructure financing needs.

As potential investors in this area, though, there are several things that require some attention. For project debts, there is usually a higher level of credit risk inherent in non-recourse and limited recourse finance, in comparison with corporate and public sector credits. As for private investors, particularly life insurance companies and pension funds, they need to know what they are getting into, what are the risks, how specific coverages cover specific project risks. Is it fairly priced? Investors like high grade securities which provide safe investment outlets and attractive yield and liquidity. These will require thorough research before making the investment.

7. The development of the local currency bond market is important to AIG because we have life and non-life insurance operations in most of the markets in Asia. We

are a provider of long-term funds because we mobilize individual savings through our insurance operations. So we have a pool of funds that is long-term in nature. Therefore, we have to invest locally to deliver the appropriate return, while at the same time providing that long-term capital to support the development of the local economy. Because the money we get is insurance money, we have to be prudent in our investment approach. We do not invest in a speculative manner, as it would put policy holders' interests at risks as well as putting national savings at risk. As a result a lot of our insurance reserves are invested in the local bond markets. So we need well developed markets that we can tap into regularly. Well-developed bond markets help us hedge our liabilities, which are long-term in nature. If you don't have long duration instruments to invest your assets in, it poses a big problem for the industry, as there will be a huge maturity mis-match between assets and liabilities. This creates reinvestment risk.

Since the 1997 Asian financial crisis, all Asian governments recognized the need to develop a deeper and more balanced debt market. AIG has been a strong supporter of the efforts initiated by the various APEC working groups as well as agencies of the respective Asian economies. We are so pleased to witness and benefit from the progress that has been made thus far. We will continue to be a dedicated and responsible player in this development, which will contribute to bringing Asian debt markets to a higher plane.