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Broadening the Investor Base

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Recent global financial developments underscore the importance of cultivating strong, resilient financial markets.

The need to develop deep and liquid local currency bond markets as an alternative financing source to bank funding and international credit markets gained new impetus with the onset of the current global credit crisis. Markets with underdeveloped domestic debt markets have proved less resilient to stresses from credit rationing from international capital markets and the banking sector—especially where undeveloped local currency debt markets encourage an over reliance on foreign currency bank borrowing. Emerging East Asia is not immune to global contagion, but the lessons learned from the 1997/98 Asian financial crisis and the significant work done to develop domestic debt markets resulted in more diverse financial systems that are more resistant to external shocks.

Efforts largely focused on encouraging domestic issuance in local currency bonds using institutional reforms as incentives and removing national impediments that compromise capital flows—the Asian Bond Markets Initiative has been a major driver of much of the effort at the regional level. However, attempts to broaden the investor base have been less successful—as highlighted in consecutive *AsianBondsOnline* surveys, where market participants point to the lack of investor diversity in local currency bond markets as being the single most important impediment to deepening local currency debt markets.

A broad, diversified and mature investor base can play a key role in reducing volatility in capital flows to emerging markets and in stimulating sustainable domestic growth.

Developing Asia still relies less on bond markets than on equity or bank financing. Part of the problem may lie in the limited investor base. A broader investor base with different investment views and time horizons can (i) provide an important source of stability and liquidity to financial markets, (ii) promote the efficiency of price discovery, (iii) play a key role in reducing volatility in capital flows to emerging markets, and (iv) stimulate sustainable economic growth. Today, investors in emerging East Asian local currency bond markets are dominated by largely government-controlled contractual savings sectors (CSS). Strong growth in contributions outstrip the availability of new local currency debt assets and the CSS are frequently restricted in their investment guidelines—in some cases there are restrictions on investing offshore or in higher-risk assets, requirements on pension funds to guarantee minimum returns and a disproportionate allocation to investments in fixed-income securities. The combination of forced investment, lack of available debt assets and the absence of new high-quality domestic issuers create a “crowding in” effect—whereby CSS buy much of the available debt stock, resulting in compressed credit risk margins. This leaves investors subsidizing domestic borrowers. It also discourages discretionary investment allocation into Asian fixed-income markets, as tight credit margins are considered too low to justify the underlying credit risk. The result is debt markets that lack liquidity as well as investor diversity.

Local currency bond markets benefit from investor diversification

A range of intermediaries with differing portfolio preferences mean markets are less dependent on a dominant investor group whose investment decisions could destabilize markets. Diversification implies a broader range of market participants by type of intermediary, risk preferences, product usage, form of prudential regulation, ownership criteria, and by domicile. A corollary to this is that no amount of investor diversity can completely insulate a market in extraordinary market conditions—as the recent turmoil shows. The recent credit seizure may also suggest that a security-based model or a system encouraging an environment of unsupervised credit risk transfer is no longer what emerging markets should aim for. Nevertheless, a diverse investor base within a prudently regulated environment significantly reduces the risk of one-way portfolio flows and volatility. Also, all participants in debt markets (savers and borrowers) benefit from having distinct choices available in intermediation channels, assuming they have the most transparent means to evaluate those alternatives.

To broaden the investor base, financial markets need to be more effective in pooling surplus savings and allocating them to the most productive investments.

Investor participation—particularly foreign investors—remain constrained by capital controls, taxation policies, lack of access to local funding and hedging, as well as a general lack of product choice. To improve financial market effectiveness, several steps can be taken:

Allow greater choice to existing nonbank intermediaries—including government-owned contractual savings vehicles (CSV). Some CSV's in the region are presently required to invest up to 70% of their assets in local fixed-income instruments. In an environment where the growth of contributions outstrips the growth in local currency bond markets, this can lead to excess demand for assets regardless of compressed risk premiums.

Permit more freely transnational issuance and investment in Asia's capital markets. Supply and demand elements need to be addressed together to encourage a more diverse investor base with markets priced to reflect credit fundamentals. Greater supply of local currency debt securities widens investment choices away from traditional investors of local currency debt. It can also lead to increased borrowing costs that might more adequately reflect risk in the corporate sector. Allowing increased foreign ownership of securities adds much needed balance to the demand function. Some caution needs to be exercised to ensure that markets are not overly reliant on a single investment group—either foreign or domestic.

Encourage participation of retail investors, primarily through mutual funds that can act as a counterbalance to buy-and-hold investors. Mutual funds tend to be actively managed and therefore sensitive to short-term interest rate changes.[11]

Broaden the local institutional investor base by establishing funded pension schemes and a domestic insurance sector. Increased demand from institutional investors has the potential to become a driver of local currency bond markets—and capital markets more generally—as investment regulations and liberalization of asset allocation restrictions gain more traction. A broadening of the institutional investor base can also create demand for long-term financial instruments.

Be open to all investor-types. Ensuring a level playing field, including entry requirements and taxation for local and foreign entities can help expand investor participation. Addressing impediments such as capital controls, and fostering development of hedging and financing instruments, can also help. More openness can lead to higher sensitivity of capital flows and volatility of exchange rates, which requires proactive risk monitoring by regulator authorities.

Develop a coherent policy framework and effective regulation to foster development of nonbank financial institutions—especially in the areas of regulation, enforcement, competition, taxes, skills, and investor education.

Develop a broader array of financial instruments and supporting infrastructure—including government repurchase markets, securities lending, and derivatives markets. Extension of the yield curve in sovereign and corporate fixed-income securities could also promote more diverse local financial products.

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[1]Some caution needs to be exercised in promoting exclusive retail bond investment channels as it can limit supply of tradable debt and encourage further buy-and-hold investment.