The Case for Bond Market Development

Making the case for the development of bond markets, especially domestic bond markets, has a number of general advantages for the local economy. There are several types of bonds characterized by type of issuer, risk, buyer, and currency denomination.

An international bond, for instance, is a security issued by a domestic company or a foreign company in an international currency to tap foreign capital in the foreign market. In contrast, a domestic bond is an obligation of a domestic issuer denominated in domestic currency and sold and traded in domestic markets. These bonds typically carry coupons or interest payments for specified periods of maturity. Both international and domestic bonds mostly consist of government bonds and corporate bonds.

The most important difference between corporate bonds and government bonds is their risk profile. Corporate bonds usually offer a higher yield (i.e. basically return on your investment) than government bonds, because the credit risk is generally considered greater, although this is not always the case. Many developing countries have chosen to issue bonds in international markets in addition to domestic bonds. This is partly due to the limited ability to get funding in the local markets. These funding strategies tap the larger pool of resources but can also create vulnerabilities in the economy due to of course the exchange rate risk and the so-called rollover risk.

Earlier, we established that bond market development (and we will focus on the domestic bond market) can benefit both the government and private sector. So, what steps must be taken to develop these markets?

Key Conditions

To develop domestic government and corporate bond markets, it is important to have the following key conditions in place:

1. ***Sound Macro Economic Framework***
   A sound macroeconomic framework provides a stable and conducive environment for bond market development. Both domestic and foreign investors will be reluctant to purchase domestic bonds when there are expectations of high inflation, large devaluations, or high risk of defaults. If a country is perceived as not having the ability to manage its public expenditures and tax revenue, or has built up substantial debt obligations, investors (both foreign and local) will perceive a high default risk and the cost of financing government borrowing through the issuance of bonds will rise. Having a sound macroeconomic framework also includes having a clear and credible bond issuance strategy and debt management framework. What do you borrow for and how will you pay back.

   The development and professionalism of the domestic banking sector can also “feed” the domestic bond market development.

2. ***Development of the Banking Sector***
   In many countries, banks are major holders of domestic government bonds, which are generally seen as relatively safer assets, and serve as collateral for a variety of transactions. Banks can also act as primary dealers to improve market liquidity. In contrast, domestic and foreign investors' concerns about the soundness of the banking system will adversely affect the ability of the government to roll over or issue new debt.

   A troubled banking system can further complicate the development of bond markets because important related markets, such as interbank and repurchase agreement transactions, are unlikely to function properly. A sound, legal, and regulatory framework governing bond markets supports the development of a deeper, broader, and more efficient bond market.

3. ***Legal and Regulatory Framework***
   One risk that exists for bond investors is the risk of default. So it is critical to have investor protection, which is provided via bankruptcy law, property right legislation, and bond covenants in most cases.

4. ***Functioning Financial Infrastructure***
   A well-functioning financial infrastructure is needed to ensure the security and enhance the efficiency in bond trading. Financial infrastructure here refers to the physical underpinnings for a financial market exchange, including trading platform and trading system, and the market regulator and the industry that processes, evaluates, and validates the information being produced and used by the markets.

5. ***Institutional and Foreign Investors***
   Opening up to institutional and foreign investors has built a critical mass of investors to provide market depth and liquidity. Governments can jumpstart bond market development by opening up to foreign investors gradually and carefully.
   Institutional investors can exert pressures for better accounting and auditing standards, as well as for a more accurate and timely disclosure of information to investors. Opening up to institutional and foreign investors can be introduced as the market starts to develop. We will discuss the sequencing in bond market development in more details below.

The Challenges

Bond markets worldwide are built on the same basic elements: issuers with financing needs, investors, intermediaries that bring together investors and issuers, and infrastructures that provide conducive environments for transactions and settlement. Developing a domestic bond market is a complex undertaking that depends on each country's financial and market system development and is often also culturally "determined". Countries face many challenges, including the following:

- Lack of sound macroeconomic policies: High fiscal deficits, high inflation, and especially exchange rate volatility can weaken investor confidence.
- Shallowness of the investor base: In many cases, markets are dominated by a few banks and other institutional investors, which makes competition scarce and transaction costs high.
- Inefficient debt management practices: For example, irregular and nontransparent government bond issuance practices discourage investors, including longer-term foreign investors, from entering the local market.
- Poor monetary policy coordination: Poor coordination between a government and it's central bank authorities can create simultaneous issuance of government and central bank instruments, which further fragments an already small market.

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These challenges, however, should not prevent authorities from developing a bond market because of the potential benefits for the government and the economy. Several countries have successfully developed their domestic bond markets despite facing critical challenges.

For instance, since the 1997 crisis, Singapore, Malaysia, Indonesia, South Korea, and Vietnam have achieved remarkable progress in developing their respective domestic bond markets (Laeven, Luc and Fabian Valencia, 2012). Total market capitalization in the Asian region surpassed $10 trillion in 2017 and comprises more than 60 percent of the underlying gross domestic product, which is 18 times larger than the pre-crisis level. Indonesia and Thailand have made concerted efforts to develop their markets, including strengthening public debt management capacity. South Korea and Malaysia have developed bond markets that are well balanced between the government and corporate segments, with significant depth in both markets. These countries have also established sound market infrastructures in line with the development levels of their bond markets (International Monetary Fund and World Bank, 2018).

Final Thoughts

Developing a domestic bond market is a long and challenging process. During the early stages of development, it is crucial that a country focuses on building a robust, efficient government bond market to set the stage for corporate bond market development. Sequencing the different steps in government bond market development is dependent on country-specific circumstances. The size of the economy, the level of competition, the sophistication of the financial sector, and the types of potential investors are all important factors. These factors determine not only the appropriate sequencing of initiatives, but also whether public sectors should actively engage in improving different aspects of market development.

For the Dutch Caribbean Island Curaçao we are confident to say that the Dutch Caribbean Securities Exchange, or DCSX for short, was and still is one of the key factors in the financial infrastructure that can facilitate the development of the domestic bond market. The DCSX was founded in 2009 and started its operations in 2013 basically. The domestic bond market initiated with listings of government bonds that were listed but not yet traded on the exchange's platform, followed by local corporate bonds a few years later. The success of the domestic bond listings showed the potential for more bond market development in Curaçao. As a result, the DCSX started considering the possibility for international bonds to be listed and traded on its platform. And yes, the first substantial international bond listing application arrived. In consultation with the regulator, and other stakeholders, the DCSX Management considered the pros and cons of this type of listing. The Listing Committee took the final vote and so the first international bond listing denominated in a non-domestic currency on the DCSX platform was approved. This listing was a success in the raising capital period due to several key factors including:

- Due Diligence documents were provided timely;
- All application related queries were addressed timely by the proactive Listing Advisor;
- The Prospectus contained all information and was prepared at high quality level;
- A well planned "Roadshow" for investors with all necessary parties and making use of the right distribution channels;
- Trust from Foreign Investors.

The process has it challenges of course but with the right team the road to a successful listing for the issuer does not have to be long.

As the DCSX we will continue working hard to develop the domestic and international bond markets even further alongside our Members, our Listing Advisors, our Brokers, our Regulator and other stakeholders.

Sources:

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