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

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

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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.

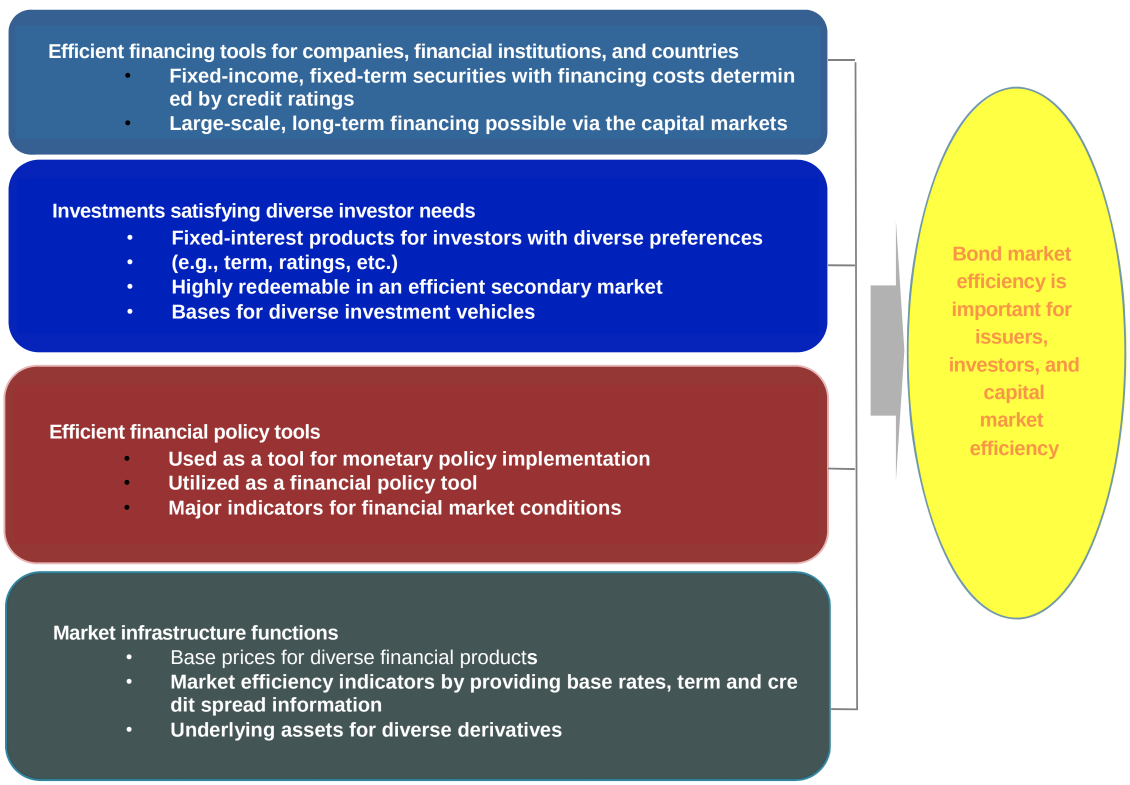
A bond market also offers benefits for bond investors with diverse products that meet demands as from investors diverse as investment terms, credit ratings, etc. In general, major investors include financial institutions, pension funds, and investing public. Investor bases vary depending on a stage that 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 ensure efficient market operation. Secondary market also should be a subject of oversight by a regulatory framework that desirably stipulates market operation requirements for both exchange market and OTC market, which would ensure sound operation.

In addition, a prudential tool to ensure investors to acquire proper information throughout cycles of issuance and repayment and achieve soundness of market. First, legal basis and rules of disclosure rules should be established for issuance. In general, this may not be critical in a nation with a well-developed corporate bond market that has already established infrastructure related to issuance procedure and disclosure. On the other hand, a country that is just about to set up a corporate bond market must first build up a sophisticated issuance procedure and information flow to ensure investor protection and operation of overall market. In this regard, regulators must design and develop a sophisticated issuance procedure including qualified issuers; an issuance-related reporting process and contents; method of offering post-issuance information; deposit and registration procedures; method of issuance; necessary documentation and post-issuance management and procedure.

Also, secondary corporate bond market needs a certain set of requirements including trading methods; trading infrastructure; detailed bond trading procedure, trading standards and disclosure rules. As for infrastructure, the market should establish its regulatory basis should on types of bond trading. Moreover, it is recommended to set up an information platform through which secondary market information is distributed to investors.

2. Issuer

Companies issuing corporate bonds should review incentives for issuance and design a market structure that would live up to such incentives. The existing literature provides evidence that companies finance via corporate bonds with diverse incentives. Hoshi, Kashyap and Scharfstein (1993) report that bank supervision discourages investment proposals and accordingly, a company with multiple investment opportunities increases percentage of corporate bond financing.

Building a market where companies can choose from multiple financing structures can be an important element to boost growth for business and ultimately, overall economy. Therefore, facilitation of bond market should be pursued for building diverse types of markets that are in line with financing structures required for all stages of business growth.

Companies generally source their finance from banks or corporate bonds depending on their conditions. Also, they prefer private placements or public offerings to finance through corporate bonds. In general, large-sized, well-known firms tend to opt for corporate bonds. While companies with high growth potential tend to raise capital through equity financing, companies in their stage of full growth usually finance via corporate bonds.

For incentives for choosing corporate bonds instead of bank loans, the most important factor would be market conditions, for instance, stage of development of a corporate bond market. In a country where both markets are fully-developed, other factors including degree of information asymmetry, financing costs, and financing conditions could be important. Incentives for corporate bonds are generally known to be higher in a market where information asymmetry is low; incentives for large-scale financing are high; and financing via capital markets imposes no cost disadvantages as the market made its full growth. This signals importance of policy drives to expand investor base for higher market efficiency; designing a cost-effective market structure for less financing costs; and enhancing information transparency. All of these will eventually increase incentives for corporate bonds and facilitate the market.

3. Investor base

Expanding investor base and diversifying bond products that suit investor preferences are essential for facilitating corporate bond market. Corporate bond investors buy corporate bonds to receive pre-defined interest payments during investments and principal payment at maturity. Even if an issuer performs well and reports high earnings, a corporate investor would receive a fixed amount of investment profit at predetermined principal and interest payments. This predisposes corporate bond investors to exhibit conservative investment behavior. To this extent, for building a market meeting investor needs, it is indispensable to have issuers with stable credit standings issue corporate bonds.

In case of issuers with relatively lower credit ratings, on the other hand, it is needed to design a product scheme with which investors can share profits of issuers. Such scheme would build a market structure that would meet demands of investors. Specifically, warrants or convertible bonds can provide investors with opportunities for making profits, offsetting inherent credit risk. This will help offer conditions under which investors with diverse risk profiles can meet their individual needs via bonds with diverse structures.

What are helpful to promote corporate bond market are plans to expand a pool of professional investors. Because corporate bonds have diverse credit ratings, complex structures, and large trading units, it is difficult for investing publics to access. This emphasizes needs for policy drives to expand investment base via indirect investment vehicles. Professional investors are capable of large-scale investments based on their analysis on issuers' creditworthiness and product characteristics. Fostering professional investors and facilitating indirect investment vehicles will surely broaden investment base for corporate bonds.

4. Intermediary

Another precondition to a well-functioning corporate bond market is smooth operation of intermediaries. In developed countries with active corporate bond markets, investment banks analyze diverse demand for corporate financing and business features to design suitable financing structures and underwrite corporate bonds on a firm-commitment or stand-by basis. Based on their capability of analysis, underwriting, and commercialization of risk, investment banks play a key role in facilitating corporate bond market. Hence, it is critical to enhance investment banking function of securities firms.

More specifically, it is desirable to improve capability of business analysis of securities firms to help them nurture their roles as brokers. Designing diverse product structures would be made possible only by their ability of business and credit analysis. On top of this, their ability to underwrite corporate bonds as dealers is essential for sound development of the corporate bond market. Because it is hard to grow corporate bond market only with the function of brokering, other roles such as underwriting and post-issuance management of bad debt should be strengthened to promote market development. In this regard, it is necessary to nurture large-scale securities firms with expertise in brokering corporate bonds. If securities firms with sufficient capital, professional human resources, and proven expertise take hold in the market, they will be able to use aggressive market-facilitating strategies to boost their profits and further, the entire market.

5. Infrastructure

Infrastructure surrounding corporate bond market includes CRAs, bond pricing agencies, and depositories. They are responsible for providing information on corporate bond market; and ensuring stability in trading via settlement and depository. In order to facilitate corporate bond market, relevant infrastructure should have its roles and functions emphasized. CRAs analyze every element that may affect redeem-ability of credit bonds such as ABS and corporate bonds to label creditworthiness in a simplified format of information such as credit rating for stakeholders. Credit assessment offers information, and addresses information asymmetry among investors and issuers. This enhances market efficiency by determining risk premiums that are different across credit ratings. As an independent third party independent from issuers and investors, CRAs, based on their professional capability in analysis and consistent standards, provide information on issuers' credit risk for investors.

In this sense, investors tap into credit ratings as objective indicators for evaluating creditworthiness of credit bonds when they purchase, hold, and dispose those bonds in their portfolio construction. Another role of credit assessment is enhancing market transparency. CRAs not only publicize creditworthiness of issuers, but also regularly monitor changes and then provide information to the market. Once risk premiums are determined across credit ratings, they serve to enhance market efficiency. Recently, credit ratings are increasingly used for purposes other than bond issuance. In particular, their use in internal investment guidelines and for regulatory purposes has been prevalent around the globe. Also, credit ratings have been widely adopted in managing credit investment products by financial institutions and pension funds. For regulatory purposes, they have been used for prudential supervision of banks, central banks' collateral framework, and asset managers' investment policy. When computing the BIS capital ratio, credit ratings are utilized as a standard for internal ratings, and in the standardized approach, as a tool of measuring of risky assets.

For a corporate bond market to achieve sound development, credit assessment should play its intended roles under a proper regulatory framework, which poses another challenge. Especially, regulators must come up with a series of regulatory regimes about the market entry, conduct of business, and disclosure rules to improve CRAs' accountability and confidence.

In most countries, corporate bonds are not traded every day. Thus it is a challenge to measure fair market price. This is why some countries let investment banks or bond vendors with proven expertise in bond trading provide mark-to-market information. Price information with low credibility often undermines reliability of transaction. To address the issue, the financial authority in Korea designates a bond pricing agency that provides mark-to-market information on various bonds including corporate bonds. Bond pricing agencies collect data on bond issuance and trading, based on which sets price models to compute mark-to-market data on individual bonds and disclose the data to the market. Such data are used by financial institutions to price their bond holdings, and the prices become reference for bond trading. Korea's mark-to-market system has helped enhance bond price credibility, and facilitate bond trading.

Bond registration and deposit are regarded as important elements for safe and efficient bond trading. Bond registration is a system where rights of bondholders are administered by book entry, rather than issuance of physical certificates. Bonds are registered via a register managed by a government-designated registrar. As such, adopting a bond registration system helps clarify bondholders' rights, reduce costs of bond issuance, and promote efficiency in bond trading.

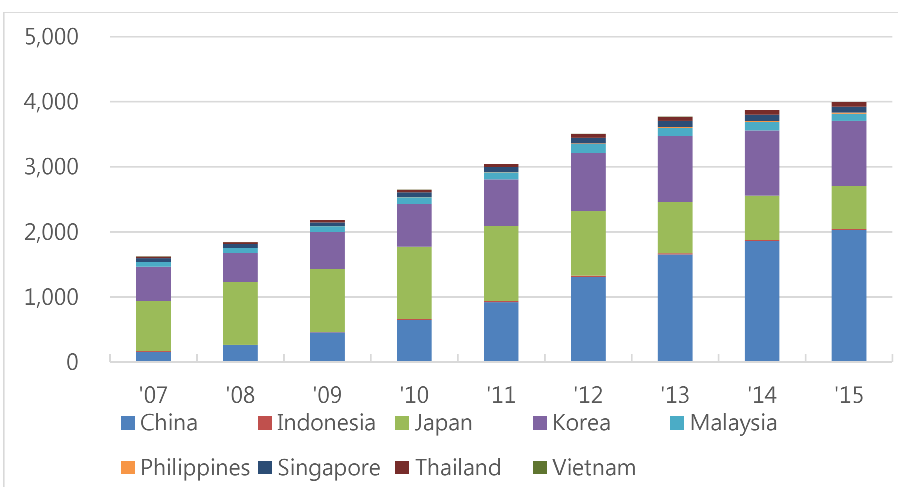
In general, bonds are registered in following process. An issuer establishes a contract delegating principal and interest payments. A bond registrar registers bond issuance information in register as soon as bonds are subscribed after the issuer establishes a contract delegating the principal and interest payments and bond subscription. After the subscription, the issuer immediately notifies the information to the registrar that would record it in the bond register. When registered bonds are traded, the registrar receives information of new holders at the time of settlement to transfer the ownership accordingly. This reduces bond issuance costs, accelerates issuance process, and enables fast back-office operations.

III. Corporate Bond Market Development in Asia and the Pacific

A. Overview of local corporate bond markets in Asia and the Pacific

The corporate bond market in Asia and the Pacific continued to grow steadily even after the global financial crisis in 2008. The size of the corporate bond market in terms of the balance outstanding in the sample countries increased more than 10% after 2007 until 2012. The growth was mainly driven by China. The Chinese corporate bond market grew more than 40% annually from 2007 to 2012. This is remarkably rapid growth especially compared with the other major corporate bond market in Asia, namely Japan and Korea. Although the growth in Chinese corporate bond market significantly slowed down after 2012, the growth rates are still much higher than competing neighbor countries.

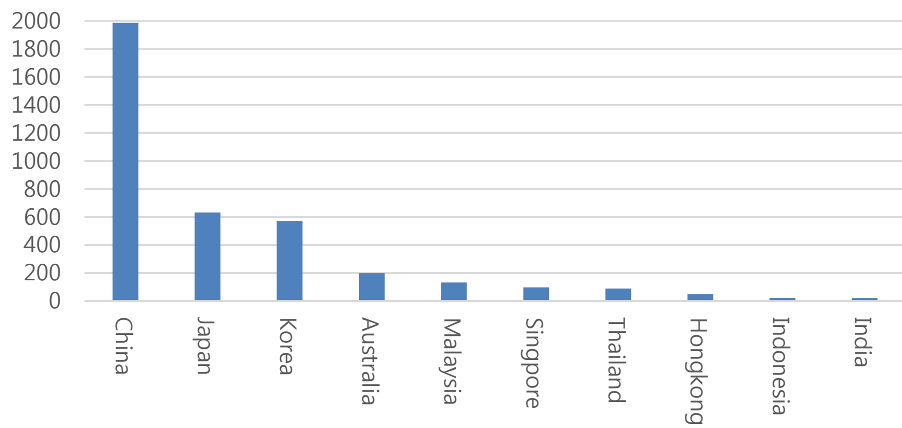
Figure 2. Growth of the corporate bond markets in the sample countries



Source: AsianBondsOnline.
Note: Unit in terms of billions of US dollars.

In Asia and the Pacific(except North America), China has the largest corporate bond market. As of June 2015, Chinese corporate bond market marked 1,988 billion USD in terms of the balance outstanding, which is more than 50% of the sample corporate bond market in the region. Two other major corporate bond markets in the region include Korea and Japan. Korea's corporate bond market which is considered as one of the most active corporate bond market in Asia recorded 571billion USD in terms of the balance outstanding. While Japan has the largest government bond(JGB) market in Asia, its corporate bond market is relatively less active than JGB market.

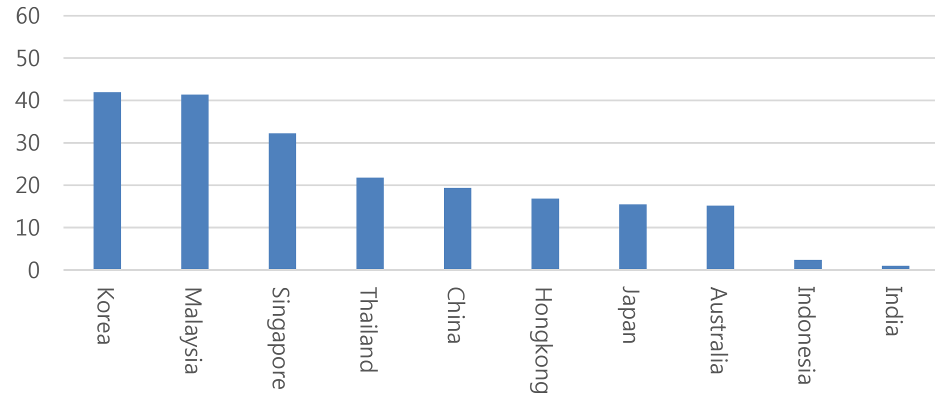
Figure 3. Amount outstanding of bonds issued by companies (2015 Q2)



Source: BIS.
Note: Unit in terms of billions of US dollars.

It is notable that the corporate bond market development in Asia and the Pacific(except North America) are not quite successful so far. China, Korea, and Japan have sizable corporate bond markets, but the other countries in the region have under-developed corporate bond markets. Most countries heavily rely on banking sector for financing their development. When we compare the size of corporate bond market and GDP, it is obvious that the market development is still in early stage. The ratio of corporate bond market to GDP is higher than 40% only in Korea and Malaysia. China and Japan, which have the two largest corporate bond markets in the region, have the ratio lower than 20%. Japan is well-known for its heavy reliance on banking sector. Though the size of Japanese corporate bond market is bigger than Korean one, the degree of maturity is not higher than Korean market in terms of openness and product diversity. While Chinese corporate bond market is simply the largest one in the region, it can be still regarded as a developing market with respect to quality measures. In contrast, Malaysia and Singapore have shown relatively higher degree of market development. The ratio for Malaysia and Singapore are 41% and 32% respectively. This could be partly because the two countries have relatively well developed financial markets.

Figure 4. Corporate bond market to GDP ratio (2015 Q2)



Source: BIS.
Note: Unit in %.
GDPs are as of December 2014.

For many countries in Asia and the Pacific, the corporate bond markets have only limited role in financing for development. Some countries have large corporate bond markets, but their qualitative measures are not as good as the quantitative growth. In some other countries, the market development direction is in the other way. However, the most serious problem is likely to be that the corporate bond markets hardly exist in many countries in the region.

B. Case study: Korea's experience in corporate bond market development

Korea has relatively well-balanced corporate bond market both in quantitative and qualitative measures. Although Korean market still has many weak points especially compared with the United States and European corporate bond markets, it has shown very rapid market development. Therefore, I will investigate the characteristics of Korean corporate bond market in order to shed light to the other countries in the region for their market development. Some developing countries in Asia actually try to adopt Korea's experiences to improve their financial regulation and infrastructure. Korea innovated the market system right after the 1997 financial crisis, which appeared to contributed to its growth significantly.

1. History of corporate bond market in Korea

The corporate bond market in Korea has enjoyed continuous growth thanks to an increase in demand and supply, and the government's policies to foster the bond market. The corporate bond market emerged as a major financing tool for companies and financial institutions after the introduction of public placement bonds in 1972. With improvements in legal and institutional framework and changes in demand and supply, the corporate bond market has grown into one of the well-functioning markets today.

Before 1972, corporate bonds were issued via private placement by several large companies. CB and secured bonds were issued by some firms. At that time, corporate bonds, once issued, were mostly underwritten by policy banks and public financial institutions including Korea Development Bank (KDB). Bond guarantee was introduced in 1972, paving the way for the creation of the public placement market for corporate bonds.

Growth of the corporate bond market in Korea shows significant difference in the time of post- financial crisis from the time of pre-financial crisis. Before the Asian financial crisis, the Korean corporate bond market was dominated by guaranteed bonds. Major bond investors were bond funds and banks. Most companies issued bonds carrying guarantees from banks, securities companies or merchant banks. Especially, easing of regulations on bond issues led to a gradual increase in financing via bond issuance.

The Asian financial crisis drastically reshaped the structure of the corporate bond market. During the crisis, some large corporate issuers went bankrupt. This caused deterioration in the asset quality of financial institutions guaranteeing the payment of bonds issued by defaulted issuers. Consequently, the financial market was frozen. In the wake of the financial crisis, the government strived for an overhaul of the corporate bond market. As a result, a structural shift took place in demand and supply, and the related market infrastructure made an improvement. In parallel, the market structure changed. Further, the asset-backed securities (ABS) market was opened with adoption of related laws and regulations.

The corporate bond market underwent significant structural changes after the crisis. Non-guaranteed bonds came to dominate the bond market. Bond issue volume rose gradually. Various bonds were issued with different issuance structures. The ABS market was introduced. However, several bond defaults weakened investor confidence in the corporate bond market. Investors strengthened their credit rating criteria for inclusion of corporate bonds in portfolios. Hence the corporate bond market has been transformed into a market dominated by high quality bonds. Recently, the government has taken policy measures to facilitate the issuance of bonds with lower credit ratings. By introducing high-yield bond funds, launching the qualified institutional buyers (QIB) market, and stimulating CDO issues backed by lower-grade bonds, the government has encouraged lower-rated companies to raise more funds via the corporate bond market.

2. Key policies

Korea has undertaken policy measures to enhance transparency and stimulate growth in the bond market. Most noticeable are the following post-crisis policy measures: introduction of the bond pricing regime; measures by the Ministry of Finance and Economy (MOFE) to grow the bond market in February 2000 and November 2005; the Financial Supervisory Commission (FSC)'s measure to foster the bond market in December 2006; the measure for improving the primary bond market in October 2011 aimed to nurture investment banks; and the bond market normalization plan in 2012.

In 1999, mark-to-market (MTM) pricing was introduced for bonds in order to address difficulties in bond trading stemming from non-transparent price information. Unlike stocks, bonds are treated as separate issues according to timing of each issue, even if they are issued by the same issuer. Hence not all bond issues are traded in the market. Even government bonds are generally traded up to a certain point within one year after issuance and then their trading decreases sharply. It is therefore difficult to determine bond prices based on bonds in circulation. These characteristics are incorporated into the MTM pricing regime for bonds, under which bond pricing agencies are set up to estimate fair value of bonds based on market prices and publicly disclose bond prices.

After the Asian financial crisis, Korea introduced the MTM valuation system, and gradually expanded its scope. MTM valuation was applied to all types of investment funds in 2000. Its scope of application was further expanded to include variable insurance products and repurchase agreements (RP) in 2002. Three bond pricing agencies were formed in 1999 to provide bond pricing and information services. One more agency was founded in 2012. Currently, there are four bond pricing agencies operating in Korea. The MTM bond pricing system contributed to making the bond market more transparent and the secondary market more efficient.

In 2000, the MOFE carried out its policy measure to develop the bond market with focus on market structure improvement. The measure included: i) streamlining the bond issue process; ii) broadening the role of financial intermediaries in bond transactions, iii) improving the structure of bond issuance and trading; iv) allowing establishment of IDB and bond brokerage firms (securities firms specializing in bond trading); and v) introducing RP transactions. The latter two were designed to boost bond trading. As part of the measure, the bond demand base was also expanded by increasing the number of financial institutions dealing in bonds, and encouraging institutional investors to invest more in bonds. In addition, the disclosure system was adopted to ensure greater transparency in the bond market. Under the disclosure regime, securities firms were required to report bond trade data within thirty minutes after the trade execution to KOFIA, which, then, must disclose such trade data immediately via its terminal. These disclosure requirements enhanced transparency in OTC bond trading and increase efficiency in the secondary market.

In 2005, the MOFE explored possibility of starting bond administration companies (the debenture trustee system) and guarantee insurance business in an effort to invigorate the bond market. The 2005 policy measure included the following key priorities: i) making transactions easier and more convenient for those investing small amounts in bonds, ii) alleviating the burden of securities companies to hold instruments, and iii) improving the specialized bond dealer system to build the broader demand base. However, no progress was made on bond administration companies because the revision of the Commercial Act was needed. In 2009, the relevant act was amended to introduce the debenture trustee system. For the guarantee insurance regime, the Korea Credit Guarantee Fund Act was revised to allow Korea Credit Guarantee Fund to guarantee timely payment of principal and interest on bonds. However, the market for guaranteed bonds could not receive a boost from the new regime.

In October 2011, a measure was implemented to improve the primary market for nurturing investment banks. The measure sought to normalize the issuance process by requiring arrangers to function due diligence and market-making. Before the measure was adopted, due diligence had been a formality because of the streamlined issuance process. Arrangers hardly performed their function of market-making. As a result, issue price of a bond had been determined by agreement between an issuer and its arranger, rather than by the market. However, the introduction of the due diligence and market-making obligations allowed bond issue prices to be determined by the market. Activities surrounding due diligence made issuer information more readily available to the market. When the corporate bond market squeezed in 2013, the government announced its plan to normalize the market in July 2013 by providing tax benefits to high-yield funds and promoting corporate bond funds.

3. Market infrastructure

(a) Issuance infrastructure

To make a public offer of bonds, the issuing company should be registered with the FSC and file a securities registration statement with the FSS for bond subscription or sale. Article 9.5 of the FSCMA defines public sale as making an offer to more than fifty individual investors to subscribe for securities. A threshold of fifty people is used to determine whether the offer is made to the public or not. The issuer is not subject to the requirement to file a securities registration statement when issuing bonds via private placement. More relaxed disclosure requirements are applied to private placement issuance. However, privately placed bonds are not allowed to trade in the secondary market for one year after the issuance.[1] Limits are imposed on holding of private bonds by institutional investors under their internal investment policy or under the relevant law.[2] When banks underwrite privately placed bonds, they should pay contributions to Korea Credit Guarantee Fund.

Securities issuance regulation in Korea is based on an emphasis on disclosure. Under the regulation related to disclosure, issuers need to make full disclosure of required information in a pre-set form to investors. Regulatory authorities do not verify or assess accuracy or appropriateness of information disclosed by issuers, leaving judgments and decisions up to investors.

The FSCMA requires an issuer to submit a registration statement for securities subscription, and, once the statement is accepted, allows the issuer to make an offer for subscription. For corporate bonds, a securities registration statement is deemed to be accepted on the date when it is filed, if the statement is prepared in a pre-set format without omission of any material information. The registration takes effect in 7 days from the filing date. Recently, the Korean government has revamped procedures for corporate bond issuance. As a result, book-building results should be taken into account when coupon rate of public placement bonds is determined. Moreover, information on the determined bond price must be included in a securities registration statement.

(b) Bond listing process

Once issued, bonds go through listing process. Only listed bonds are eligible for trading on the exchange. Deciding whether to list bonds depends on an issuer. However, if bonds are listed, these bonds can be traded on the exchange and the issuer's credibility increases. Also, the listed bonds can be used as collateral or substitute securities. Institutional investors are allowed to invest in listed bonds. Most corporate bonds in Korea are listed on the exchange because of the advantages previously mentioned.
To ensure efficiency and stability of the secondary market, Korea Exchange(KRX) allows issuers to list their bonds only if they meet listing requirements. The exchange has a set of listing standards for securities with respect to bond listing. Listing of bonds

[1] Article 11.3 of Enforcement Decree of the FSCMA, and Article 2-2 of Regulation on Securities Issuance and Disclosure

[2] For instance, Article 106 of Enforcement Decree of the FSCMA concerning the management method of trust assets stipulates that investment in privately placed bonds shall not exceed 3% of each item of trust property in case of an unspecified money trust.

is not mandatory in Korea, although most bonds are listed on the exchange. There is no disadvantage to unlisted bonds. However, listing bonds on KRX has many advantages. For example, listed bonds can be traded on the exchange, and are assigned with their own bond code (ISIN code). Hence most publicly placed bonds are listed on the exchange. For listed bonds, bond information (e.g. the issue date, payment date, amount to be listed, coupon rate, and credit rating) is publicly available to investors via securities data terminals, market news or KRX' website. Moreover, changes in information about listed bonds (e.g., the conversion price, credit rating and others) are managed during the listing period. Bonds may be delisted to protect investors in the event that the company listing such bonds faces operational suspension or goes into default.

When a securities registration statement is filed and accepted by the FSS, a new listing application and related documents should be submitted to KRX for listing bonds. The issuer or its lead manager can apply for new issue listing. Required documents for bond listing include a new listing application form, copies of contracts on bond issuance and subscription, three-year financial statements and other financial information, and a certificate of payment for debt securities.

KRX has established listing rules and requirements regarding an issuer's capital; bond subscription methods; amount of issuance amount and outstanding bond; and bond registration. Listing criteria for bonds are different from listing criteria for securities, and are more eased. In addition, KRX operates electronic disclosure document filing system, through which companies listing bonds disclose their material information efficiently, and also operates electronic disclosure distribution system, through which individuals search and view disclosure documents filed by companies whose bonds are listed on the exchange.

(c) Disclosure and oversight

Korea has two-tier disclosure system for corporate bonds; primary market disclosure and secondary market disclosure. Primary market disclosure documents mainly include a securities registration statement and a prospectus. Secondary market disclosure consists of periodic disclosure (quarterly, semi-annual and annual reports), event-driven or ad-hoc disclosure (material event notices) and other disclosures (fair disclosure and others).
Primary market disclosure is designed to help investors make informed decisions on bond investment by requiring corporate issuers to disclose detailed information on their business profile and bond issuance. A securities registration statement contains information about the offering method, pricing method, subscription procedure, major rights represented in securities, risk factors, subscription and sale (with underwriter's opinion thereof) and issuer profile. For periodic disclosure, issuers must release their quarterly, semi-annual and annual reports via the FSS's electronic disclosure system. For event-based or ad-hoc disclosure, issuers are required to disclose if they face any issues related to credit (e.g. bankruptcy) or financial condition.

KRX is responsible for administration and management of listed bonds. To ensure investor protection and market stabilization, the exchange may suspend trading of any bonds if i) fake or counterfeit bonds are discovered; ii) the guarantor's business operation is suspended; iii) in case of equity-linked bonds, the related equity issue is put on the watch list; or iv) delisting is triggered when any of pre-specified conditions is met. Furthermore, KRX introduced a new reporting requirement for issuers to make sure that accurate information on listed bonds is readily available. Issuers are required to report any changes in listed bonds to KRX. Further, information on the price and quantity of exchange-traded bonds must be disclosed through bond information terminals. As for bonds traded in OTC, trade data should be reported to KOFIA within fifteen minutes after the transaction is completed. KOFIA must make the data publicly available in real time. This reporting requirement aims to enhance post-trade transparency.

(d) Credit rating system

There are two types of credit ratings; issue rating and issuer rating. An issue rating is an assessment of the likelihood that an issuer will pay principal and interest on a particular bond issue. Creditworthiness of the issuer and characteristics of the issue are taken into consideration to assign a rating. An issuer rating indicates creditworthiness of an issuer, i.e. the overall capacity of an issuer to meet financial obligations, based on the analysis of the issuer's financial position. An issuer rating is used as a basis for assigning an issue rating. In other words, an issue rating is notched up or down from its issuer rating, depending on issuance terms, such as the existence of guarantee/collateral, and seniority/subordination. Credit ratings serve the function of providing information, which tackles information asymmetries between issuers and investors. Also, they play their role of enhancing market efficiency in that risk premiums are determined differently based on credit ratings.

The credit rating industry in Korea is comprised of three full-service credit rating agencies and one specialized credit rating agency. Korea Investors Service (KIS), National Information & Credit Evaluation (NICE) and Korea Ratings (KR) are the three major rating agencies. Seoul Credit Rating & Information (SCI) is the specialized rating agency providing rating services only in commercial paper and ABS.

The credit rating market has made its growth with the bond market (also the credit market). Growth of the credit rating industry in Korea can be divided into fledgling (1985-1997), growth (1998-2007) and stabilization (2008-present) phases. The period from 1985 to 1997 before the Asian financial crisis falls into the fledgling phase. Credit ratings were first introduced and applied when the bond market was opened. The Korean government put a credit rating regime in place by adopting issuer eligibility criteria for CP and corporate bonds in 1985 and 1986. Credit rating agencies (CRAs) were established and began providing rating services. NICE commenced its rating service in 1985. Non-banking financial institutions were the major shareholders of the rating agency. KIS and KR entered the credit rating market. KIS's shareholders were banks. KR's major shareholder was KDB.

Most bonds were guaranteed bonds prior to the Asian financial crisis. The role of CRAs was therefore confined to identification of eligible issuers. Since the majority of corporate bonds were issued based on creditworthiness of their guarantor, credit of an issuer was not closely and accurately assessed and bond pricing was not dependent upon such credit assessment. As a result, credit ratings had limited influence. Korea's credit rating industry started to grow in earnest after the financial crisis. The crisis back then resulted in sweeping reforms of the legal and regulatory arrangements for the capital markets. Dominance Guaranteed bonds in the bond market slipped away, while non-guaranteed bonds became dominant in the market. With introduction of ABS, the scope of entities or securities subject to credit rating assessment was broadened. The credit rating market showed remarkable growth as the bond market continued to grow. With wider perception, credit ratings were factored into bond pricing, thereby greatly increasing influence of CRAs.

Stakeholders began to pay more attention to accountability and reliability of CRAs before and after the global financial crisis. As some companies experienced credit crisis, investors became more sensitive to credit risk. Dominance shift began in the credit market towards high quality (higher-investment grade) bonds. CRA regulations underwent major changes to keep up with such shift. CRA laws were amended in 2009 and 2013 to strengthen the accountability of CRAs and introduce the code of conduct for CRAs. Considerable changes were made to the relevant regulatory framework.

In response to changing in the market and regulatory environment, CRAs reshaped their governance structure drastically and made various efforts to increase the timeliness and appropriateness of credit ratings. CRAs also strengthened their own internal code of conduct and improved rating process while striving to enhance the transparency and fairness of credit rating assessment.

Korean credit rating agencies moved to forge strategic alliances with or attract equity investments from global rating agencies in order to adopt advanced analytical techniques and build stronger trust with their stakeholders. KIS signed joint venture and affiliation agreements with Moody's Investors Service in 1998. Moody's became the largest shareholder of KIS in December 2007 by acquiring 50% plus one share holdings in the agency. KR entered into a strategic alliance with Fitch Ratings in 1999 to introduce sophisticated rating techniques. Fitch Ratings made its equity investment in KR in 2001 and became the largest shareholder in 2007 as a result of its acquisition of a controlling stake in KR. Changes in the number of companies with outstanding or current ratings assigned by three CRAs in Korea can be identified using the CRAs' annual disclosures of ratings performance**.** The number of business entities rated by CRAs rose from 458 in 2000 to 507 in 2001, but plunged to 343 in 2004. The number made a rebound, reaching 500 at the end of 2013, but dropped slightly year on year in 2014.

IV. Strategies for the Market Development

A. Proposed directions

1. Goals of corporate bond market development

For sustainable economic growth, an economy needs to establish financing mechanisms for bolstering companies' growth. A well-functioning corporate bond market is essential to provide a source of finance for companies. Corporate bond market provides non-financial and financial companies with access to large-scale, long-term funding, which in turn enables the companies to grow continuously. Ultimately, their growth contributes greatly to economic development. Among other things, the corporate bond market plays a part in increasing the economy's efficiency by allowing differentials in the costs of funding for companies depending on their credit quality.

Corporate bond market development also brings diverse benefits for investors. It offers a broad array of investment options of different maturities and credit quality to satisfy diverse investor needs. Given that, growth and development of the bond market would take the financial market to the next level. Above all, creation of a secondary market where bonds are readily cashable, and the existence of a broad investor base with different preferences are preconditions for market development. Thus, efficient primary and secondary markets need to be established.

A vibrant and robust corporate bond market provides bond intermediaries with more opportunities to generate revenues by engaging in bond issuance and trading activities. The bond market, together with the stock market, is one of the main market segments in which securities firms are engaged. As the corporate bond market grows and develops, securities firms develop and offer various services associated with corporate bonds, thereby promoting further growth development of the financial market.

Lastly, the bond market can be used as an important financial policy tool. A well-functioning corporate bond market means the existence of an effective policy instrument for the financial market. The bond market is utilized to implement various financial policies. Bond yields and maturity structures are important indicators showing current state of the financial market. Given that, the development of the bond market would help advance financial policies and regulatory framework to the next level.

2. Challenges in the development process

The corporate bond market accounts for only very small portion of GDP in many local economies. Corporate bonds are often issued through private placement and sold to banks. The corporate bond market also lacks in transparency. The identified challenges in corporate bond market development are summarized as following;

First, the local corporate bond markets in Asia and the Pacific lack in legal, institutional and regulatory frameworks for issuance and trading. Although laws and acts provide the legal basis for corporate bond issuance, it is not applied rigorously. And a comprehensive regulatory regime or mechanism does not exist for both primary and secondary markets for corporate bonds.

Second, the efficient issuance and trading of corporate bonds are constrained by dominance of private placements in the corporate finance. In Asia and the pacific, corporate bonds are used as a substitute for bank loans for companies with insufficient collateral. Bonds issued by those companies based on their creditworthiness are sold to or underwritten by banks. The absence of credit rating agencies predisposes investors to conduct their own analysis to evaluate the credit quality of corporate bond issuers, which hinders the efficient issuance and circulation of corporate bonds.

Third, heavy reliance on banks and lack of diversity among investors impede expansion of the investor base for corporate bonds. Corporate bond investors are primarily banks and insurance companies. The dominance of private placements is the main obstacle to widening the investor base.

Fourth, use of corporate bonds as a financing source is limited due to the lack of companies’ awareness of and knowledge in corporate bonds. Although companies have demand for financing via bond issuance, they do not perceive corporate bonds as a major source of funding because the corporate bond market is underdeveloped. This becomes a stumbling block in developing the bond market as a primary financing source for firms. Nevertheless, the bond market serves as an important financing channel for SMEs. Furthermore, it is highly likely to become an important avenue for SMEs to raise long-term large capital while growing into a large company.

Fifth, the absence of market infrastructure, such as credit rating function or system and bond market statistics, impedes the development of the public placement market. Since there are few reliable credit rating agencies in many local economies, investors have to rely on their own assessment of issuer credit quality when making investments in corporate bonds. And investors find it difficult to sell the corporate bonds they purchased, unless the bond issuer is a high-profile company in the market. Moreover, it is hard to obtain data on the size of aggregate bond issue volume because the majority of corporate bonds issued are privately placed. Credit rating system for corporate bonds and a well-functioning secondary market do not exist so that bond prices are determined arbitrarily.

3. Proposed directions for the market development

Efforts to build up an efficient corporate bond market should be directed towards the following; First, fundamental improvements are required for the legal and regulatory framework for corporate bonds. Appropriate laws and regulations on corporate bond issuance and trading should be introduced. Relevant disclosure regime must be put in place as well. The corporate issuance procedure should be revamped, and a responsible body needs to be designated for overall regulation of corporate bonds. These moves would underpin the aggressive implementation of policies to foster the bond market. Moreover, incumbent laws pertinent to corporate bonds should be amended to establish comprehensive legal grounds for the corporate bond market.

Second, it is necessary to enhance the primary market's transparency and promote public placements. Investor confidence is a very critical ingredient in bond market development. Furthermore, a policy measure should be formulated to encourage investment in corporate bonds by ensuring the wider circulation of corporate bond data across the market and thus enabling investors to make decisions using such data. Most imperative is the transformation of the primary market into the one dominated by public placements. Public placement bonds are expected to diversify the investor base and bring greater market transparency, thereby invigorating the secondary market.

Third, a new issuance regime should be introduced to ensure that corporate bonds are issued in electronic book-entry form. Issuance by physical printing is an impediment to market development in terms of costs and trading efficiency. Another impediment is related to information collection on corporate bonds. In this regard, adoption of the new regime for bond issuance via electronic book-entry would reduce bond issuing costs and increase efficiency in issuance and trading. The electronic book-entry system would facilitate the circulation of corporate bonds and raise efficiency in bond issuance.

Fourth, overall operating systems for the bond market should be improved to ensure transparency in the bond issuance process. As seen in the Korean case, the use of a listing regime may be a very efficient option to stimulate the issuance and trading of corporate bonds.

Fifth, it is necessary to improve secondary market for the corporate bond market. In many countries in the region, there is no mechanism and information disclosure system for corporate bond during and after issuance. And most of the corporate bonds are not deposited nor settled through central settlement and depository institutions. Corporate bonds can be traded through stock exchange but this has not been utilized for corporate bonds in many economies due to underdeveloped infrastructure. Well defined disclosure regime and infrastructure development would be essential for the further development of corporate bond market.

Sixth, perceptions on corporate bond need to be improved. Efforts should be made to help companies perceive bonds as a useful source of long-term massive financing. For example, some countries may push for pilot deals in which selected financially healthy companies raise long-term funding at low costs by issuing bonds. The corporate bond market can become active only if issuers change their perceptions of corporate bonds.

Seventh, a disclosure regime for corporate bonds should be improved, and a transparent statistics system should be introduced. Information on corporate bonds needs to be delivered to stakeholders in a fast and transparent manner for creating an active and efficient corporate bond market. Use of a data collection center is one option to consider. If a data collection center collects and publicly discloses bond issuance and trading data, it would increase transparency in corporate bonds, in addition to efficient centralized collection and disclosure of bond market data.

Eighth, a credit rating system needs to be introduced for corporate bonds. If individual investors themselves have to evaluate the creditworthiness of issuing companies, this would undermine market efficiency, and make fostering the bond market difficult because corporate bonds are held by small number of investors. Furthermore, it would take time and costs for investors to assess the credit quality of corporate bonds upon their issuance. This may be a hindrance to growth of the corporate bond market. The adoption of credit rating agencies would bring greater information efficiency and help create an active bond market. However, some local corporate bond markets are not large enough to see the creation of a credit rating agency(s) in the private sector. If so, they may want to consider setting up a dedicated unit for credit rating assessment in a public body or any related regulatory agency, and gradually transferring the credit rating function to private credit rating agencies in the long run.

Lastly, a gradual and phased policy approach should be taken under a master plan for improving the corporate bond market. Corporate bond markets exhibit different characteristics because of their country-specific economic and market conditions. Therefore, it is impossible to improve the bond market structure overnight. Hence, each country needs to implement policies for bond market development by gradually improving the relevant market infrastructure in the short run and enhancing the market structure in the long run through consensus and cooperation among market participants. The government's role would be an essential element in the effort to improve the market structure.

B. Strategies for the corporate bond market development

1. Regulatory framework

For corporate bond issuance, introducing issuer eligibility criteria is crucial for short-term priority. In the long run, legislation should be enacted to provide legal grounds for bond issuance and determine the issuance process, disclosure and other related aspects of the corporate bond market. The types of bonds companies can issue and the general issuing process must be defined and prescribed in relevant laws and rules. Moreover, an issuer registration regime should be in place to require issuing companies to be registered with relevant regulatory authorities. Securities registration scheme need to be introduced with respect to the issuance process. These institutional arrangements are expected to make the corporate bond market more transparent and enhance investor confidence in the market.

The corporate bond market needs to be overseen by one comprehensive regulatory body. Unified regulatory framework would enable the responsible regulator to control and supervise the overall corporate bond market and proactively execute policies for market development. In order to put a disclosure regime in place, the following actions need to be taken: setting up a platform for filing bond registration statements with the relevant regulatory body; and building a platform for primary market disclosure (securities registration) and secondary market disclosure (post-issuance periodic disclosure). In addition, transparency in the corporate bond market should be enhanced by establishing mandatory disclosure requirements for corporate bonds. The introduction of such mandatory disclosure regime would help strengthen investor confidence in corporate bonds.

It is also useful to build an electronic registration platform to ensure bond issuance under standardized framework. Specifically, it may be considered to have financial authorities set up a platform for issuers to file in bond registration statements via website. Thus, most of bonds can be issued immediately after registration statement is filed electronically. For post-issued reports, continuous and event-based disclosures have to be made by issuers throughout bond’s lifetime.

2. Public placement

Strict separation of markets between public and private placements is needed for creating an active public placement market. Regulations for the private placement market may need to put restrictions on transactions and investors. On the other hand, incentives for public issuance need to be provided for the public placement market. That is because it is important to encourage a wide range of investors to buy publicly offered bonds and make public placements attractive to issuers by highlighting the reduction in issuing costs. Large firms need to be encouraged to issue bonds via public placement whereas smaller firms induced to issue bonds via private placement and sell them to banks.

3. Legal and institutional arrangements

Laying the legal groundwork for bond issuance and adopting registration and depository systems are preconditions for corporate bond market development. Local economies need to strengthen legal grounds for bond issuance, registration and others while improving regulatory underpinnings for corporate bonds by introducing a clear, well-defined registration process. Countries need to overhaul the scope of eligible corporate bond issuers, the issuance process and the registration system.

These institutional arrangements are intended to enhance the credibility of corporate bonds and ensure greater market transparency, thereby bolstering the stability of the bond market. When it comes to issuing and holding bonds, it is necessary that bonds be issued and held in book-entry or electronic form (a long-term goal). The depository system would reduce the costs of administering securities, ensure the reliable transfer of securities, and enhance transparency in securities information. Moreover, the bond market could be managed more efficiently by linking the listing regime to the depository system.

4. Investor base

Corporate bond market serves as a substitute for bank lending. In some countries the bond markets have been driven by banking sector because of the underdeveloped investment fund market or other investment segments specializing in corporate bonds. Bank loans and corporate bonds are not clearly distinguished. Private placement is the dominant method of bond underwriting. It is important to expand the base of specialized corporate bond investors. Banks need to change their perception of corporate bonds and thus treat corporate bonds as a different investment instrument from bank loans. It is also necessary to develop a financial business segment specializing in bond underwriting. This calls for improvement in the underwriting function of securities firms.

5. Credit rating system

It is very important to introduce credit rating system because it helps accurately assess the creditworthiness of bond issues, thereby making the corporate bond market more active. If individuals invest in corporate bonds based on their own analysis of bond credit quality, it would be difficult to build the secondary market. Besides, information inefficiency would impede the expansion of the investor base. Thus, greater access to information on the bond market requires the introduction of credit rating systems that evaluate the creditworthiness of corporate bonds. On top of this, efforts are needed to enhance the reliability of credit rating agencies in the long run, which would result in the wider investor base. In addition, measures must be taken to establish the secondary market and form market prices. The adoption of bond market evaluation system also needs to be considered.

V. Conclusion

In many countries in Asia and the Pacific, corporate bond markets are dominated by private placements which are very similar to bank lending. This implies that these markets remain in their nascent stage, given their regulatory aspects, investor base, issuers' market perception, and market infrastructure. However, the market survey suggests that the regional corporate bond markets have strong growth potential. Corporate bond market can be an important source of financing for SMEs. Recently, non-banking financial companies such as asset management companies and insurance companies are increasingly interested in the corporate bond market.

Corporate bond markets may vary in their characteristics depending on their country-specific economic conditions and market environment. Thus, one country's experience with bond market development cannot be a "one-size-fits-all" solution for other countries. It is important to highlight the need for gradually revamp the market infrastructure, and undertake policies for reshaping the market structure, based on consensus and cooperation among market participants, from the long-term perspective.

About Economic and Social Commission for Asia and the Pacific (ESCAP)

ESCAP is the regional development arm of the United Nations and serves as the main economic and social development centre for the United Nations in Asia and the Pacific. Its mandate is to foster cooperation between its 53 members and 9 associate members. ESCAP provides the strategic link between global and country-level programmes and issues. It supports Government of countries in the region in consolidation regional positions and advocates regional approaches to meeting the region's unique socio-economic challenges in a globalizing world. The ESCAP office is located in Bangkok, Thailand.

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