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The future of debt markets

by

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Abstract

Discussions at the 12th OECD-WBG-IMF Global Bond Market Forum focused on three key areas related to the future of debt markets: *(i)* the challenges facing new and infrequent sovereign issuers in assuring durable market access in frontier and emerging markets; *(ii)* the future prospects for the securitisation and covered bond markets; and *(iii)* the future role of large bond investors.

Financial markets continue to struggle. In the current climate of elevated sovereign risks and hollowing of the investor base, it was becoming increasingly important for new and infrequent sovereign issuers to better manage investor relations. Securitisation issuance has slumped in recent years as the investor base narrows and the market faces a number of hurdles, in particular on the regulatory front. The global fixed income investor base is changing and has become more concentrated post crisis, with large bond investors playing an increasingly important role, and contributing to the strong increase in cross-border capital flows. Discussions also highlighted a number of ongoing risks, including *(i)* that investor uncertainty would prove critical in managing risk in the near-term and *(ii)* that some regulatory changes might aggravate the challenges facing debt managers.

JEL Classification: G15, G18, G20, G24, G32, G38

Keywords: Government debt market, sovereign issuers, frontier markets, outlook on securitization and covered bonds, large bond investors, investor base.

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OECD-World Bank -IMF Global Bond Market Forum

The Annual OECD-World Bank-IMF Global Bond Market Forum provides a platform for sovereign debt managers and other financial officials to discuss the latest developments and trends in worldwide debt markets, to share information on country cases and best practices, to identify emerging practices and techniques, and to debate new policies in this policy area. The Forum is mainly targeted at senior level officials from debt management offices, ministries of finance, central banks and capital market regulators from both OECD and emerging markets, as well as key market participants. Forum meetings are organised undet the aegis of the OECD Working Party on Public Debt Management. Information on Forum meetings and other related activities can be found on www.oecd.org/daf/publicdebtmanagement

The OECD, the International Monetary Fund, and the World Bank Group hosted on 5-6 May 2011 the Twelfth OECD-World Bank Group-IMF Global Bond Market Forum meeting in Paris . The Forum meeting was attended by sovereign debt managers, central bankers, rating agencies and bankers.

This year's Forum assumed greater importance in light of the financial crisis and its impact on market functioning and debt levels. The attendance of senior experts from a number of private sector and international organisations further stimulated the discussions which focused on three key areas:

- the challenges facing new and infrequent sovereign issuers in assuring durable market access
- the outlook for securitisation and covered bond markets
- the future role of large bond investors.

The first two issues are important in the context of the recovery of fixed-income markets on the one hand, and the (new) conditions for financial stability on the other. The third topic examines the challenges and outlook for new sovereign and corporate issuers, or those trying to gain market access, given the lessons of the crisis, and the broader implications of competition from more established emerging (or other credit) markets. This policy note provides a summary of the presentations, discussions and policy conclusions of the 2011 Forum meeting.

1. Introduction

On 5-6 May 2010, the OECD, World Bank Group and IMF convened the 12th OECD-WBG-IMF Global Bond Market Forum in Paris, with focus on *"The Future of Debt Markets".* The forum was attended by more than 60 participants (mostly sovereign debt managers and central bankers) from 23 OECD countries, 7 other sovereign states (including China, Russia and Indonesia) and 5 international organisations. The attendance of senior experts from a number of private sector and international organisations further stimulated the discussions which focused on three key areas: (i) the challenges facing new and infrequent sovereign issuers in assuring durable market access, (ii) the outlook for securitisation and covered bond markets, and (iii) the future role of large bond investors.

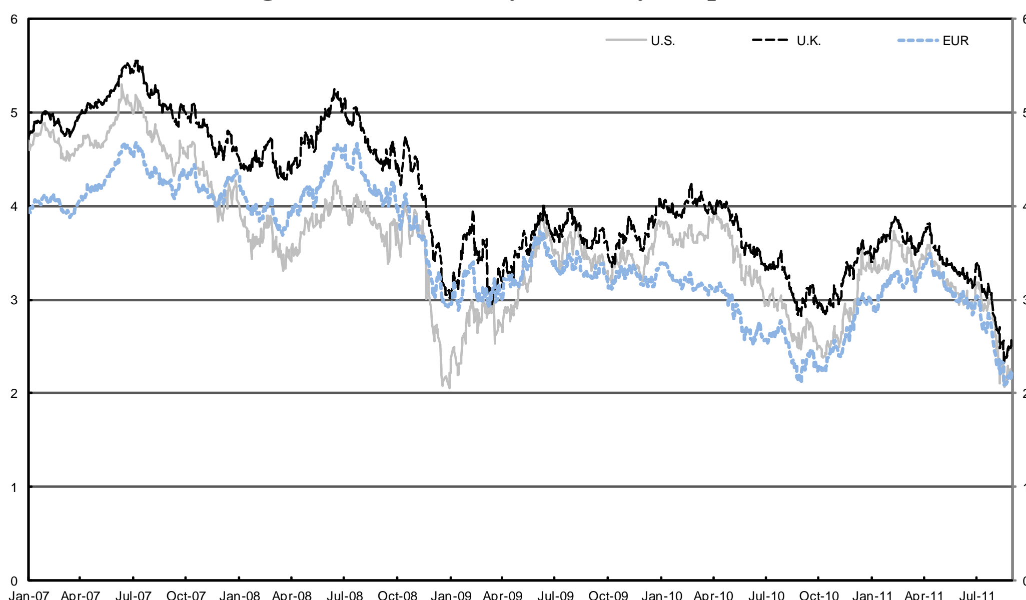
Speakers also noted that the Forum meetings demonstrated an important degree of continuity. The 11th Forum meeting held in April 2010 focused on the *Post-Crisis Landscape for Debt Markets*, a subject of great importance in light of the then immediate aftermath of the global financial crisis and its impact on market functioning and sovereign debt levels. The latter discussions included such issues as the potential impact of policymakers' exit, the measurement of sovereign risk, the determinants of investor demand, and changes in operating conditions in primary and secondary markets for government debt. This year's Forum topics on *The Future of Debt Markets* constitute a follow-up. They are particularly important in the context of policies for a balanced recovery of private debt markets without endangering financial stability. Financial markets continue to struggle as they recover from the global credit crisis, with heightened sovereign risk having an impact on (a) the functioning of fixed-income markets, (b) private and public debt levels, and (c) the regulatory response to the global crisis. This note provides a summary of the presentations and discussions.

Discussions at this year Forum were held against a continuing backdrop of volatile financing conditions in debt markets, particularly in advanced economies (Figure 1). Market perceptions of sovereign risk remain elevated, reflecting the higher levels of debt that have been generally accumulated as a consequence of the global crisis, coupled with increased political risk and ongoing concerns relating to the health of the banking sector. These factors point to the need for sovereign issuers to remain actively focused on how best to establish sustained market access and contain financing risks. This is an issue for both well established and frontier issuers, and is intrinsically linked to the durability of the investor base, in particular, the robustness of demand from external creditors.

In the current climate of elevated sovereign risks and hollowing of the investor base, it was becoming increasingly important for **new and infrequent sovereign issuers** to better manage investor relations. To achieve twin objectives of ensuring durable market access and attracting a stable investor base, it was appropriate for emerging and frontier issuers to focus on relationship-building prior to issuance, be transparent as to the use of proceeds, and invest time in ongoing dialogue and investor education.

Securitisation issuance[1] has slumped in recent years as the investor base narrows and the market faces a number of hurdles, in particular on the regulatory front. Significant steps are now being taken to improve transparency of the market and realign previously skewed incentives, which should combine to shore up investor confidence. Once the market has regained trust in the product and achieved sufficient regulatory clarity, securitisation is expected to return as an important channel for both lending markets and the wider global economy. With securitisation being a key financial instrument enabling risk transfer away from the banking sector, sustainability of the market is expected to derive significant benefits for the financial system and global economy over the longer term.

Figure 1. Benchmark yields (10-year, per cent)



Source: Bloomberg

The covered bond market is set to benefit from relatively preferential regulatory treatment, in some cases at the expense of private-label securitisation[2]. Said to have experienced a "good crisis", the covered bond market never actually closed amid the turmoil in 2008 and issuance has again proved resilient in the face of the European sovereign debt crisis. Participants believed asset homogeneity was a key to a sustainable covered bond market, and expressed therefore some concerns that a US proposal to broaden the range of eligible assets might lead to an increased risk premium across the entire asset class.

The global fixed income investor base is changing and has become more concentrated post crisis, with **large bond investors** playing an increasingly important role, and contributing to the strong increase in cross-border capital flows. Decisions to allocate investments into emerging market assets were now being driven more by 'credit risk' of individual countries, rather than an outright allocation to the wider 'emerging market' asset class as has been done in the past. It was expected that the future focus of large bond investors would continue to shift from advanced markets to emerging markets.

Investors at the forum did however express their concern at the potential for capital controls, and the adverse effect this might have on their future decisions regarding cross-border fixed income investment. It was also noted that sovereign debt managers needed to pay more attention to communicating with investors because of an increase in competition among issuers. It is important for them to provide reliable and coherent information about 'bench-marks' and underlying medium-term borrowing strategies.

2 Financial stability issues and the future of debt markets

During the opening session, concerns were expressed about the following financial stability issues: the significant use of interest rate derivatives by globally systemically important financial institutions (GSIFIs), new regulations on the use of derivatives, and the resulting vulnerability of large banks to future interest rate shifts; tail risks associated with investing in the covered bonds by banks; the complications related to strong capital inflows into emerging and frontier markets; and the increase

in sovereign risk. These financial stability issues have a direct bearing on assessing the future of debt markets and for this reason are important elements in the context of policy-setting and decision-making for governments as issuers and regulators, private issuers, financial intermediaries, investors, and rating agencies.

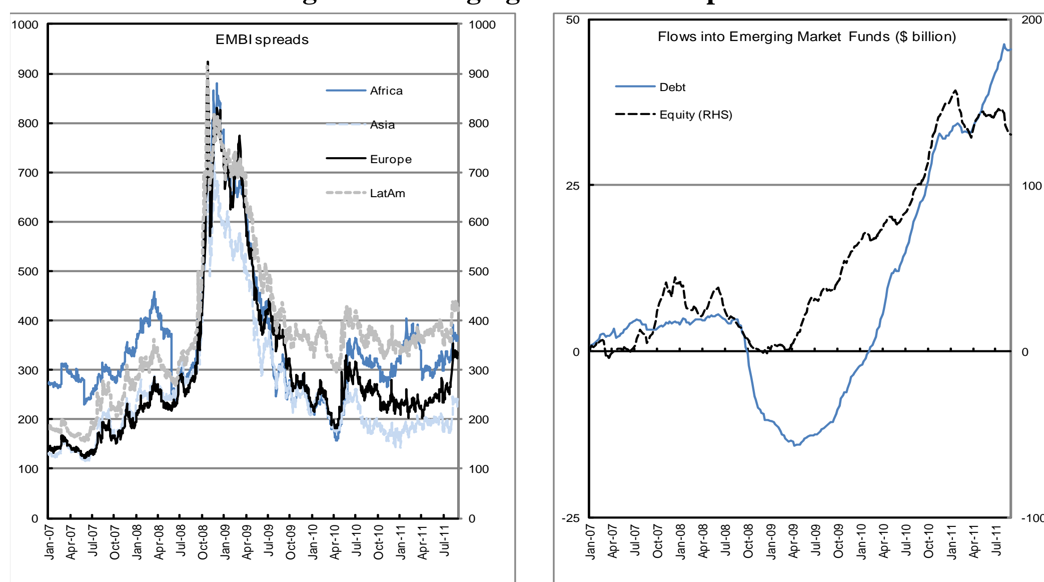
3 Assuring durable market access: challenges for new and infrequent issuers

The first session of the Forum focused on how the landscape for sovereign issuers in international capital markets – and in particular, frontier market issuers – was evolving. Issues such as the need for effective and efficient investor relations, and the importance of determining the appropriate size of an issue were discussed.

While financing conditions for more advanced economies continued to prove challenging, the outlook for emerging and developing economies (EMDEs) seeking to access international capital markets appeared more positive. Despite the volatility in the underlying benchmarks, the trend meant that long-term yields were at all time lows, reflecting ongoing efforts by advanced economies to maintain a loose monetary stance. Taking account of the level of emerging market spreads meant that the all-in issuance costs for emerging and developing economies in international capital markets were generally low after the 2008 global crisis. (Figure 2).

The outlook on the demand side was also relatively positive. There was significant investor interest in these markets as evidenced by the strong portfolio flows into emerging market funds (Figure 2). The need to invest those funds has created significant demand for new issues. Participants felt that, overall, that trend was well supported by key fundamentals including the relative improvement in credit quality, global liquidity conditions, and still limited competition from corporate borrowers. Nevertheless, despite the positive cost considerations, accessing international capital markets is not without its risks.

Figure 2. Emerging market developments



Source: Bloomberg, EPFR

Size

In that context, participants discussed the relative merits of the size of an issue. However, there was no clear consensus on how best to achieve the balance between size of issue and the associated costs and risks. Size is critical if issuers want to target dedicated emerging market funds; consequently, a large issue would attract a significant liquidity premium. However, issuing a larger size than is immediately needed would entail a significant cost of carry, adding to the overall cost of financing. In addition, it raises the risk of potential wastage, particularly if issuers were unable to readily absorb those funds into suitable investment projects. In that context, there was a risk that the return on any associated expenditures would not provide adequate value-for-money, would not add to the productive capacity of the economy or otherwise generate sufficient resources to repay the debt in the future. And that could lead to a decline in credit quality and ultimately pose a risk to debt sustainability, constraining the terms of any future market access.

However, some participants highlighted that there were niche investors—notably private banking clients—that would be more flexible in their demands, and could be satisfied with a smaller issue size. Consequently, new issuers who have not yet established a track record in accessing markets, and face some challenges in terms of developing and implementing an effective public sector investment plan, should consider launching an issue with a relatively smaller size and then subsequently re-opening the issue to bring it to a liquid benchmark size. That would allow resources to be allocated as and when issuers had identified well specified and targeted investment projects.

Participants also pointed to the refinancing risk, and the exposure to sudden stops, that would be aggravated as the size of an issue increased. Given the experience of the crisis, where international markets were effectively closed for several months, and the acknowledged capacity constraints in many EMDEs, effectively managing the refinancing risk associated with larger issues could prove very costly in the future. In that context, the success of a first issue would be critical in determining the potential for re-accessing the market.

Finally, there was some discussion of the risks of relying on external creditors for significant quantities of financing. Participants acknowledged that such investors can be quickly affected by negative market sentiment and emphasized that the most effective mitigant against the risk of a sudden stop was to ensure that macroeconomic fundamentals remained strong.

Preparation and investor relations

Participants pointed to the need for good preparation to secure the success of a first issue. In particular, significant resources need to be allocated to investor education, with road-shows playing a critical role in building demand for an issue. Transparency would also be critical in attracting investors to new issues. Again, this is an area where debut issuers should not underestimate the extent of the effort required. Key information should be provided, and issuers should not shy away from outlining the extent of the macroeconomic and financial challenges they face, and prospective investors should be clear about the likely path of future fiscal and debt management decisions. Some participants mentioned the importance of securing IMF and World Bank support for the issue as a way to enhance the credibility of the underlying macroeconomic program being financed. Related to that, the prospective use of proceeds was also identified as an important element of the story, with a well set-out investment plan a factor in helping to secure a positive reception from investors. When re-accessing the market, participants recommended that issuers should explain past decisions and outcomes, thereby enhancing accountability and building greater confidence in authorities' capacity.

Participants highlighted that the need for such intensive investor dialogue in the context of new issuers constrains those countries in their ability to rapidly take advantage of positive market conditions. This means that if market conditions are volatile, by the time the market is primed for the issue, it may no longer be cost-effective requiring a deal to be postponed. Debut issuers also needed to recognize the challenge of issuing into a crowded market space, which again could prove negative for the success of the issue; in that context, the positive benefits of biasing issuance to the early part of the fiscal year, or even pre-financing, were discussed. To mitigate that execution risk, participants highlighted the importance of having sufficient depth in domestic debt markets or access to other sources of funding, so that EMDEs can compensate for any unanticipated delays in financing. EMDEs with a more established market presence are in a relatively stronger position in this respect. In particular, established names can use non-deal road-shows to maintain investor interest on an ongoing basis, allowing them to rapidly come to market when conditions look particularly positive.

Participants encouraged issuers to be innovative and efficient in their investor relations activity. Given the resource costs involved, issuers should be active in the use of websites or leveraging opportunities, such as the IMF/World Bank meetings, where they could reach out to a wide audience.

Instrument design and pricing

In terms of instrument design, participants recommended debut issuers used standard structures. In particular, standard documentation was important; however, both issuers and investors should undertake significant due diligence and assure themselves that all the clauses of the contract, and their associated implications, were well understood. In that context, some participants raised a concern that both investors and issuers were becoming complacent with respect to this issue and needed to be more careful. This was an area of challenge for frontier issuers where independent advice would be needed to fill capacity constraints.

In terms of pricing, the elevated levels of sovereign risk embedded in the underlying benchmarks, and the associated market volatility, is an important challenge for newer issuers. In this climate, it is not clear what the most appropriate benchmarks are and what the appropriate spread should be, which increases the risk of mispricing. Any mispricing by investors of a new issue could damage the reputation of that issue and make re-access more difficult.

From the issuers' perspective, it would be important for them to have a clear perspective on the appropriate target level for the price. This would clearly signal whether it was prudent to go ahead with an issue, given prevailing market conditions. Such benchmarks would be important given that market conditions would likely remain relatively unpredictable over the medium-term. Participants suggested that the anticipated internal rate of return on the planned investment projects would provide a suitable guide for such decisions.

Conclusions

Overall, to establish and successfully sustain good quality market access, frontier issuers were encouraged to take the time to build a strong and credible track record of servicing their debt obligations, allocate sufficient resources to investor relations and establish strong public financial management frameworks that generate effective public sector investment programs. New issuers also needed to recognize that the bar with respect to the required degree of transparency was higher in this current climate of elevated sovereign risk. New issuers should borrow prudently, taking account of their capacity to repay, with the liquidity of an issue a secondary concern relative to fundamental debt dynamics. However, current demand conditions look positive suggesting that opportunities were there for those that are well prepared and have adequately assessed the cost-risk tradeoffs.

4 The outlook for securitisation and covered bond markets

The second session focused on the future prospects for the securitisation and covered bond markets. Following the financial crisis, securitisation issuance levels fell away sharply, while covered bond issuance is benefitting from a market environment of heightened sovereign risk and favourable regulatory treatment. While covered bonds share some similarities to securitisation[3], investors find security in the double layer of protection with underlying loans "ring-fenced" and retained on the issuers' balance sheet. In contrast, securitisation continues to be stigmatised by the role that US sub-prime securities played during the financial crisis.

Securitisation is one of the debt instruments that enable banks to disperse and redistribute credit risk to a broader and more diverse investor base. It offers banks with a long-term source of funding that better matches their liability profile, and provides investors with direct exposure to diversified sectors of the economy. A sustainable recovery for lending markets and the wider global economy might inexplicably be linked to the fortunes of the securitisation market. Based on this year's forum discussions, it seems likely that securitisation will return as an important channel for lending markets in the longer-run, although a number of headwinds could inhibit or delay a recovery in the shorter term. The impact of regulatory reform efforts as yet remains unclear, the investor base has diminished, and key segments of the market continue to rely on government-backed liquidity and asset purchase programs. What is clear is that investors are demanding transparency, simpler structures, and strong underlying collateral.

Covered bonds were judged to be a safe and highly-rated instrument for investors. The market proved its resilience during the recent financial crisis and record issuance in 2010 has continued into the first half of 2011. The high quality of underlying assets and strict market regulation has been working in favour of covered bonds, as has support from the ECB's purchase program. The key question for participants was whether covered bond markets were capable of filling the void left by securitisation, and whether they also provided a good substitute for government guaranteed-bank debt and sovereign bonds. While covered bond markets have predominantly been a European affair, plans are now underway to establish a covered bond market in America. A number of participants did however express some reservations over the US proposal to broaden the underlying assets available for use in covered bonds, which could result in a higher risk premium across the wider asset class.

Securitisation market background

Prior to the global financial crisis, benign economic and financial conditions had helped to fuel an explosion in global securitisation issuance which peaked at around USD4 trillion in 2006. However, the market suffered from a number of structural shortcomings and private-label issuance slumped in the wake of the global financial crisis. Arguably, the entire securitisation sector was unfairly tarnished by the fallout from the US-subprime crisis. Forum participants believed it was a misconception that all securitised product was toxic and opaque, when and in reality non-US-subprime securitisation had not actually experienced a credit crisis. In fact, not all securitisation was as unsound as was the case in the US subprime mortgage sector[4], which by itself represented less than 10% of all US securitised mortgages. Securitisation acted primarily as a legitimate funding tool in Europe, as opposed to securitisation being an "end in itself" for capital arbitrage reasons as was often the case in the US.

In Europe, it had never really been a credit story, but rather one of investors being forced to mark-down their portfolios to reflect extreme illiquidity risks. In most part, collateral performance remained strong in Europe, and indeed the resilience of the European structured finance market can be evidenced in the post-crisis defaults data. Analysis compiled by Standard & Poor's found that only 0.95% of all European structured finance issues defaulted between mid-2007 to the end of 2010. This

compares to a default rate of 7.7% for all US structured finance issuance and 6.3% for the global universe of corporate bonds over the same period (Table 1).

Table 1. European structured finance default rates (S&P mid-2007 to Q4 2010)*

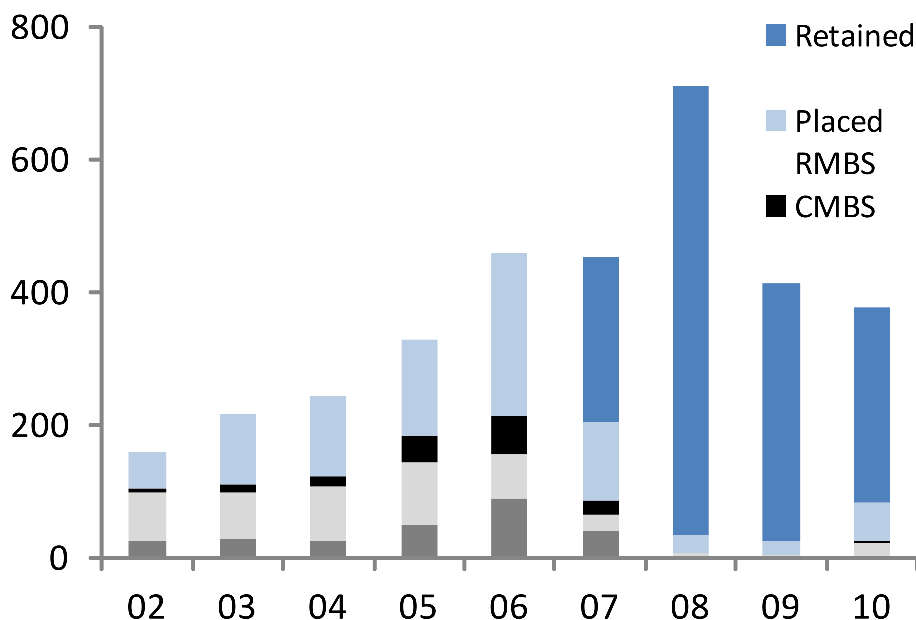
ABS	Structured Credit	CMBS	RMBS	**All European**		**All US structured finance***		**All Corporate****
0.16%	2.86%	2.74%	0.07%	**0.95%**		**7.71%**		**6.34%**

*by initial issuance volume ** by number of ratings

Source: Standard & Poor's

Although there have been some signs of a re-emergence in private-label European issuance in 2010, key segments of the market continue to rely on support from the ECB's liquidity program or other government-backed asset purchase programmes. As can been seen in the figure below, the proportion of European securitisation issuance that is "retained" on bank balance sheets for the purposes of generating liquidity at the ECB remains high.

Figure 3. European securitisation issuance, 2002-2010, EUR bn



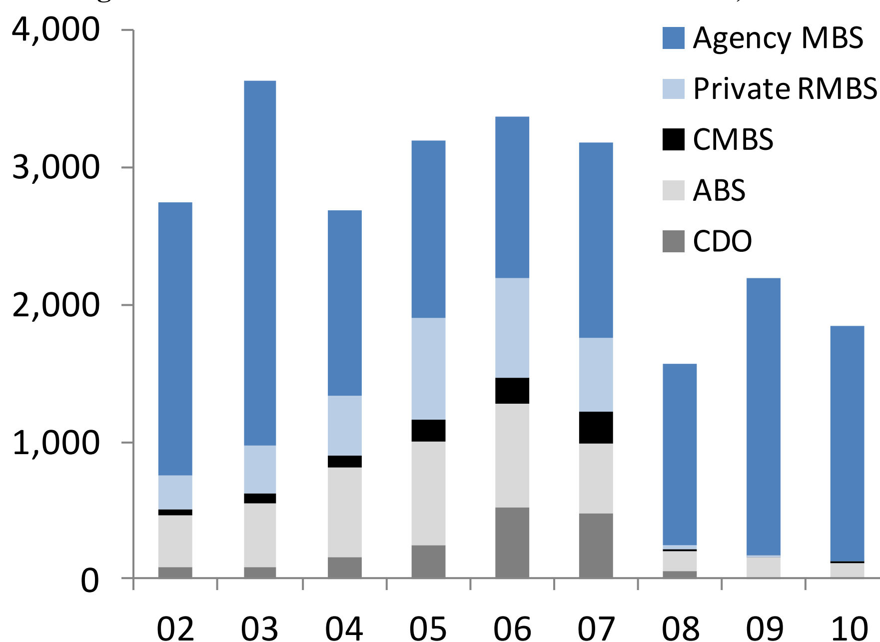
Source: AFME (Association for Financial Markets in Europe).

However, private-label or "placed" issuance did increase from EUR 25 billion in 2009 to EUR88 billion in 2010, the majority made up of prime RMBS (residential mortgage backed securities) in the UK and Netherland. This represents a rise in "placed issuance as a proportion of total issuance" from 6% in 2009 to 23% in 2010, and is a good reflection of the recovery is taking shape in the Europe

securitisation market. However, it still pales in comparison to the EUR460 billion of "placed" issuance recorded at the height of the market in 2006.

At the peak of the market in 2006, issuance of securitisation in the US was almost four times that of European issuance[5]. In the US, the Federal mortgage agencies (which include Freddie Mac, Fannie Mae and Ginnie Mae) are currently funding more than 90% of US mortgages, and as result are crowding-out any near term recovery from private-label issuers (Figure 4).

Figure 4. American securitisation issuance 2002-2010, USD bn

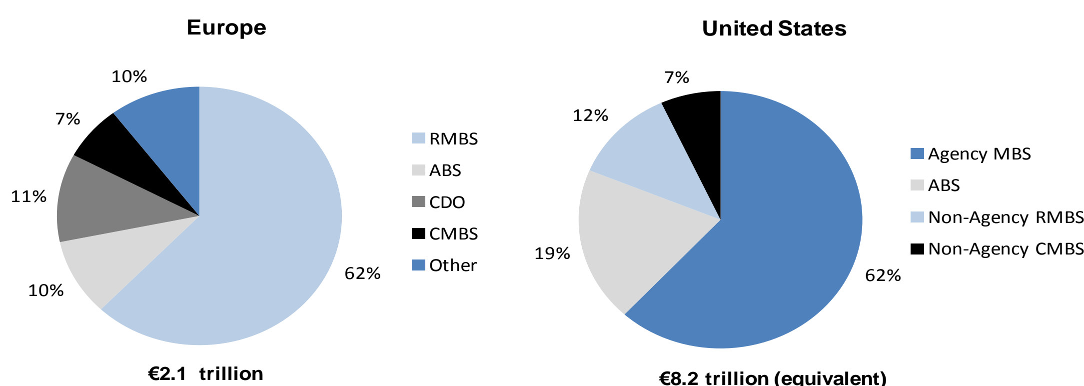


Source: SIFMA (Securities Industries and Financial Markets Association)

Indeed, US non-agency issuance fell from USD2.2 trillion in 2006 to a mere USD129 billion in 2010. This 2010 non-agency issuance figure was largely confined to the relatively vanilla segment of ABS (asset-backed securities, excluding mortgages), in most part is auto loans and student loans.

By the end of the March 2011, it was estimated that a record 51.7% of the €2.1 trillion in outstanding European securitisation was "retained" by originating banks[6]. The growing share of retained issuance (from almost zero at the beginning of 2008) is both a stark reminder of the funding difficulties faced by European banks, and of the significant role the ECB is playing as liquidity provider to the European banking system. The charts below provide a break-down of total securitisation market outstandings in both Europe and the US as at the end of 2010 (Figure 5). Around two-thirds of the European market was comprised of relatively-vanilla RMBS securities while around two-thirds of the US securitisation market was based on MBS products issued by US federal mortgage agencies.

Figure 5. European and US structured finance outstanding Dec 2010



Source: SIFMA and AFME

5 Securitisation: Key Issues and Policy Conclusions

An improvement in the economic backdrop and early signs of a return in investor demand for yield-enhancing products has support a recovery in securitisation issuance in Europe. Although spreads have narrowed, allowing securitisation to become a more economic proposition as a source of bank funding, a number of other factors are likely to inhibit a full recovery for the market in the near term. Regulatory reform is offering little support to the securitisation market and investor confidence remains shaken with the asset class tarnished by the role played by US-subprime during the credit crisis.

Regulation

The securitisation market faces a deluge of regulatory changes of which the eventual and cumulative impact of regulatory reform had yet to be fully assessed. While regulatory changes are necessary and might seem to make sense on an individual basis, the cumulative impact could overwhelm the market, precluding some investor segments from making a full return. Basel III liquidity requirements are likely to limit demand from the banking sector which has traditionally been the largest investor in the asset class, and tougher capital requirements contained within to Solvency II capital regulations are also likely to restrict demand from insurers.

Participants felt that the costs associated with the impending regulatory onslaught need to be weighed up against the benefits that securitisation offers as a source of long-term bank funding and its ability to redistribute credit risk. The banking system and wider economy needs a healthy securitisation market to lend support the recovery process. For the recovery in securitisation to become sustainable, it’s likely that the asset class will require simpler structures, less tranching and standardisation of product disclosure to aid transparency efforts.

Investors

Investors remain largely risk averse in the current economic climate of heightened sovereign risk. Others are be weighed down by the legacy structured product that remains on balance sheets and are themselves being forced to deleverage and raise further capital. Forum participants estimated that

more than half of the pre-crisis investor base had disappeared (including those SIV, CDO and ABCP vehicles that fuelled demand at the height of the market) and it remained uncertain as to which part of the investor community would be capable of filling this void. For a number of participants it was unclear where new investors would surface from, but others were more confident and had seen signs of private demand returning from both hedge funds and commercial banks as they widened their search for yield.

A sustainable recovery in private-label issuance was likely only to occur at such a time that the ECB and US government were comfortable enough to step back from their supporting roles as liquidity provider to the securitisation market. The timing of such moves remains uncertain, with both the US and Europe unlikely to remove official support in the near term.

Conclusions

What can we conclude about the future prospects for securitisation? Significant steps have been taken to improve the transparency of both securitised products and the markets in which they trade. In the medium term, these efforts are likely to shore up investor confidence by realigning incentives, improving disclosure, and increasing transparency through the standardisation of data, representations and warranties. Once pre-conditions are in place and investors and issuers have increased certainty on the regulatory front, securitisation is expected to return as an important channel for both lending markets and the wider economy. With securitisation being a key financial instrument enabling risk transfer, sustainability of the market will provide significant benefits over the longer term.

6 Covered bonds: key issues and policy conclusions

Covered bonds have offered European banks with a cheap source of long-term funding for more than a decade. The covered bond market was said to have experienced a “good crisis” amidst the turmoil in 2008, having never actually closed. And the market has continued to demonstrate its resilience in the face of the European sovereign debt crisis, with issuance reaching record levels in 2010 and early 2011 as investor risk tolerance diminished and demand for secure assets rose. Later in 2011, issuance was boosted by European banks having difficulties in selling unsecured bank debt.

Certainly, the covered bond market did not suffer from the same structural shortcomings that were so severely exposed across some parts of the securitisation market. In comparison to securitisation, the covered bond market benefited from incentives being aligned between issuer and investors (as the issuer retains the credit risk), not being an arbitrage product (instead funding only real economy assets), no use of tranching (so no conflict of interest between different classes of covered bond investors), no leverage inherent in the structure (as is the case for securitisation), a clear legal framework (as opposed to idiosyncratic contractual arrangements), and strong supervision. The key question for forum participants was whether covered bond markets were capable of filling the void left by securitisation, and whether covered bonds could provide a good substitute for government guaranteed-bank debt or sovereign bonds.

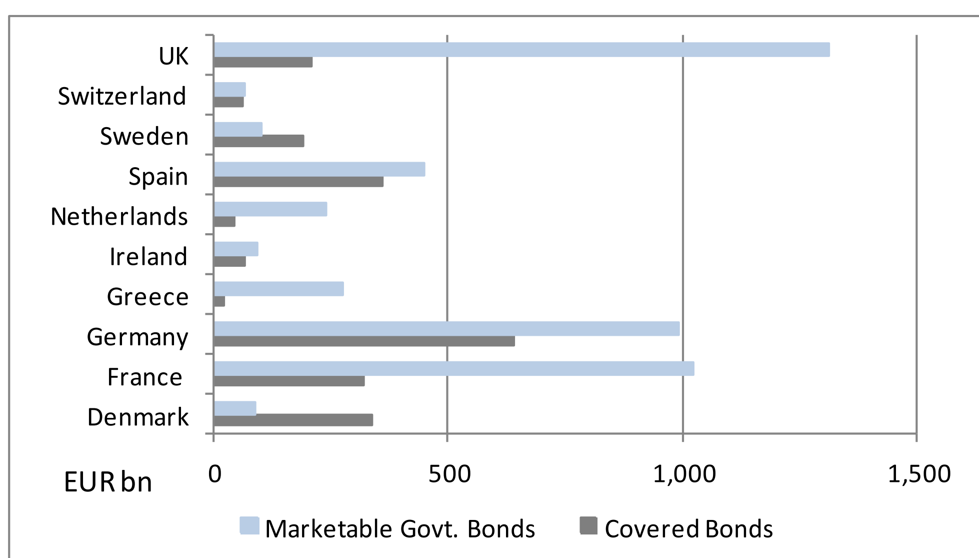
Regulatory support is an obvious factor in favour of covered bonds. The market has received favourable treatment from the ECBs liquidity and purchase programs, haircuts, UCITS compliance, Basel III (in most cases), and Solvency II. In addition, the disclosure requirement is low in comparison to securitisation, and a number of countries provide specific favourable treatment (e.g. in Germany, registered covered bonds are not subject to mark to market rules). Covered bonds can however suffer from a number of drawbacks. Legal uncertainties arise from the zero default track record. Different legal frameworks and country practices across countries make an identical treatment of covered bonds difficult. In the case of issuer insolvency, covered bond creditors and swap

counterparties have a senior claim on the pool (effectively subordinating depositors and unsecured debt holders)[7]. Coupon and principal payments are solely derived from pool flows, and should a cover pool turns static upon insolvency, covered bond investors will then be treated pari passu with other creditors.

Covered bonds vs. sovereign bonds

Covered bonds typically offer investors with a higher yield than sovereign debt, without a substantial increase in credit risk. The size of covered bond issuance is also comparable to central government marketable government bond outstanding amounts in a number of countries (figure 6). It could therefore be argued that covered bonds are a suitable substitute for sovereign debt in some jurisdictions.

Figure 6. Central government marketable bond vs. covered bond as of 2010 (outstanding amounts)

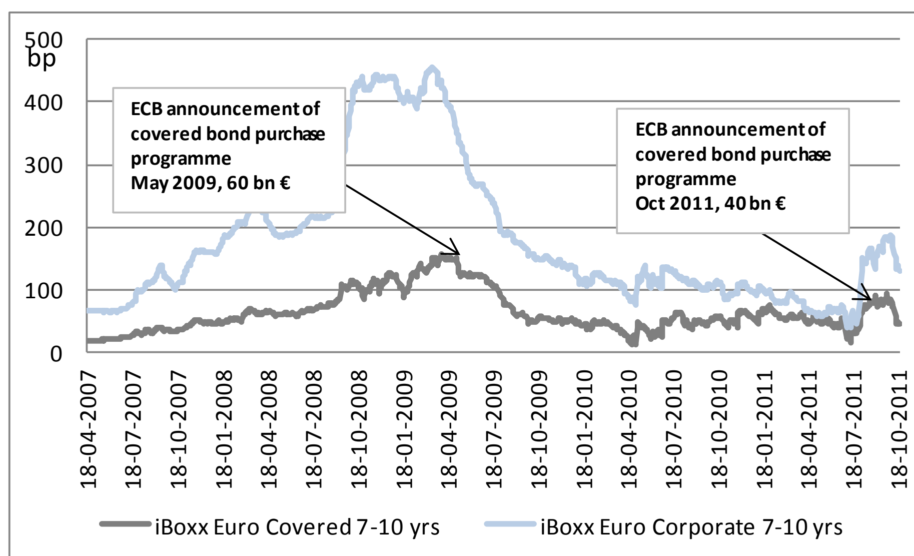


Source: ECBC (European Covered Bond Council) and OECD

Sovereign issuers attending the forum considered covered bonds to be a good substitute for government bonds, although they did not consider this disadvantageous to their government bond issuance programmes. Debt managers from fiscal surplus countries supported the issuance of covered bonds as they foresaw lower levels of government borrowing leading to smaller, less liquid government bond markets.

However, the iBoxx index spreads shown in Figure 7 mask individual country performance. Correlation between core and peripheral European bond markets began to diverge significantly during the global financial crisis and ensuing European sovereign debt crisis, and in some cases has turned negative. In May 2011, the yield on covered bonds in Ireland and Spain actually dipped below the respective government bond yields in these countries.

Figure 7. Spreads over sovereign / covered vs. corporate

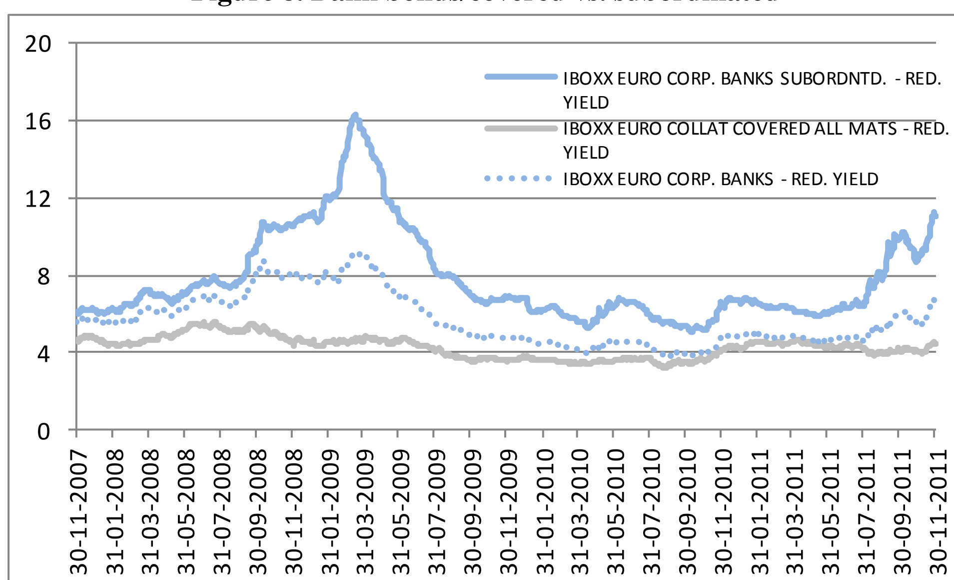


Source: Datastream

Covered bonds vs. unsecured bonds

Covered bonds provide the banking sector with a cheaper source of funding relative to unsecured bank debt (figure 8), especially during periods of market stress. Covered bond issuance also helps banks to diversify their investor base given the seniority they hold over unsecured bonds. Central bank support can also create a favourable environment for covered bonds. Beirne et al (2011) suggested that the revival in the covered bond market had been at the expense of unsecured bond issuance, rather than increasing bank issuance as a whole.

Figure 8. Bank bonds/covered vs. subordinated



Source: Datastream

Conclusions

Participants expect that 2011 will be another year of record covered bond issuance. Debt managers noted that rising covered bond issuance would not be disadvantageous to government borrowing operations, but rather, that covered bonds were a good substitute for government debt. Covered bonds were recognised as a key source of lower-cost funding in comparison to unsecured bank debt, although issuance was likely to be limited by the amount of eligible bank assets and therefore a need remained for alternative funding channels. The outlook for 2012 is very choppy with the threat of subordination to holders of unsecured debt (or asset encumbrance) from the rise in covered bond issuance remaining a challenge for investors and regulators alike.

Participants agreed that regulations and supervision should remain strict. The quality of the cover pool and homogeneity of the underlying assets would remain a key driver for the resilience of the covered bond market. Some participants argued that broadening asset classes backing covered bonds, as in the US draft covered bonds legislation, would also lead to an increase in yields of covered bonds. Even traditional covered bonds would be affected by an increased risk premium.

7 Future role of large bond investors

The global institutional investor base is changing, becoming more concentrated, with large institutional investors playing a more dominant role. This is happening at a time when international investment flows have become a key topic in the global policy debate, with the current preference for emerging over advanced economies and new liquidity measures such as QE2. This third session focused on these changes in the investor base and their impact. More specifically, the following questions were addressed: How is the investor base changing, why and how? Which investors are most dominant today? What is the impact on how investment decisions are made by large investment companies or asset managers, on other investors in the bond markets, and the functioning of government debt markets, particularly issuance strategies of debt managers? How do these changes effect advanced and emerging market countries, given the current environment?

Against this backdrop the debate focused on the key policy challenges ahead for bond markets, from the standpoint of debt managers, investors, rating agencies and intermediaries.

Key policy issues and trends

Over the last 18 months the structural change of strategic investment flows shifting from advanced economies (AEs) into emerging market economies (EMEs) has continued its consolidation. Their size exceeded $ 47 billion in 2010 which is 50 % above the previous peak. There was broad agreement among discussants that pull and push factors are behind this shift and that real money funds will become an essential funding source for EMEs over the long term. Pull factors in EMEs relate to the higher expected growth and yields, as well as improved credit rating (all EMEs investment indexes are now investment grade). Push factors relate to low growth and yields in AEs and concerns about sovereign risk associated with high public sector debt.

Up to now market size has been an important differentiating factor as the largest EMEs are receiving most capital inflows. In several notable cases (Hungary, Mexico, Poland, Indonesia) foreign funding is around 30 % of domestic public debt. The smaller markets have received lesser inflows in relative terms because of their lower degree of development limiting the supply of liquid instruments.

In those markets hedge funds are getting exposure through credit linked notes issued by local banks. These instruments are also used to gain exposure to markets with capital controls restricting access. It is expected that as markets continue to develop that capital flows would be more evenly distributed across EMEs.

Real money funds have been dominating foreign investment in EMEs as opposed to hedge funds that during the pre-crisis period. Their allocations are still small to the share of EMEs in the investment universe but are expected to become over time a major funding source. EMEs share of GDP growth is increasing and expected to be 50 % of global GDP in PPP terms by 2017. Discussants agreed that over time this larger share in GDP will need to be reflected in their portfolios. Pension funds, for example, have substantially reduced their exposure to AEs equities and are looking to reduce duration mismatches and can be expected to become relevant buyers EMEs Government bonds now at less than 1 % of their portfolios. Exposure to EMEs is preferred in local currency fixed income securities rather than foreign denominated debt as it is seen as a play on the economy rather than on credit risk. Other real money investors are also expected to contribute to capital inflows into EMEs such as endowment funds and foundations currently not invested in EMEs, public pension schemes with 2-6% exposure, and corporate pension schemes with only 0-1% exposure.

Currently large funds already dominate markets and they can be expected to concentrate most of the allocations of capital to EMEs, which will increase their capacity to impact prices. However, it was discussed that this risk would be mitigated as these investors apply multiple investment mandates and vehicles. Large fund managers are also playing an important role in investor education, enabling investors to better understand investment opportunities across AEs and EMEs. It was also raised that there is a trend of growing fund management business domiciled in EMEs investing abroad that could reduce the concentration of capital managed by large international fund managers.

Structural changes are also taking place in institutional funds originated in EMEs that are starting to have an impact in both EMEs and AEs. Mexico provided the example of domestic syndications reaching $ 2.5 billion whereas the international ones are limited to $ 1 billion. Growing local pension funds in EMEs have contributed to support domestic demand for fixed income securities. Their size is still small at around 10 % of total pension funds but can be expected to become a relevant player. Sovereign wealth funds resulting from reserve accumulation are already influential players in the international investment landscape, particularly in AEs. They will continue to be important investors and they are also becoming key players in south-to-south portfolio investments. Overall the trend is for EMEs to become a source of capital for both their domestic market as well as internationally.

The ongoing shift in the investment landscape is already posing challenges to AEs issuers in several ways. On the one hand, the local investor base is less captive than it used to be. Several countries pointed that the issuance strategy had to be accommodated to the needs of local pension funds. For example, Denmark, contrary to its previous strategy, issued 30–year bonds in 2008 to address the demand of its local pension funds. On the other hand, AEs are as exposed as EMEs to foreign investors both from AEs and EMEs. This exposes them to new scenarios that included uncertainty over their behaviour (e.g. Canada, Finland); impact on liquidity as in some countries these investors tend to be buy-and-hold (e.g. Sweden); and crowding out of domestic investors (e.g. Canada). The discussion revolved over the renewed importance of DMOs conducting effective communication and monitoring strategies aiming at both AEs and EMEs investors.

In spite of the clear trend towards higher and more stable exposure of international investors to EMEs there are several challenges that limit the speed of the change. On the demand side, there is a need to increase the investment culture of AEs institutional funds. It is expected that pension funds

will rely on outside expertise to increase their EMEs exposure. On the supply side, discussants highlighted three areas of enhancement: improved access covering clearing and settlement arrangements, withholding taxes and capital controls; increased supply of assets including corporate bonds and infrastructure funds; and increasing secondary market liquidity. There were differing views on the relative current illiquidity of local currency bond markets in EMEs, but there was overall agreement that bonds are always more liquid in domestic markets than when externally traded.

Conclusions

The Forum concluded that the change in the investor landscape is gradual but irrevocable with challenges for both EMEs and AEs. Main policy lessons from this shift include the following:

- Sound domestic macroeconomic fundamentals are essential and will become differentiating criteria blurring the current distinction between AEs and EMEs.
- EMEs in different degrees would need to reinforce market accessibility, diversification and increased supply of offered assets, as well as improved secondary market liquidity.
- The profile of the investor base is changing the investment and market dynamics landscape. Pension funds and sovereign wealth funds will become major players and both AEs and EMEs will be confronted to the challenge of maintaining a stable foreign investor base.
- A reliable and broad domestic investor base will be even more critical than currently, but will be less captive. It will also be affected by greater participation of foreigners in domestic bond markets with the risk of domestic investors being crowded out.
- The dynamics of the domestic and foreign investor base will determine to a greater extent than currently the types of products offered by the issuer.
- Issues faced by EMs and AEs in terms of the investor base will be more similar as demand becomes more volatile. Both groups would need to reinforce their investor monitoring capabilities as well as their investor relations programs.

Notes

1 Structured finance securitisation (or 'securitisation' for short) refers in this report mostly to private-label securitisation products. Another category of securitisation is linked to the pass-through securities issued by the US federal mortgage agencies (*e.g.* Fannie Mae and Freddie; see IMF (2009). Covered bonds could also be considered a form of structured finance, but we will treat them as a separate category as they do not involve tranching or SPVs, instead remaining on the balance sheet (see for details Blommestein *et al.* (2011).

2 Covered bonds can also be considered as a form of structured finance. (See for details footnote 1 and Bloomestein *et al.* (2011)

3 See footnotes 1 and 2.

4 Even in the US, not all securitisation can be classified as "unsound". For example, securitisation of several prime assets (such as automobile loans) can be considered as a"proper" securitisation activity.

5 When comparing non-agency issuance in the US to placed issuance in Europe, we are applying an average EUR/USD daily exchange rate 2006 of 1.26.

6 AFME (Association for Financial Markets in Europe) Securitisation Date Report Q1:2011. Compare this to 7% retained issuance (of total issuance) at the end of 2007.

7 Concerns have been raised by regulators on the subordination of unsecured debt and deposits by covered bond issuance. For example, Thomas Huertas of UKs Financial Services Authority noted during the Global ABS 2011 that "There is a limit how far this collateralisation can go without significantly raising the risk of deposits or other senior obligations of the bank" (http://www.bloomberg.com/news/2011-06-14/asset-encumbrance-needs-regulator-vigilance-eba-s-huertas-says.html).

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