February 19, 2014

Rating Research Services

Executive Comment:

Formosa Bond Market Needs More Diversified Issuers And Investors To Reach Its Full Potential

Author:
Hwa-Ping Chang, President, Taiwan Ratings Corp.; (886) 2 8722-5898;
hwaping.chang@taiwanratings.com.tw

Table Of Contents

RMB-Denominated Assets Are Set For High Growth Potential

Issuers Need Greater Incentives To Increase Formosa Bond Supply

Investors Seek Greater Flexibility And Choice From The Demand Side

What Can We Learn From The Dim Sum Bond Market?

Rating Agencies Can Play An Important Role In The Formosa Bond Market

Formosa Bond Issuance Is Likely To Grow Strongly After A Good Start In 2013

Related Criteria And Research

Executive Comment: **Formosa Bond Market Needs More Diversified Issuers And Investors To Reach Its Full Potential**

Foreign-currency dominated bonds are nothing new in capital markets but the new Formosa bond in Taiwan is quickly demonstrating its high growth potential while still in its infancy. Formosa bonds are renminbi (RMB)-denominated bonds issued in Taiwan, and take their name from the island's old Portuguese name meaning "beautiful". The Chinese renminbi's growing acceptance in global financial transactions has helped spur the investment market's awareness of and interest in Formosa bonds. Taiwan Ratings Corp. believes there is immense potential for the Formosa bond market to expand over the next few years and satisfy corporate investment demand now that many Taiwanese companies operate in China and deregulation continues to boost economic activity across the Taiwan Strait.

In our view, the more diversified issuers and investors that enter the Formosa bond market, such as RMB-dominated mutual funds or foreign institutional investors, the more successful it will be. There are also many good practices in more established markets that could help to broaden Taiwan's Formosa bond market and improve its framework. A number of factors could encourage greater Formosa bond issuance, in our opinion. These include more liberal qualifications for issuers, better flexibility in the usage of funds raised, tax incentives, and the availability of a foreign exchange hedging tool. We also believe more disciplined loan pricing among banks in Taiwan should also help raise the attractiveness of direct financing through Formosa bonds.

Overview:

- More diversified issuers and investors could help create a successful Formosa bond market in this early stage of development.
- More liberal qualifications for issuers, better flexibility in fund usage, tax incentives, and a foreign exchange hedging tool could help to simulate demand and supply.
- Rating agencies play an important role increasing information transparency for Formosa bonds in primary and secondary markets.

In addition, we believe credit ratings would help to increase the transparency of information on Formosa bonds in the primary and secondary investment markets. This would not only assist with Formosa bond pricing but also help enhance market liquidity. However, market participants should bear in mind that issue ratings on Formosa bond may not always be the same as the credit ratings on the issuers, depending on the terms and conditions of the issue.

RMB-Denominated Assets Are Set For High Growth Potential

Since the first launch of Formosa bonds by **CTBC Bank Co. Ltd.** in March 2013, the cumulative issuance amount has reached RMB10.6 billion in 2013 from 13 issues. Four of these have been assigned issue ratings. Nonetheless, the total issuance level, together with RMB11 billion loans by Taiwanese companies is still far below the cumulative RMB180 billion in deposits held by banks operating in Taiwan. In addition, the increasing demand from Taiwan-based life insurers to allocate their funds in Formosa bonds, which carry a higher yield than New Taiwan dollar (NT$) bonds suggests sizeable growth potential for the Formosa bond market. We believe there are also numerous incentives for the many Taiwanese corporations operating in China to issue Formosa bonds to finance their business needs across the Taiwan Strait, particularly since interest rates are likely to begin rising moderately in 2014.

Issuers Need Greater Incentives To Increase Formosa Bond Supply

The prevailing low interest rate on indirect financing due to intense competition in the banking sector remains one of the key reasons for the limited supply of Formosa bonds by Taiwan-based entities. Corporations can secure cheap funding from domestic banks, which makes it natural for corporations to issue either NT$ or USD-denominated loans then translate into RMB when needed if the total cost of indirect financing remains lower than the cost of issuing Formosa bonds directly.

We recognize the Taiwan government's intention to promote Formosa bonds, but we believe further deregulations and incentives could be provided to corporations to help the market's development. In particular, a less-restrictive list of qualifications for issuers could help to stimulate demand from China-based corporations with funding needs and in possession of acceptable credit strength. As with other markets, the presiding government in Taiwan may also seek discussion its Chinese counterpart regarding the flexibility of funds raised by Formosa bonds to make them a more attractive funding option. Currently, issuers are not permitted to wire transfer RMB funds raised by offshore RMB-dominated bonds back to China (with the exception of China's Qianhai special economic zone).

Investors Seek Greater Flexibility And Choice From The Demand Side

In our view, Taiwanese investors could require more flexibility and choice to increase their demand for Formosa bonds. For Taiwan life insurers, whether or not the regulator defines Formosa bonds as foreign investments could affect their investment decisions over this investment vehicle. This is because despite Formosa bonds carrying a higher coupon yield of 3%-4% compared to the yield on NT$ government bonds (about 1.1%) or corporate bonds (about 1.3%-1.5%) with similar duration, the Formosa bond could still be less attractive compared to other overseas fixed-income securities offering 4%-6% yields with similar issue credit profiles.

For Taiwan banks, the demand for Formosa bonds also depends on the RMB deposit rate provided by **Bank of China Taipei Branch**. We also believe investors need more diversified issuer types in the Formosa bond market, because the current issuer qualification somewhat limits diversification from investors' point of view. Moreover, we believe a better tax incentive could be given if the Taiwan government intends to establish Taiwan as a key offshore RMB hub. In our opinion, the current tax structure is also less favorable for foreign institutional investors compared to the Dim Sum bond market in Hong Kong.

What Can We Learn From The Dim Sum Bond Market?

Hong Kong has also been positioning itself as a key offshore RMB market. With active support from the Chinese government, Hong Kong's offshore RMB business has grown rapidly since the inception of the Dim Sum bond market in 2007. The annual issuance amount of Dim Sum bonds is more than RMB 100 billion. In addition, the market contains a far more diversified set of issuers including the China sovereign, Chinese banks, Chinese state-owned-enterprises, Hong Kong-based banks, and even foreign banks all contributing to an ever-growing issuance pool. In addition, the percentage of rated Dim Sum bond issuers jumped to over 80% in 2012 and the first quarter of 2013, compared with the initial stage when less than half of Dim Sum bond issuers were rated.

Rating Agencies Can Play An Important Role In The Formosa Bond Market

Ratings have become institutionalized among issuers and local scale ratings provided by Taiwan Ratings Corp. benefit investors by allowing them to distinguish the credit strength of individual issues based on their local relativity. Currently, most issuers of Formosa bonds are themselves rated, but some of their issues are not, despite the fact that so far all issues are of senior debts that usually rank in pari passu with issuers' other senior liabilities. In addition, some of the issuers do not have local scale ratings because of their Chinese background. We believe that as a ratings agency, we are in a position to provide the most transparent information on Formosa bonds in terms of their creditworthiness. This information could support pricing discovery and more efficient capital allocation compared with the current situation where most issues are placed among a buy-and-hold investor base with less liquidity.

Formosa Bond Issuance Is Likely To Grow Strongly After A Good Start In 2013

In our opinion, a number of factors could transform offshore RMB bonds issued in Taiwan into a more attractive choice for issuers and investors. These include most importantly, the participation of Chinese corporates, greater involvement by international investors to improve liquidity in the secondary market, and a more established framework with high incentives to boost demand and supply. Even so, Formosa bond issuance could continue to grow in 2014 given the likelihood of a moderate increase in interest rates beginning in 2014 and rising global focus on possible appreciation in the RMB.

Related Criteria And Research

Related Research

- **China Credit Spotlight: The "Dim Sum" Market Needs More Sovereign Issues, Best Practices, And Large Investors To Succeed**, www.globalcreditportal, Aug. 29, 2012