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Gaining a Competitive Edge: Government Bonds, Collateral and Regional Economic Growth

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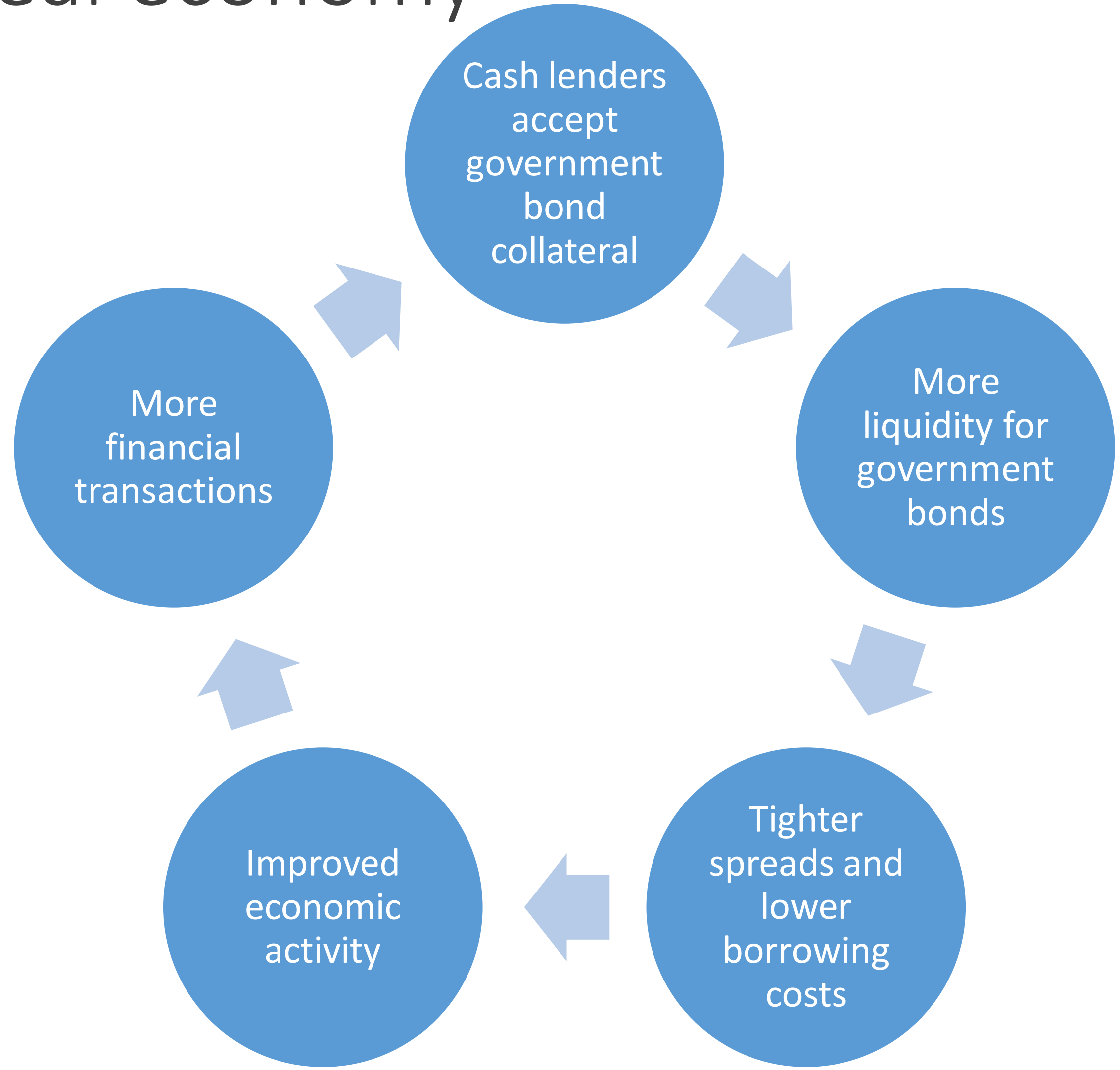
Governments have natural incentives to support collateral transactions using local currency bonds

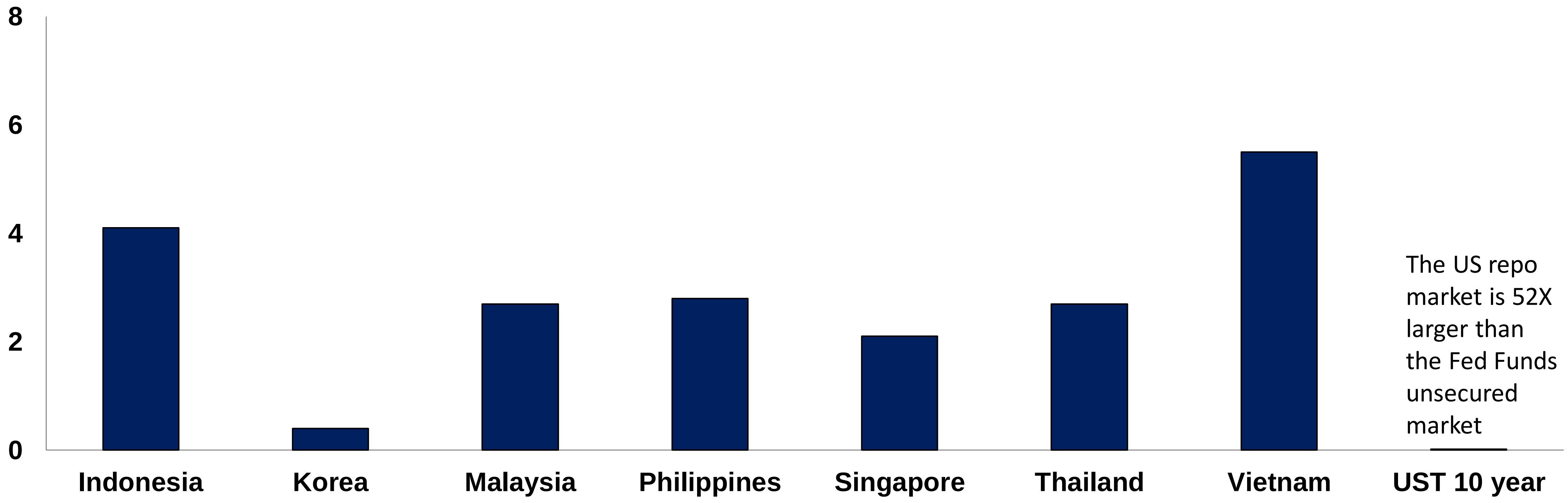
- Collateralized short-term funding drives sovereign debt demand, which in turn lowers funding cost
- Lower borrowing costs across the domestic financial system typically mean more predictable domestic growth
- This relationship can be traced through data and economic theory
- Collateral can be based on long-term or short-term debt issuance
- Collateralized transactions are one of many inputs to government debt demand

Capital markets have expected transmission channels through the real economy



Government bond bid-offer spreads support stable funding markets and macroeconomic policy

Government bond bid-ask spreads, 2019
(Basis points)



Sources: Asian Bonds Online, Federal Reserve Bank of New York, Finadium analysis

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Source of demand: government bonds used as collateral for OTC derivatives margin

OTC derivatives requirement

- Agreement made to conduct an OTC derivatives transaction
- End-users have a variety of commercial, hedging and investment requirements for engaging in OTC derivatives, for example an Interest Rate or Total Return Swap

UMR rules

- Initial and Variation Margin must be delivered to support the transactions under Uncleared Margin Rules
- Initial Margin must be eligible collateral: government bonds are often used
- Variation Margin is in cash

ISDA CSA

- ISDA Credit Support Annexes (CSA) can allow local government bonds
- By agreement with both counterparties

Clients

- Clients can hold local debt issues without having to source outside collateral
- No portfolio drag from collateral transformation costs or holding low value assets

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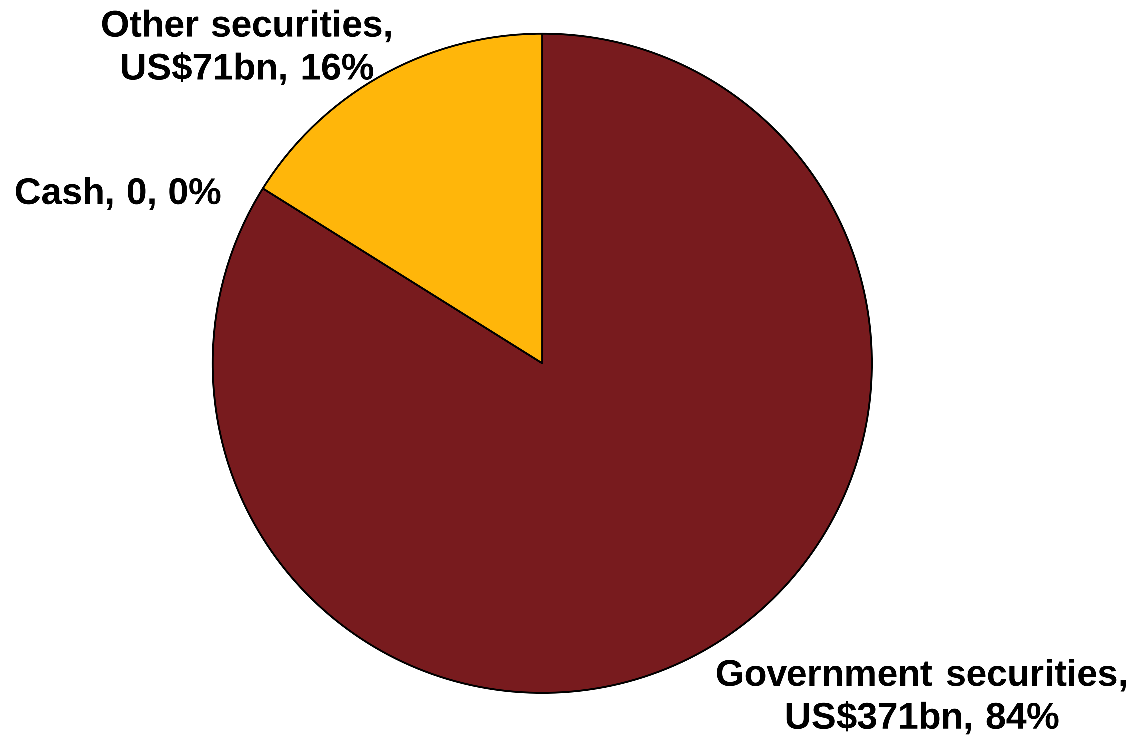
ISDA's 2019 Margin Survey found US$442 billion in posted Initial Margin

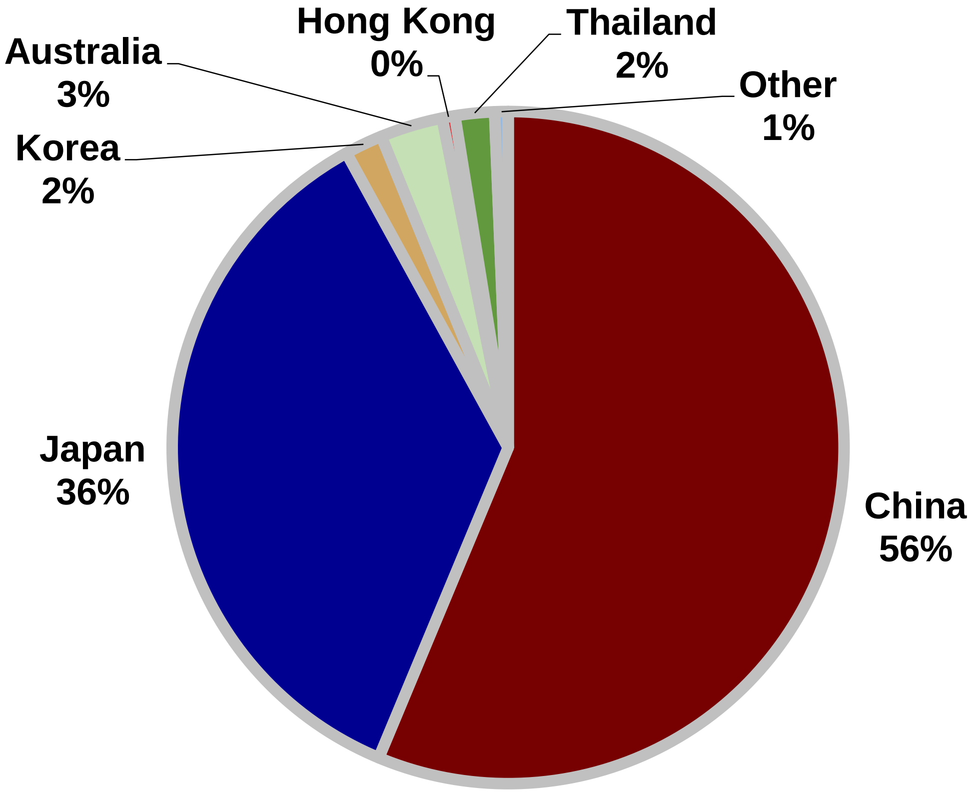
Initial Margin received by the 20 largest market participants by type



Source: ISDA Margin Survey Year-End 2019

Source of demand: local currency repo markets drive collateral utilization

Asian repo outstanding by country, 2019
Total: US$3.1 trillion



Source: Finadium, "Local Currency Repo in Asia: Collateral Growth and the Path to Mass Adoption"

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What happens in a repo transaction

Collateral (bonds) ($1)

Start

Collateral provider

Cash provider

Cash value of collateral minus haircut ($0.98)

Can be structured as a sell/buy-back or as a cash loan with pledged collateral

Cash borrowed plus interest (rate)

End

Collateral provider

Cash provider

Collateral (bonds) ($1)

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The use of bond collateral boosts financial stability compared to unsecured financing

- Collateralized transactions provide two-sided protection to investors in case of default
- Securities can be bankruptcy-remote as opposed to cash that may sit on a counterparty's balance sheet
- Collateral is transparent and risk can be measured
- Collateral can bring financial stability benefits when combined with appropriate macro-prudential regulation

An argument for collateral is an argument for regional development

- A greater use of Asian regional sovereign debt as collateral in financial transactions encourages demand for these assets
- Greater demand drives reduced bid-offer spreads, which in turn lowers borrowing cost
- OTC derivatives and repo are two sources of collateral demand
- The importance of collateral markets is analogous to cash bond and FX markets
- National governments can help by encouraging collateral usage in domestic and regional transactions
- The same principle can apply to domestic collateral demand and regional collateral baskets

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