

**High Level Workshop 2007
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KfW's Experience as an Issuer on Local Emerging Bond Markets

1. KfW's interest in capital markets of emerging economies and its issuance approach

KfW Bankengruppe is the promotional and development bank of the Federal Republic of Germany and the 16 German federal states. KfW gives impetus to economic, social and ecological development in Germany, Europe and worldwide. It supports small and medium-sized enterprises in Germany and investments abroad as well as measures to protect the environment; it extends loans at favourable interest rates to future homeowners and is engaged in developing countries.

For its own financing KfW is prohibited by law from taking deposits. For this reason, it seeks funding almost exclusively in the international money and capital markets. To be able to fulfil its promotional tasks KfW has acted for many years internationally, with a variety of innovative instruments. Given bond issues equivalent to around 55 billion euros per year in 23 currencies, KfW is a true "global player".

KfW's investor base comprises mainly institutional investors – central banks, commercial banks, insurance companies and pension funds.

KfW has several reasons for pursuing a globalisation strategy in its funding activities. The prime reason is the necessity to diversify its funding sources. Strong capital inflows and growth experienced by pension funds and insurance companies in emerging economies are of relevance.

In view of its role as a development bank, KfW wants to contribute to building up the capital markets in the emerging countries and make these economies better guarded against external shocks.

Not least, KfW aims to support the development of the bond and derivatives markets in emerging countries in order to offer its loan borrowers worldwide tailor-made financings in different currencies.

2. Criteria for local bonds market issuance

Which are the criteria that play an important role in KfW's decision to issue in emerging market countries? Major topics are

- legal framework,
- taxation and
- derivatives market.

2.1 Legal Framework

The legal framework (excluding tax) of a bond issuance comprises the underlying jurisdiction, documentation requirements, the accounting and reporting system, language and ratings.

2.1.1 Jurisdiction and Bonds Documentation

The underlying law is of high national importance. For this reason, KfW accepts the requirement of bonds to be issued under the respective national jurisdiction. This means additional effort in terms of personnel resources and financial means, not least because often a local law firm has to be involved. For a borrower this is feasible, but issuing under internationally accepted law, for example US, UK or German law would be preferable. In an ideal world, KfW, however, would rather have the opportunity to use its internationally recognized standardised bonds documentation – the so-called MTN Programmes. Today, this is already possible in a number of countries.

From an issuer's point of view, the willingness of emerging countries to accept standardised issue platforms is the ultimate litmus test for the degree of capital market liberalisation.

2.1.2 Accounting and Reporting Requirements

Different accounting standards often present a big hurdle. KfW is a German promotional bank and up to now its accounting is in accordance with the German Commercial Code (HGB). As from 2007 its accounts will be prepared in accordance with IFRS. A requirement to prepare or reconcile accounts in accordance with different national accounting standards would go beyond the capabilities even for a large institution like KfW.

In this context one also has to consider issuers' other reporting requirements. The individual segments of the international capital market are networked to such an extent that it has become indispensable to provide all investors with

uniform information. KfW as a globally active issuer has to take care that all investors have access to the same information at the same time. For this reason, reporting and disclosure requirements should be reduced to a common denominator - for example an initial one-time due diligence and thereafter annual reporting in the form of an annual report – as is international practice. Provision of information between annual updates needs to be limited to material developments.

2.1.3 Language

It would be helpful for international issuers if English were the generally accepted language for documentation and reporting.

A number of countries require issuers to provide such information in the respective national language and this causes considerable capacity and coordination problems. In practice, this would make a translation of all bond and reporting documents such as the Annual Report and possibly further information into a variety of languages necessary. The issuer would need to monitor these processes regularly and ensure that these reports are delivered on time to the different authorities. This holds operational risks not to be underestimated.

2.1.4 Rating

Some countries require foreign issuers to apply for ratings provided by one of their national rating agencies. KfW obtains annually updated ratings from all three large international rating agencies: Fitch, Moody's and S&P. The obligation to provide additional ratings would be problematic for various reasons, which are mainly: Further coordination and disclosure commitments, additional cost, higher operational risk and increased internal manpower requirements.

For these reasons, KfW is not in a position to meet these requirements but is convinced that there are good reasons for countries to accept international ratings instead. The major advantage is a "neutral" opinion on globally operating issuers which is comparable also across borders. This contributes to an enhancement of market transparency and is from KfW's point of view highly recommendable.

2.2 Taxation

The tax treatment of bonds is another aspect that plays an important role for the possibilities to issue. Particularly important are withholding and transaction taxes that are levied on payments made in connection with bonds. Also important are taxes imposed on bondholders.

Relevant topics to clarify prior to a possible KfW issuance in a local market are: For tax purposes, will the bond be treated in the same manner as a government/corporate bond of the respective country? And: Will the bond be treated equally with possible bonds of supranational issuers?

Taxation influences the attractiveness of bonds and, thus, the pricing. In the market, all issuers have to ensure that they offer products that are interesting for investors. At the same time the funding costs should be roughly the same throughout all markets. This balance may be disturbed through taxes raised in the individual markets.

2.3 Derivatives

The existence of a derivatives market to hedge interest and currency risks is in most cases the indispensable prerequisite for KfW to issue a bond because due to the different cash flows generated by bonds and loans it is not possible to use the issue proceeds immediately and directly to refinance loans in local currency.

For fundamental risk considerations, KfW does not enter into open currency positions and, therefore relies on hedging transactions, at the time of issuance - usually swaps.

The existing base of derivatives in emerging markets is very heterogeneous. The scope ranges from "not existing" in smaller markets that are only just emerging to "almost anything is possible".

3. KfW's experience in local bonds markets

The following examples of Malaysia and Mexico point out the topics mentioned.

3.1 Malaysia

The Malaysian bonds market has accomplished an internationally important role within only a few years. And it is exactly one year ago, that KfW launched its first issue in the local Malaysian bond market. This first issue was preceded

by a very constructive coordination process. The clear requirements of the Malaysian authorities were very helpful.

With regard to most of the aspects above, Malaysia has introduced international standards. Among those, the acceptance of German GAAP and of IFRS is of foremost importance. Moreover, the Malaysian tax law does not differentiate between KfW bonds and other issuers' bonds, which makes an undistorted pricing possible.

The disclosure obligations and the fact that all documents prepared in the context of the bond issue can be submitted exclusively in English also contributed to KfW's decision to enter this market. And finally: the ratings of the large international agencies were accepted.

KfW was prepared to issue under Malaysian law and to prepare a completely new one-time documentation for the bond. Beyond the framework conditions created so far, it would be desirable if the already existing international issue programmes were accepted. KfW issues the major part of its bonds under its EMTN Programme under German law. This programme has already been recognized by many countries as the basis for issuing, among others in Hong Kong and Singapore.

KfW's first MYR bond was a big success. In addition, KfW was able to make a small contribution to expanding the offer to Malaysian investors. After the first issue KfW decided to offer a local issue programme in Malaysia, which was opened in January 2007 with a large 10-year bond. The related currency position could be closed by concluding a swap. The fact that it is possible in Malaysia to conclude swaps with relative large volumes and long maturities shows that the derivatives market has already achieved a high degree of maturity.

Malaysia opened and deregulated its capital market. The bond market is largely transparent; transaction costs for market participants are declining. Given the growing market volume, a stable, low interest rate level and a permanently increasing importance in the global context, Malaysia is a success story.

3.2 Mexico

Historically, Latin America has been strongly oriented towards the US dollar. However, most recently it has used its domestic currencies more strongly in the capital market. "Going local" is the trend that has intensified in the past 2 to 3 years. Mexico is a good example for this successful development. The country has had a functioning local capital market for a long time. What is new,

however, is that the volume of funds raised by Mexican companies in the international market since 2004 has roughly halved, while the capitalisation of the local bonds market is growing at two-digit annual rates. Demand from investors is huge.

Mexico has become largely integrated into the international capital market. The legal framework for KfW is positive. The Mexican supervisory authorities have basically accepted KfW's international EMTN Programme. To be able to use the Programme for issues in the local market, only minor additional requirements have to be fulfilled, which are manageable. German law is accepted as the basis for bonds as much as German or international accounting standards for disclosures.

The tax treatment of KfW bonds – as in Malaysia – does not differ from the treatment of similar products issued by Mexican borrowers. Withholding tax does not exist in Mexico. Only individual income tax has to be paid on investment income. Thus, Mexican tax law does not impose restrictions.

How do market participants hedge currency risk in Mexico? At the end of 2006 the capital market showed a high capitalisation. The Mexican peso is freely convertible and there are no access restrictions for foreign market participants.

A relatively liquid swap market has developed from this basis, in which market participants may obtain quotes for large volumes equivalent to 100 million US dollars for maturities of up to 10 years. For smaller amounts maturities of up to 30 years are even possible. There are no formal obstacles. Nevertheless, the swap market is still not broad, deep and liquid enough to meet the increasing demand for hedging instruments. The swap market continues to be sometimes a bottleneck, but can be expected to further develop to the extent that the entire Mexican capital market continues its strong growth.

4. Recommendations

KfW's conclusions drawn from these two examples and the experience in other countries lead to the following recommendations. From a global issuer's point of view, a long-term integration into the international capital market should be considered. This includes abolishing market access restrictions and freely convertible currencies.

Regulations in order to allow a greater variety in the markets could target the following fields:

- Foreign law should be accepted as the basis for an issue.
- Foreign issue programmes should equally be accepted.

- International accounting standards should be accepted and ideally also the accounting standards of some large countries (at least for a transitional period).
- English should be accepted for the documentation and disclosure.
- Disclosure requirements should be in line with international standards.
- International ratings should be accepted.
- Tax inequalities should be eliminated.
- Transaction costs should be kept low. Transaction taxes or charges should be abolished.
- Only one or at best a few clearing and settlement systems should be established in any one country or region, which are coordinated across national borders and enable the transfer of capital and securities.

If these recommendations were implemented, the conditions for a further opening of the local capital markets would be substantially improved and a number of new opportunities would arise. KfW wants to further support this process and is prepared to engage in cooperation with other countries as well.