# Development of Bonds Market: Kenya's Experience

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## *Abstract*

*Development of bonds market widens the financing options for firms and enables the government to shift its domestic debt to longer-term securities. However, development of bonds market requires that certain conditions be in place. These include a developed money market, wider participation and protection of investors, reduced information asymmetry and an efficient trading system. This would boost the market microstructure and facilitate development of the market. The level of development of Kenya's bonds market indicates that the country is very far from developing this market. The length of treasury bonds market is shorter than that of developed bonds markets, the trading system is not harmonized with intermediaries using different pricing models, and the regulatory framework is also weak to accommodate diversification of corporate bonds. Also, growth of corporate bonds is yet to pick momentum, and the debt market is thin, with the type of securities that have negative implications on the competitiveness of the market. There also gaps between the regulatory framework and the objectives of bonds market development. Thus, developing the bonds market requires huge investment in institutional building.*

## Abbreviations and Acronyms

| | |
|---|---|
| ABS | Asset Backed Securities |
| AFA | Association of Financial Analysts |
| AfD | French Development Agency |
| BESA | Bond Exchange of South Africa |
| BMA | Bond Market Association |
| CBK | Central Bank of Kenya |
| CDS | Central Depository System |
| CMA | Capital Markets Authority |
| CMDF | Capital Market Deepening Fund |
| DCR | Domestic Currency Rating |
| EADB | East Africa Development Bank |
| FISB | Fixed Income Securities Board |
| FISMS | Fixed Income Securities Market Segment |
| GCR | Global Credit Rating |
| IAS | International Accounting Standard |
| IPO | Initial Public Offer |
| ITC | Investment Trust Company |
| JSE | Johannesburg Stock Exchange |
| MDGs | Millennium Development Goals |
| NBMC | National Bond Market Committee |
| NHC | National Housing Corporation |
| NSE | Nairobi Stock Exchange |
| NSSF | National Social Security Fund |
| OMAM | Old Mutual Asset Management |
| PDs | Primary Dealers |
| PDS | Private Debt Securities |
| SIMS | Stanbik Investment Management System |
| SPV | Special Purpose Vehicle |
| SROs | Self Regulatory Organizations |
| UNEXCOR | Universal Exchange Corporation |

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# 1. Introduction

The 1980s and 1990s have seen developing countries embark on revitalizing capital markets to enhance mobilization of long-term capital. The evidence that long term capital is positively related to economic growth has justified this effort. Further, the recent need to meet the Millennium Development Goals (MDGs) demands mobilization of adequate financial resources, and this has kept the momentum for capital market development high.

Kenya has followed suit in developing its bonds market in the capital market reform process. Although treasury bonds were introduced into the market in the early 1980s, the market faced various challenges that constrained its development. Until 2001 when the government took a deliberate effort to shift domestic debt to long term instruments, government bonds maturities were short. Corporate bonds were introduced in mid-1990s, but the growth momentum was not maintained. Ten years after the first bond was listed, there are less than ten corporate bonds listed in the market. Further, the demand to diversify the bonds with mortgage-backed bonds among the banking institutions and infrastructure bonds has not been successful.

Bonds market is an alternative vehicle for mobilizing finance for both the government and the private sector in financing long term projects such as housing and infrastructure development, in addition to financing government deficit. The development of bonds market plays a crucial role in promoting partnerships in the development process between the government and the private sector. Successful development of bonds market requires a number of conditions such as a developed money market, favourable macroeconomic policies, market participation, appropriate trading system and a sound legal and regulatory framework. Experience also shows that development of government bonds market is crucial in paving way for development of corporate bonds market.

This paper examines the factors influencing the development of the bonds market in Kenya by carrying out a situation analysis of the market, which includes examining the performance of the market, appropriateness of the institutional set up and the policy environment.

## 2. Factors Influencing Development of Bonds Market

For a bonds market to contribute significantly to the development process, it requires that the market caters for a diverse risk preference, is liquid, efficient and has minimal volatility. To achieve this, there must be a sound fiscal and monetary policy, effective legal and regulatory framework, secure and efficient settlement and custodial system, effective information disclosure system, a diversified investor base, anf favourable tax policies. For treasury bonds especially, there is need for an effective financial system, a sound and prudent debt management and credible and stable government. In addition, the development of a well-functioning money market is essential in enhancing liquidity of the market. An active money market is the precursor to an active secondary bond market.

### 2.1 Prerequisites

World Bank (2001), Jones (2002) and Christensen (2004) identify various requirements in development of a successful bonds market. They include:

*(i) Active money market*

An active money market is the precursor to an active secondary bonds market as indicated in Table 2.1. Money markets are essential for conducting indirect market-based monetary policy operations and providing the liquidity necessary for a market in government bonds and private sector debt securities. They also make it easier for financial institutions to cover short term liquidity needs. In addition, it becomes less risky and cheaper to warehouse securities for on-sale to investors and to fund trading portfolios of securities.

The development of a well-functioning money market calls for the existence of banks and other financial institutions that are commercially motivated to respond to incentives, so as to actively manage risk and maximize profits. They (banks) must have adequate incentives to develop treasury capacity, which is the ability to actively manage liquidity and interest rate risk. Multilateral trading, where price discovery is by all institutions in the market, is key otherwise large differences in pricing will arise within the market over relatively short

**Table 2.1: Prerequisites for a successful bonds market**

| Prerequisite | Benefit(s) |
|---|---|
| Active money market | • Enhances liquidity in the bonds market |
| Effective policy framework | • Defines the path clearly for bonds market development<br>• Builds credibility |
| Legal and regulatory framework | • Provides necessary oversight of the market and ensures its stability<br>• Defines parameters linking fiscal budget with security issuance, showing the ceilings, and legal properties of bonds<br>• Ensures fair, efficient and transparent markets<br>• Minimizes systemic risk through clearly defined roles and obligations of market participants |
| Secure and efficient trading and settlement systems | • Proper surveillance, settlement, trade and dispute resolution<br>• Improves market integration<br>• Increased liquidity<br>• Reduced operational risk |
| Quality information disclosure | • Improves market access and transparency<br>• Improves investor confidence<br>• Improved participation and liquidity |
| Broad investor base | • Improves competition<br>• Improves participation and liquidity<br>• Stabilizes demand |
| Functional sinking fund and issuer guarantee | • Reduces investment risk<br>• Improves investor confidence |
| Benchmark Issues | • Prices corporate bonds and other debt instruments accurately |
| Favourable tax policies and tax incentives | • Improves participation and in turn liquidity through increased transaction volume<br>• Checks excessive speculation<br>• Improved savings and investment liquidity<br>• Increased market competitiveness from decreased cost of capital |

*Source: Own compilation*

intervals, which will reduce the information content of market price signals. Weak banks cause segmentation in the inter-bank market, which leads to volatility in the overnight rate and lack of unified pricing.

### *(ii) Institutional framework*

A sound institutional framework for debt management embodying good governance practices, prudent procedures, and strong capacity for managing operational risks is essential for bonds market development. A clear legal framework, well specified organizational arrangements, public disclosure and auditing procedures are key elements of an effective governance structure for debt management. The soundness and credibility of a financial system can be supported by assurances that the debt portfolio is being managed prudently and efficiently. The organizational framework for debt management should be well specified, and must ensure that mandates and roles are well articulated. Sometimes, a risk management office is established to undertake risk analysis, monitor and report on portfolio-related risk, and assess the performance of debt managers against any strategic benchmarks. Debt management activities should be supported by an accurate and comprehensive management information system with proper safeguards.

### *(iii) Legal and regulatory framework*

Financial markets do not develop without a sound legal, regulatory and supervisory framework. The regulatory framework for securities markets is usually seen as having three distinct objectives–assurance of fair, efficient and transparent markets; minimization of systemic risk; and, protection for investors and consumers of financial services.

The fundamental parts of the legal framework supporting an efficient domestic securities market usually include an explicit empowerment of the government to borrow budgetary rules for the issuance of government securities, rules for the organization of the primary market, the role of Central Bank as a government agent for debt management framework, rules governing issuance of securities, and rules pertaining to the secondary market. A legal framework is important in defining the exact parameters under which fiscal budgeting process will be linked to securities issuance, limiting issuance through debt ceilings or other

devices such as sinking funds and defining the legal properties of securities and their use as collateral in transactions such as REPOS. The rights and obligations of parties to debt contracts in the primary and secondary markets for issuers, investors, and intermediaries need to be defined. Thus, minimum guidelines should exist for disclosure of material information, liability for entities handling third-party investment accounts, and vehicles to allow proper legal recourse against mutual funds, pension funds, and even the government and corporations as issuers.

Effective regulation of the secondary market should include: regulations of market intermediaries, market conduct (including trading rules), market surveillance and transparency requirements. More importantly, providing incentives for the preparation and disclosure of high-quality information, and breaking the hold of banks as monopolisers/controllers of information is important for bond market development.

The regulatory structure of securities markets is, in many cases, built around Self Regulatory Organizations (SROs) such as exchanges and security dealers' associations as a supplement to the government regulatory authorities. SROs typically provide the first layer of regulatory oversight, guiding their members to meet the objectives of regulation. Non-uniformity of capital requirements across different classes of market participants can be an important factor in creating incentives for self-regulation. If members of securities depository and settlement corporations are required to hold higher levels of capital than non-members, the members will have greater incentives to monitor those financial institutions with lower capital requirements.

### *(iv) Trading and settlement systems*

This looks at the method of matching trades, settlement, surveillance, dispute resolution, failed trades and defaults. In determining the potential efficiency of the bonds market, an important factor is whether bonds are issued as paper or are paperless (dematerialized) securities registered in security accounts. Dematerialization of securities ensures that transactions take place quickly and cheaply and that security accounts protect investors against destruction, loss, theft, or forgery of paper securities, eliminating the problem of tainted script.

Organizing the central depository as a separate agency, even if located within the Central Bank, allows for a clear delimitation of responsibilities, the possibility of independent oversight and, at a later stage, full independence of the system. If custody is fully or in part privately provided, governance arrangements and oversight must be sound. Because of the centralized nature of a securities depository, policy makers might find regulation of the fee structure necessary to prevent monopoly pricing. Efforts to link custody arrangements on a cross-border basis should be sought at a later stage to broaden the market base.

For an effective secondary market infrastructure, trading and information systems that facilitate an efficient completion of transactions are key. The automated trading systems are increasingly the preferred avenue for most countries, with their costs three to four times lower than those of traditional exchanges using a floor and open-outcry method.

### *(v) Information disclosure*

This entails adopting internationally accepted accounting practices, and corporate governance guidelines. Improving market access and transparency by providing high quality information about debt structure, funding needs and debt management strategies to market participants and the public at large is essential. It is the prerogative of the government in consultation with capital markets and Central Bank to provide appropriate guidelines on disclosures. In designing the overall regulatory and disclosure framework applicable to secondary market trading systems (extent of entry or exit or whether to allow internalization or force disclosure of order flow), policy makers will need to consider the rapid advances in technology, the size of the country, and the extent of its integration in regional and global capital markets.

In order to attract and maintain investor interest, bond issuers need to disclose objective, relevant, and timely information about themselves and the securities being offered to the public. The existence of an equity market is practically a prerequisite for private sector bond market development as it often sets an example for disclosure practice. In addition to meeting regulatory disclosure requirements, the development of private sector bond markets could be aided by voluntary disclosure. The voluntary public release of credit rating agency of a

private sector bond issuer could form an important element of a voluntary disclosure system.

Most fixed-income securities markets have traditionally been opaque, with scant and delayed information on transactions available to the public. Major intermediaries should voluntarily provide pre-trade, indicative prices to the market through business information vendors, as well as hold regular meetings with the market makers, the Central Bank, investors and other market participants to ensure a shared understanding of developments in the capital market and appropriate consultation on reform options.

### *(vi) Investor base*

A diversified investor base for fixed-income securities is important for ensuring high liquidity and stable demand in the market. This calls for a heterogeneous investor base with different time horizons, risk preferences, trading motives and high liquidity. Where one group of investor exits or gains entry in the market over a short period and where there are no counterbalancing order flows from other investor groups, even liquid markets can become illiquid in such instances. Some of the questions to address include: how can mutual funds and other collective savings schemes play a role in the securities market? Should foreign investors be allowed in the market and what role should they play in the bonds market? How can retail investors be effectively and efficiently served in the bonds market? Should banks continue to dominate trading in bonds, particularly government bonds?

Having access to major savings pools, such as retail or foreign investors, structural reforms of pension and retirement funds to encourage their investment in bonds and reforming or creation of mutual funds and other collective investment schemes need critical consideration. Foreign investors tend to be relatively more sensitive to risk, and manage their portfolios actively, which means a stable macroeconomic environment and prudent capital account liberalization is essential to maintain a stable and growing participation of foreign investors in debt securities markets.

### *(vii) Sinking fund provision and issuer guarantee*

The laws in countries such as South Africa provide for establishment and maintenance of a fund out of which any liability of a member arising from buying and selling of listed securities for different categories of claims is paid for if such a member fails to discharge her liability. Protection provided by the fund is based on the principle that in those instances in the buying and selling of securities on the exchange where a client has performed under a statutory duty (that is, in terms of the Act) the fund will provide general protection. In other instances, the quantum of protection is restricted. The fund has liability for losses in respect to both general protection and limited protection.

### *(viii) Benchmark issues and other debt instruments*

Development of government benchmark securities by concentrating new issues of debt securities in a relatively limited number of popular, standard maturities can assist governments in the development of liquidity in those securities and thereby lower their issuance costs. Markets can then use such liquid issues as convenient benchmarks for pricing a range of other financial instruments. Spreading the relatively few benchmark issues across a wide range of maturities (building a benchmark yield curve) can facilitate better risk management in financial markets. Accurate pricing of less liquid debt instruments such as corporate bonds is needed for fairness among different groups and generations of investors, and this would be difficult without reference points provided by benchmarks. A number of countries are developing matrices for the valuation of less-liquid debt instruments based on net present value, where the rate of discount is calculated by reference to the relationship between the rating of a particular bond and the rating of a risk-free benchmark government bond.

Policy makers need to weigh the advantages of longer-term benchmark issues against the possibility of higher cost associated with longer-term benchmark bonds, the refinancing risk that comes with focusing on maturities, and the needs of government debt financing and benchmark development.

In many emerging economies, Kenya included, both tradable debt securities (such as treasury bonds, corporate bonds, municipal bonds, etc) and non-tradable debt instruments (such as special purpose

government bonds issued for financing specific projects and not traded in the secondary debt market) are issued. Issues of special purpose bonds should be discouraged, since they limit the liquidity of debt instruments. Consequently, the market should generally narrow the variety of debt instruments by consolidating and standardizing debt securities issues, with an emphasis on marketable debt securities.

### *(ix) Favourable tax policies*

Taxation of capital gains and income from bonds affects consumption, savings and investment decisions, influencing the general level of savings, the demand for financial assets, and investment. An inappropriate tax system hampers the emergence of new financial instruments such as mutual funds and asset-backed securities.

Tax authorities in most developing countries often skew the tax regime to take advantage of a relatively well-institutionalized financial sector from which revenue can be raised easily. As a way of stimulating national savings, many countries have employed various tax incentives for certain financial assets. Tax incentives used with care can be effective in achieving certain economic goals, such as promoting a long-term bond market. Contributions to pension plans are tax exempt in many countries, and savings through life insurance receive special tax treatment in many countries.

Contributions to private pension funds are a major source of national private savings, hence representing an important source for institutional investment in the capital market, including debt securities such as bonds. Policy makers should give careful consideration to designing a tax regime for pensions and other collective investment vehicles that are conducive to bond market development.

## 2.2 Stages in Development of Bonds Market

Table 2.2 summarises the stages in development of the bonds market.

*Stage 1* is the nascent stage of bonds market development. Priority should be given to strengthening and developing the short end of the market. Initiatives related to developing an active money market with market-determined price setting are required to enhance liquidity of the bonds market. Other factors of concern include: transparency in

**Table 2.2: Stages in the development of bonds market**

| Stages | Requirements | Implications on bond microstructure elements |
|---|---|---|
| *Infant stage* (development and strengthening of the short end of the market) | Coordinating debt management and monetary policy (Developing an active money market) | - Debt management coordination helps in cost/risk trade-off and minimizes the borrowing costs to the bond issuer<br>- Coordinated monetary policy helps in price stability<br>- The coordinations enhance confidence of the market in the authorities commitment to market principles<br>- A well-developed money market reduces liquidity risks for bondholders by providing access to the immediate cash market. It also facilitates the emergence of a sovereign yield curve, as money market benchmarks lead to the development of long-term yield curves |
| | Market transparency | - A transparent market that disseminates pre-trade and post-trade information to traders lowers spreads, improves efficiency and attracts more participants by increasing their confidence in the pricing process |
| *Youth stage* (development and strengthening of the mid-term funding instruments) | Upgraded trading arrangements | - Provides greater immediacy to traders and guarantees them liquidity even under uncertain market conditions |
| | Upgraded settlement systems | - Reduces the clearing and settlement burden by reducing the number of players among whom cash and securities transactions have to be squared |
| | Upgraded market regulation | - Organized exchanges lead to more efficient price discovery since they enhance the information flow among traders and lead to more informed trading behaviour. |
| Maturity stage (development and strengthening of the long end of the market) | Development of benchmark bonds | - Availability of benchmark securities with different maturities helps develop a hedging market and improve trading since the prices of these securities trade close to par and are thus better able to capture the market interest rate |
| | Broadening the investor base | - A broader investor base improves bond market liquidity because of the size effect but a large number of investors with diverse risk profiles enable smooth dissipation of market shocks<br>- A large investor base generates incentives for financial innovation, leading to greater market dynamism and lower transaction costs |

*Source: Own compilation*

securities operations and instrument design, especially standardization of issues. Initially, the focus should be on simple and secure solutions capable of handling the limited number of daily transactions expected. Other than focus on more technical issues such as whether to use single versus multiple price auctions, fundamental issues such as lack of competition among bidders should be given attention.

In the *second stage*, a lot of efforts go into upgrading the trading facilities, the settlement process and market regulations. More advanced features of a securities market such as electronic trading mechanisms, advanced securities depositories, and settlement procedures are developed.

The *third stage* is the maturity stage where the market works on the long end of the market. In the movement towards longer term funding instruments, there is need to preferably start with fixed rate securities and later move to flexible rate securities with longer maturities. As the focus shifts from short term to long term, the development of a diversified investor base with different time horizons, risk preferences and trading motives that ensure active trading and high liquidity is crucial. Structural reforms of pension and retirement funds to encourage investment in bonds and reforming or creation of mutual funds and other collective investment schemes is critical. At the interim, the retail investor segment of the market can be enhanced through development of institutions such as mutual funds and investment trust companies (ITCs), which can quickly channel retail demand to the short and medium-term segment of the market.

# 3. Development of Bonds Market in Kenya

The bonds market in Kenya trades in both the treasury and corporate bonds. While treasury bonds were introduced as early as mid-1980s, corporate bonds came to the market in 1996 during the reform period. Despite the early initiation of treasury bonds in the market, the market remained almost stagnant, with the government using treasury bills to finance domestic debt. It was not until 2001 when the government took a deliberate effort to develop the market that activities of the treasury bonds market increased. However, corporate bonds market is yet to gain its growth momentum.

## 3.1 Sequencing the Development

As observed in section 2, the development of treasury bonds usually supersedes that of corporate bonds. In Kenya, the situation was no different, with treasury bonds being first introduced in August 1986 with the aim of lengthening government debt structure and financing budget deficit. However, the start was not smooth and the market remained inactive for eight months after the launch, resuming in 1987. Two issues were made in September and December 1987, introducing the 6 months and 1-year maturities. However, it was important to maintain a positively sloped yield curve and, therefore, when the bid rate for the 6 months maturity bonds was quoted at 18 per cent, the issue was stopped from trading to avoid a negatively sloped yield curve as the treasury bill rate was 13 per cent while the average yield on 1-year bonds was 14 per cent.

In February 1988, the government launched new issues, which saw the expansion of treasury bonds' maturities. The rates set for the various maturities were such that they maintained a positively sloped yield curve. The rate set for 1-year bond was 14.5 per cent, for 2-year 15.5 per cent and for 5-year bond 16.5 per cent. These rates were revised in March 1990 to 15 per cent, 16.5 per cent and 17 per cent, respectively.

The treasury bonds market became almost dormant in mid 1990s, due to attractive returns in the treasury bill market. At the same time, corporate bonds were introduced in the market. It took the government deliberate efforts in 2001 to boost activities in the market. During this period, the government adopted a policy of reducing the proportion of domestic debt in short term securities in favour of long term securities.

Although it is expected that there should be a vibrant money market, development of the bonds market was not preceded by development of the money market. However, in the reform period, efforts were made to develop the money market. A number of policy reforms by the Ministers of Finance have affected treasury bill interest rates in ways that have encouraged growth of bonds market. For example, during the first eight months of the fiscal year 2003/04, interest payments on domestic debt decreased to Ksh 16.4 billion or 10.2 per cent of revenue from Ksh 18.0 billion or 12.7 per cent of revenue in the same period the previous year.

## 3.2 Institutional Infrastructure

### *(a) Institution structure*

Institutions involved in bonds trading include the Central Bank of Kenya (CBK), Capital Market Authority (CMA), the Nairobi Stock Exchange (NSE), stockbrokers, arrangers, commercial banks and guarantors. The involvement of these actors depends on the type of bond. The issuing of treasury bonds is under the jurisdiction of the Central Bank of Kenya, which acts as Government of Kenya's issuing agent. The Capital Market Authority authorizes listing of both treasury and corporate bonds as long as the issuing company meets the eligible listing requirement.

The primary market of corporate bonds has other players involved in the preparation of the prospectus, arrangers, paying and receiving agents, placing agents, and guarantors. Arrangers are mainly involved in the corporate bonds and their role is to ensure that there is a ready market for the listed bonds. They do pre-selling activities, which involve identifying potential buyers, and this has reduced the listing risk of corporate bonds. Commercial banks play a major role as guarantors of the listing of corporate bonds. In the absence of a credit rating agent, it is important to reassure the investors of their investment in bonds.

Guarantors take the risk in case of under-subscription in the case of corporate bonds. In the case of treasury bonds, the government uses its own mechanism to raise funds to take care of shortfalls arising from under-subscription. Market trading for the bonds differs by the type of bond. Corporate bonds are structured by investment banks/arrangers while the Central Bank of Kenya structures treasury bonds. Treasury bonds are also bought through commercial banks, stockbrokers at the

Initial Public Offer (IPO) stage, while arrangers/lead broker place corporate bonds in the IPO stage. It is important to note that before 1990s, there was no secondary market for trading treasury bonds. This made them illiquid and, therefore, unattractive to investors. Trading in these bonds was through arrangements between the principal and agents. The involvement of NSE in bonds trading came with the introduction of corporate bonds in mid-1990s. This also saw the stockbrokers actively involved in non-private corporate bonds trading. They act as sponsors of corporate bonds listing and as agents in trading of all bonds.

In February 2001, the stock market underwent a restructuring, which saw the bonds placed under the Fixed Income Securities Market Segment (FISMS). REPO market, which was initiated in 1996, is not very active and mainly involves the operations of treasury bills. The first REPO in bonds trading was done by Kenya Commercial Bank in 2001. This market needs to be boosted to ensure liquidity of the market.

### *(b) Regulatory framework*

The regulatory set up in Kenya to some extent resembles that of South Africa, which has a well developed bonds market. In South Africa, the regulation of Bond Exchange of South Africa (BESA) is through Bond Market Association (BMA), a SRO launched in 1987. In turn, the working of the BMA is overseen by the Financial Markets Control Act, which was also promulgated in 1987.

In Kenya, there are various organs that make up the regulatory framework. The Capital Market sAuthority holds the statutory regulatory powers with the overall objective of driving market development and protecting investors' interest. The Authority creates, maintains and regulates the market where bonds are issued and traded in an orderly, fair, and efficient manner, through the implementation of a system in which market participants regulate themselves to the maximum practicable extent. The second schedule of capital markets (securities, public offers, listing and disclosures) regulations 2002 gives CMA power as the competent authority to grant approvals in the market. Capital Market Authority reviews the offer document (information memorandum) to ensure that the issuer makes adequate disclosure. The authority also reserves the power to extend, reopen or cancel its approval. For example, where in the opinion of the authority

circumstances have occurred or new information has emerged that fundamentally alters the basis of approval of a public offer before the allotment date, which renders the information memorandum inadequate, the authority may require the issuer to issue a supplementary prospectus disclosing such additional information, or extend the offer to allow investors to make an informed decision in light of the new disclosure, or re-open the offer for such period as shall be determined by the authority to allow investors either to re-confirm their applications for subscription or withdraw their applications or cancel the offer.

Treasury plays the role of issuer/borrower in the treasury bonds market. It is an agent in the bonds market and issues bonds according to government's borrowing requirements. The Central Bank of Kenya ensures a fair equilibrium in the money market, hence ensuring interest rates, inflation and exchange rates are maintained to levels where investors earn real returns on their funds.

The NSE is a self-regulating body that defines the rules of the game in bonds trading with the approval of CMA and within the bounds of prescribed rules. The Capital Markets Authority remains the regulatory authority of capital markets, with the Nairobi Stock Exchange (NSE) only performing delegated roles as a capital markets intermediary. As an intermediary in charge of trading rules, NSE defines penalties for failed deliveries; failure to honour payments; and bond pricing, where prices are usually expected to be within a certain range depending on the prevailing rate of interest. Prices outside the expected range would indicate there is something wrong in the pricing and would be viewed with scepticism. The CMA approves these NSE rules and roles as provided in CMA rules.

There is a substantial amount of legal drafting of rules and regulations by the CMA for which, to date, has been able to supplement its resources with private sector resources, especially through the use of committees and taskforces. These have proved useful in developing the regulatory framework, but the more important area in which the CMA needs to develop capacity is that of monitoring and ensuring compliance with the rules and regulations drawn up.

### *(c) Listing requirements*

In Kenya, corporate entities (that is multi-lateral agencies), government and its agencies and public institutions all qualify to issue bonds as long as they meet the eligibility requirements stipulated in the Capital Markets' (securities, public offers, listings and disclosures) Regulations 2002.

For securities to be listed in the FISMS of the NSE, the issuer must be a public company limited by shares and registered under the Companies Act (Cap 486) or any other corporate body. Minimum authorized and fully paid up capital must be Ksh 50 million and the net assets should not be less than Ksh 100 million immediately before the offer.

The issuing institution is required by law to prepare a prospectus, which should contain audited accounts of three consecutive years before the issue. The issuer must have declared positive profits after tax attributable to shareholders in at least two of the last three financial periods preceding the application. In addition, the audited financial statements of the issuer for five preceding years must be prepared and availed by the issuer and funds from operations to total debt for three trading periods preceding the issue should be kept at weighted average of at least 40 per cent.

Directors of the issue must be competent persons with no legal encumbrances. Issuer's track record, solvency, share ownership structure and dividend policy are not a requirement. The regulator might require a certificate of comfort where one exists. The total indebtedness of the company, including the new issue should not exceed 400 per cent. The minimum issue lot size should be Ksh 100,000 for corporate bonds.

To issue treasury bonds, it is a requirement to have placing agents; they could be Central Bank of Kenya, a commercial bank, stockbrokers licensed by NSE or a licensed investment advisor. The interval of issues range between monthly and quarterly. Interest is paid quarterly. Buying and selling of treasury bonds in the secondary market is through stockbrokers. Amounts of Ksh 1 million and above can be purchased directly from Central Bank, while amounts of Ksh 50,000 can be purchased through the other agents.

The listing process involves preparation of the information memorandum by the advisors of the intending issuer, which is submitted to CMA for review and approval. If CMA's approval is granted, the intending issuer/interested issuer announces her intentions to issue a bond to the NSE. After the terms and conditions (amount, coupon, maturity) of the issue have been announced by the borrower, the subscription or offering period commences. If the case is favourable, a bond issue takes between four and six weeks from the announcement to the offering day. During this period, the selling group is established, underwriting commitments are concluded, the offering circular is distributed and exchange listing is sought. Given the coupon and maturity, the lead manager determines the price of the bond on the day prior to the commencement of the offering. Selling, payment and transfer of funds raised to the issuer are usually accomplished within 2 weeks of the offering day.

To purchase a treasury bond, a prospective investor must have a Central Depository System (CDS) account, which is a central facility at Central Bank for holding securities by book entry without the necessity of certificates. It is a requirement of Central Bank that all investors have a CDS account for them to purchase government bonds. New investors are required to complete CDS account opening cards before making their accounts fully operational. No fee is charged to open this account. Additionally, an investor requires only one CDS account, which is to be used for all investment in government securities. When applying for the bonds, investors apply on a prescribed application form, which requires information on the issue number, face value offer payment for every Ksh 100 desired rate to maturity (% rate), duration, name of the prospective investor and CDS account number. There are two ways in which an investor can quote price by offering payment for every Ksh 100.

In competitive bidding, an investor quotes a price per Ksh 100, which they are willing to pay for new Government bonds and quantity (face value) desired. Competitive prices may be accepted or rejected depending on the value of other bids in the market. However, the bidders know the exact cost payable. Non-competitive bidding benefits those investors who are not price-sensitive and may wish to purchase relatively small quantities of government bonds. When applying to purchase the bonds, they are allowed to indicate the words "non-competitive" or "average" instead of the quoted price. At the end, the non-competitive

price is computed as an average of accepted competitive prices. The quantity that a prospective investor can apply for non-competitive quotation is limited to any amount from the minimum of Ksh 50,000 up to a maximum of Ksh 10 million per investor. An investor is not allowed to split amounts of over Ksh 10 million into two or more applications to qualify. Non-competitive bids are accepted by Central Bank at a price that is known after the auction is completed. After completing the forms, prospective investors are required to place their quotations in treasury bonds tender boxes available at any Central Bank of Kenya branch by 2.00 p.m. on closing date.

After the submission of quotations, the auction management committee meets on the afternoon at close of sale date to peruse the bids and determine the successful bids. In the auction, accepted competitive price is determined, from which an average is computed and then applied to all non-competitive bids. If an application is found to be incomplete, it may be rejected. Additionally, Central Bank reserves the right to issue the same or a lesser number of government bonds applied for by an investor as it may see fit. The results of the auction are then publicised through the electronic media, which airs the results in the evening, while the print media carries it in the Friday dailies.

There is no model for determining prices of bonds. In the case of treasury bonds primary market, the government determines the interest rates. The interest rate depends on whether the price is competitive, otherwise also known as "off-the-run" (which is normally close to the interest rate of the previous issue) or non-competitive also known as "on-the-run" (current rate of interest) basis. As for corporate bonds the issuing company, in consultation with the expert who prepares the prospectus, determine the bond price. In Kenya today, different institutions including the Central Bank of Kenya, Kenya Commercial Bank and Reuters have their own estimated yield curves. In both government and corporate issue, treasury bill rate is used as a benchmark in determining the issue price. In the secondary market for treasury bonds and corporate bonds, the stockbrokers and the buyer of bond arrive at the price through negotiation. Thus, in most cases, the price is subjectively determined, with the stockbroker mainly influencing the final price.

Corporate bond issuers are required to publish a prospectus before placing the bonds in the primary market. These details are not supposed to be published in the newspapers. The Central Bank of Kenya (treasury

bonds issuing agent) in addition to publishing a prospectus customarily, advertises for the issue through local dailies. The information contained in a prospectus includes:

- Identity of directors, senior management, employees and advisers who should accept responsibility for the information contained in the prospectus.
- Names and addresses of auditors, issuer's bankers, legal advisors, sponsors, reporting accountants and any other expert to whom a statement or report included in the prospectus has been attributed.
- Statistics and expected timetable.
- Information on the issuer, including audited accounts of the issuer or consolidated accounts of the issuer and its subsidiary undertakings for each of the two financial years preceding the publication of the prospectus as the case may be, any legal or arbitration proceedings that may have or have had in the recent past a significant effect on the group's financial position or an appropriate negative statement, business interruptions, principal investments of the business both current and future, and policy on research and development of new products and processes, among others.
- Major shareholders and related party transactions.
- Financial information.
- Debt securities for which application is being made.

To develop a bonds market, the authorities have to actively consider increasing the supply of high quality paper, creating adequate institutional investor base, ensuring a variety of instruments of differing maturities and mounting supporting infrastructure. Emphasis also needs to be placed on an efficient legal system that provides a levelled playground for both treasury and corporate bonds as important infrastructure for deep and liquid bond markets. Among legal reforms, bankruptcy laws or capacity to seize collaterals are particularly important. Experience in Kenya indicates that the regulatory framework as it is today favours government bond. For example, Central Bank of Kenya, in addition to publishing a prospectus, customarily advertises for the issue through local dailies, while corporate bond issuers are not allowed to publish their issue details in the newspapers. Ordinarily, local

dailies have wider readership, which would give treasury bills unfair advantage with potential investors and the general public over corporate bonds.

### *(d) Listing risk management*

When debt securities including bonds are listed at the NSE, the issuer bears the risk. To safeguard against these risks, there should be underwriters for corporate bond issues, promising to take up any shortfalls if corporate bonds cannot be sold at an agreed minimum price (maximum yield). In such cases, the underwriters take on market risk.

The practices in other economies show that not all bonds are underwritten. For example, it is estimated that over 90 per cent of corporate bonds in Hong Kong are underwritten while all listed corporate bonds in Indonesia and Korea are underwritten. In Malaysia, only 12 per cent of corporate bonds issued are usually underwritten, while in Chile and Peru hardly any corporate bonds are underwritten.

There are also differences in terms of institutions that have the mandate in underwriting services. In some countries, underwriting is limited to securities houses rather than banks. Alternatively, banks may only offer "best efforts" underwriting, where they make no promise to take up unplaced paper. In more developed markets, in order to reduce the issue time, bonds are placed by *competitive bidding*. This involves large underwriters bidding for sizeable blocks of newly issued bonds or the whole issue and subsequently selling all or part of the issue in the secondary market–the *bought deal*. As a result, the successful bidder needs a strong capital base, with the most efficient network for the distribution of securities.

In Kenya, there are no official underwriters, instead there are arrangers such as investment banks who play a similar role to those of underwriters but do not assume the listing risk. Bond issues are *underwritten* by a syndicate of banks and sold through a *selling group*. The syndicate comprises a management group, which is usually contractually obliged to acquire the entire issue from the borrower, and the underwriters, who are committed to buying their agreed share of the issue from the lead managers. The selling group obtains its allotment of bonds from the lead managers.

For treasury bonds, there are no underwriters, neither is there a requirement for their services. Whenever an issue is made and it receives less than one hundred per cent subscription, treasury usually has to make do with whatever they realize and look for alternative sources of funds to fill the financing gap as a cash management measure, thus taking the listing risk.

In situations where the issuer does not satisfy the requirements, or is not willing to be subjected to the disclosure requirements, it may seek credit enhancement to have the securities it seeks to issue guaranteed. The guarantor may be a bank or an insurance company or any other institution with necessary financial capacity acceptable to the authority. Guarantee document is subject to approval of and is submitted to the authority with the information memorandum.

*(e) Credit risk rating*

A key prerequisite for the development of a corporate bond market is the existence of some form of independent credit risk assessment. All tradable Private Debt Securities (PDS) must be rated to ensure confidence and assist in the investment decision making process. A credit rating agency serves as an intermediary between the users and providers of finance and can help in establishing a cost efficient means of financing the country's private sector. For this reason, most countries have reinforced efforts to develop credit ratings. How successful these efforts have been in most countries is very difficult to judge because the practice of the independent credit rating of corporations is still new.

Section 12 of the Capital Markets Act (Cap 485A) gives provisions for the registration of credit rating agencies as part of the measures of building an active corporate securities debt market and impetus to deepening of the domestic capital markets. Credit rating is an objective and independent opinion on the general creditworthiness of an issuer of debt instrument and its ability to meet its obligations in a timely manner over the life of the financial instrument, based on relevant risk factors, including ability of the issuer to generate cash in the future. A rating is an informed opinion of future outcome based on known qualitative and quantitative factors. The essence of rating is to promote confidence in the capital markets by enabling the investors to be aware of underlying risks of the issuer or issued financial instruments. The rating process relies on quantitative and qualitative review of facts and

not hearsay or rumours to downgrade or upgrade a particular issuer or issued financial instrument.

The objective of credit rating is to get an indication as to whether the rated institutions are able to meet their obligations as they fall due. In the US, credit rating agencies include the Moody's and Standard and Poor's rating. Credit rating is important to companies that issue debt instruments and float international debt. It entails making an assessment of the credit worthiness of issuers of debt instruments and giving an indication of the riskiness of the issued instrument. A junk bond is known for its riskiness, and therefore when a bond is labeled junk bond, the market generally understands it as a risky bond. Thus, companies are continuously rated and a track record is maintained to determine whether the performance of companies is improving or deteriorating over time. In Kenya, there is one credit rating agency, the Global Credit Rating (GCR) company, which is the biggest credit rating institution in Africa. It rates companies that are issuing debt instruments in the domestic market and those that have intentions of raising international debt.

To ensure independence and objectivity, the applicant must be a body corporate partly owned by an internationally recognized rating agency. The applicant must make evident its capacity to perform the role of a rating agency by showing a background and experience as well as professional expertise to provide the service of a rating agency. The applicant must either be in the process of appointing or have appointed professionals including economic, financial and research analysts, and other relevant quantitative and qualitative analysts who have the relevant background in the rating business. A minimum paid up capital of up to Ksh 12 million or equivalent is required. The rating agency must also have a system of maintaining confidentiality of information supplied by issuers strictly for rating in order to safeguard and promote confidence in the rating process.

The feeling of local players such as stockbrokers is that the eligibility requirements to qualify for registration as a credit rating institution are too high to be met by local companies. The infrastructure that needs to be put in place is too limiting for or is not affordable by local companies. This includes:

- Putting in place a system for accumulating information,

- Appointing professionals including economic, financial and research analysts and other qualitative and quantitative analysts who have relevant background in rating business,
- Experience in offering the professional expertise in credit rating,
- Having a proven rating methodology,
- Existence of internal checks and balances to safeguard objectivity,
- Ownership of the applicant by an internationally recognized rating agency or having a contractual arrangement with an internationally recognized rating agency that provides technical and strategic support drawn from international experience,
- Disclosure of information to the authority, issuers and general public on the fee structure, downgrades of ratings, and ratings of debt instruments,
- Having in place a system of maintaining on confidential basis the information supplied strictly for the purpose of rating by issuers in order to safeguard and promote confidence in the rating process,
- Documents to accompany the application, such as the business plan that should include resumes of top management, management structure, brief on the rating methodology, rating grades, fee structure, among other documentation required.

The Capital Market Authority Act (Cap 485A) that spells guidelines on the approval and registration of credit rating agencies does not make credit rating of the bond issued by companies in Kenya compulsory. There is minimal credit rating going on. The challenge is the role of policy in fostering the development of credit rating agencies. Is it possible to reconcile the overriding need to promote objective ratings with official policies (that is to promote credit rating agencies or subject their performance to official audits)? Can independent credit rating be reconciled with provisions that allow some regulators to institutional investors to themselves and determine credit ratings that "their" firms can invest in?

Credit rating can be in terms of Domestic Currency Rating (DCR) in the case of local companies or international currency rating in the case of international companies. In Kenya, companies have been rated mainly using the domestic currency rating. Some of these companies include:

First American Bank, which was rated A2 in the short run and AA in the long term, PTA Bank rated AA, Heritage Insurance rated A+, East Africa Building Society BBB long term rating in March 2004, and National Industrial Credit rated A+ in August 2004. Athi River Mining was also rated A for long term and A1 for short term loans and this enabled it to issue a medium term bond in 2005 without requiring any guaranteeing. Generally, 'A' represents good rating while B represents poor rating.

Another challenge the market is faced with is lack of expertise in packaging debt products on behalf of the issuing institutions. There is a requirement for training industry participants to enable them acquire skills to carry out various functions. As soon as is practicable, the rules and regulations governing the management of bonds market and other segments of the fund management market should begin to impose minimum qualifications for people who manage funds or provide advice to investors. Record on qualification of the practitioners shows that up to end of 2001, only two people in Kenya had successfully completed the Chartered Financial Analyst programme and only one of them held the Investment Management Certificate.

Association of Financial Analysts (AFA), formed by industry members in 1998, has set itself the task of administering a professional examination programme tailored to the requirements of the local industry to enable more participants to improve their knowledge and professional skills. The AFA curriculum will have to incorporate ideas and practices from more developed markets to continually upgrade the level of skills it imparts and move as rapidly as possible to the state of the art in developed markets which, of course, is a constantly moving target. Some Kenyan universities have introduced degrees in finance, which provide a solid foundation for entry into careers in the capital markets. In all training efforts, the role of the Directorate of Industrial Training, which reimburses firms for expenses incurred on approved training programmes, should be enhanced.

However, until this pool grows, it would perhaps confer an unfair business advantage on the firms that have hired these people to require that only firms with such employees be licensed to manage funds.

### *(f) Trading system*

Trading in bonds is carried out at the Nairobi Stock Exchange. It takes place when the NSE opens for trading. Bonds are traded on the Fixed Income Securities Board. Auction system is used in the price discovery process with the open out cry trading system. The minimum board lot on the FISMS is Ksh 50,000. The board lots are at par while prices are expressed as a percentage of Ksh 100 par and rounded to four decimal places. The minimum board lot is the outstanding minimum nominal value of the bond.

The market deals with market orders. Bids and offers are displayed on the Fixed Income Securities Board (FISB) in the order in which they are called and matched, first on the basis of best price, and second on first come first served basis. Bids and offers must be equal and for at least 50 per cent of the value on offer for matching to take place. Bonds with periodic partial principal repayments are traded at the subsequent minimum nominal value following the partial principal repayments. Where the bonds traded bear a floating rate of interest, the daily applicable reference interest rate are displayed on the FISB at the start of the trading session. All bonds are traded cum coupon up to the closure of books as communicated by the issuer for determination of entitlements. No bond is traded within the last 3 working days of the principal redemption.

Clearing and settlement process differs across the type of bonds. In the case of treasury bonds, all investors who wish to trade in bonds in the secondary market have to open a Central Depository and Settlement (CDS) account with the Central Bank of Kenya. Corporate bonds are not in the CDS system. South Africa has a Central Securities Depository licensed for the immobilization of securities. The Universal Exchange Corporation Limited (UNEXcor) is the approved electronic clearing house that carries out matching, clearing and settlement of all transactions executed on BMA. All trades are booked into UNEXcor system. Bond Exchange of South Africa has a T+3 rolling settlement, which it adopted in 1997 and has achieved the full compliance with "G30 Recommendations for Clearing and Settlement". It is the first Exchange in Africa to do so.

An investor, either individuals or fund manager, wishing to sell or purchase bonds approaches a stockbroker. The stockbroker and the investor negotiate the bond yield and time to maturity is determined.

These are fed into the stockbroker bond pricing model and the price of the bond is defined. The agreed price is then offered at the trading floor during the trading period. Of interest is the fact that there is no uniform pricing model adopted in the market. Each stockbroker has his own pricing model. There is a general feeling though among the market players that the market should have a single bond pricing model, which can be used to price both corporate and treasury bonds. This would help in harmonizing the pricing process.

Stockbrokers converge at the trading floor to purchase or sell the bonds on behalf of bondholders. Bids and offers are displayed on the FISB in the order in which they are called. Once the bond price is displayed on the board of FISM, the bid deal is sealed within 30 seconds. Some players feel that 30 seconds is too short a period to make a purchase decision and conclude a transaction. When the period for trading is that short, other interested buyers may not have an opportunity to purchase the bond. They are of the view that this period should be lengthened to about an hour to avoid bond price manipulation.

Once the transaction is effected, the buyer personally settles the payment with the seller after which the stockbroker follows up on the documentation to ensure that the transaction is concluded and the ownership of the bond transferred to the buyer. The seller is required to deliver documents to effect the transfer by end of trading session of the T+2. The buyer, on the other hand, must have paid and given evidence of payment to NSE by end of trading session of the T+3. The documents from the seller and the buyer are matched (verifying documents from the seller were received within T+2 and payments were made by the buyer within T+3), after which the transactions are finalized at the Central Bank in case of treasury bonds or the Registrar of the company in case of the corporate bond. The registrar updates the register, and within 3 business days releases the new bond certificates to the local custodian or buying member, who then forwards them to the buyer. The stockbrokers are not party in the exchange of the cash transactions between the buyer and the seller because of the big amounts involved. Thus, the stockbroker's role is essentially that of an agent for facilitating bond transactions by receiving application forms and liasing with the parties to the transaction until the transaction is concluded.

Failure by seller to deliver by T+2 earns him a penalty and this is immediately communicated to CMA. A processing fee of Ksh 3,000 per transaction is levied on the defaulting member for failure to make

delivery. Where payment is not received from the buyer by T+3 for fixed income securities, an interest is charged and computed based on average weekly treasury bill rate as reported by the Central Bank of Kenya. A penalty of Ksh 3,000 processing fee is charged and suspension from the trading floor. If the penalties due to a member remain outstanding after 14 days of receipt of the claim, NSE invokes the bank guarantee, settles the outstanding claim and reports the matter to the disciplinary committee and CMA. The member is denied access to the trading floor and use of trading rights until bank guarantee has been restored. If the member does not restore the guarantee within 7 days after the exchange has invoked it, the member is suspended.

A major constrain in this process is the Central Bank of Kenya, which takes time in verification of documents so that it extends the period from T+3 to even T+7. With such variation in time for verifying documents and for concluding transactions, it is difficult to develop a yield curve. At times, development of a yield curve would be based on the T+3, since this is what is stipulated by the regulations.

Dealers normally perform the speculative role by holding onto securities and selling them when prices are high or when interest rates are expected to decrease. Currently, no primary dealers exist in the formal Kenya bonds market. However, some banks, especially the big banks, buy high volumes of treasury bonds, usually for a short time, which they later offload to the market when the interest rate is favourable or when the interest rate is decreasing. An indication of the existence of an informal dealership market. Stockbrokers sometimes buy bonds from their desperate client sellers, especially when there are no buyers (though not officially) for the bonds in the market, which they dispose as soon as a buyer is available.

### *(g) Participants in the market*

There are no restrictions on who participates in the bonds market. Unlike investment in shares where a ceiling is put on the foreign investors' holdings, the Capital Markets (Foreign Investors) Regulations 2002 gives no restriction on participation by foreign investors in government securities, both in the auction and in the secondary market.

The main investors in bonds, both private corporate and treasury, are fund managers, insurance companies and commercial banks. A few

individuals who are mainly speculators also invest in the bonds. Bonds are in huge demand from fund managers such as Old Mutual Asset Management (OMAM), and Genesis and Stanbic Investment Management Services (SIMS). The demand is largely being met by sovereign (treasury) bonds, which is comparatively less lucrative.

Institutional investors thus take up bonds to meet the legal requirements. Fund managers invest funds on behalf of pension schemes and the main objective of the fund managers is to get rid of excess liquidity. Insurance companies are expected to ensure liquidity of the portfolio they hold so as to meet the obligations in form of insurance claims, and one way of ensuring this liquidity is by holding bonds that can be sold within a relatively short period of time. Commercial banks, on the other hand, are expected to adhere to liquidity requirements by the Central Bank of Kenya, which is partly met by investing in treasury bonds. These institutional investors mainly purchase bonds for holding, not for trading. This impacts negatively on the secondary bonds market.

An issue of concern here relates to the regulatory incentives or disincentives for institutional investors to trade. Long term investors such as pension funds or insurance companies do not have the same need for liquidity as many other participants in financial markets. For this reason, they are well placed to trade by buying illiquid bonds that are relatively cheap, hence earning the liquidity premium and selling highly liquid issues. Such an activity could make bond markets as a whole more liquid. However, such trading does not appear to happen in the Kenyan market. One important reason for this is the absence of a strong mark-to-market accounting. Because historic cost accounting means that losses or gains are registered only on trading, trading is often avoided for accounting reasons, such as reporting a loss. The experience of several countries was that banks became more active traders once they were required to mark at least parts of their portfolio to market. Institutional investors might respond in much the same way.

### *(h) Disclosure rules*

Disclosure rules entail adopting internationally accepted accounting practices, and corporate governance guidelines. Improving market access and transparency by providing high quality information about debt structure, funding needs and debt management strategies to

market participants and the public at large is essential. It is the prerogative of the government in consultation with the capital markets and the Central Bank to provide appropriate guidelines on disclosures. In designing the overall regulatory and disclosure framework applicable to secondary market trading systems (extent of entry or exit or whether to allow internalization or force disclosure of order flow, for instance), policy makers will need to consider the rapid advances in technology as well as the size of the country and the extent of its integration in regional and global capital markets.

In Kenya, the disclosure requirements for bond issuers is covered under regulation 7(1)(c) of the Capital Markets (securities, public offers, listing and disclosures) Regulations 2002, which sets out, in the second schedule of part V, the requirements for Government and corporate securities. This means that bond issuers who satisfy the eligibility requirements prescribed are the ones who issue and get listed.

*(i) Protection of investors*

Disclosure rules are aimed at ensuring that the activities of quoted companies are transparent and that any risk the company is exposed to is signaled through the information disclosed. In addition, some corporate bond issues are guaranteed by commercial banks to instill investor confidence on those bonds.

Sinking fund provisions, where funds for redeeming the bonds are accumulated, is not currently made for in the legal framework for issuers of corporate bonds in Kenya. The market participants are of the view that such a provision be made especially in instances where the issuer is raising funds for a specific project that is meant to generate cash flows, which would then be used to redeem the bond. In this case, an institution in form of a vehicle would have to be established and granted the approval to issue a bond on the strength of the expected revenue stream. This is usually referred to as securitization (asset backed securities).

Given the sensitiveness of the bonds market, defaulting on maturing bonds do not auger well for the market, especially the subsequent issuers, as they will have to demonstrate that besides having a strong balance sheet, they will be in a position to honor their obligations as and when they fall due. To instill confidence in the bonds market development and enhance integrity among issuers, creation of a sinking

fund is a requirement that the regulator should consider setting up in future. The requirement will even be more urgent when introduction of Asset Backed Securities (ABS) is real. Asset Backed Securities will require creation of a sinking fund in form of a "special purpose vehicle" (SPV) as the issuers' profitability record or financial strength is not the main focus here, but the ability of eligible assets to generate cash flow in future. The SPV ensures that the issuer of securitized assets does not default.

In South Africa, Bond Exchange of South Africa (BESA) has in place a guarantee fund in compliance with Section 30 of their Act and as a policy. The BESA guarantee fund and the members "in and out" fidelity policy protect its investors and members. Where a client buys or sells securities and has to complete his part of the transaction in terms of an obligation imposed by the Stock Exchanges Control Act 1985, without receiving the proceeds of the securities sold or delivery of the securities purchased, the client will have unlimited (general) protection from the fund. In instances where a client conducts transactions in listed bonds with a member on a discretionary or voluntary manner (not in terms of an obligation imposed by the Act), the quantum of the cover by the fund will be limited. Protection provided by the fund is based on the principle that buying and selling of securities on the JSE, where a client has performed under a statutory duty (in terms of the Act), the fund will provide general protection while in certain other specified instances, the quantum of protection is restricted. General protection or full reimbursement to a buyer or seller of securities is given in respect of monies paid by such a buyer to the member or due to such a seller by the member and where the securities purchased have not been allocated or delivered to such a buyer by member/seller and monies received from a client or from a principal to be deposited by a member in a trust account and where such monies are irrecoverable. Limited protection is granted in respect of losses sustained by clients of the member or losses sustained by principals, which had dealt with the member and omissions arising out of transactions in securities entered into by such a member, and monies received from or on behalf of a client or a principal to be deposited by a member in a trust account in terms of the rules of the Johannesburg Stock Exchange (JSE) and where such monies are irrecoverable.

Losses not covered by the fund include: dealings in money market instruments, which include negotiable certificates of deposit, bankers'

acceptances, bills of exchange and treasury bills, money market deposits, dealings in futures (covered by the rules of the SA Futures Exchange), dealings in unlisted securities and dealings in bonds (covered by the rules of the Bond Exchange of South Africa).

In Kenya, there are no provisions for sinking fund in the law, which in essence should be given consideration for the reasons already mentioned. There exists a need for the establishment of a public/ privately funded but privately managed, well-capitalized sinking fund, to be run by professionally qualified and experienced managers, and which will broaden the scope of funding in the bonds market in Kenya. It is envisaged that such a fund, which should be managed by technically and internationally qualified managers, would also create "a demonstration effect" regarding the existence of profitable ventures in the bonds market, introducing more efficiency and innovation and catalyzing the entrance of more private players. It is, therefore, proposed that a private-public-donor sectors' funding partnership be undertaken for the fund. Control and management of the project should be carried out on a purely commercial basis.

A committee comprising of the NSE, the CMA, Cooperative Merchant Bank and various capital market stakeholders including stockbrokers, investment advisors and fund managers was formed in 2001 in response to this need to promote a Capital Market Deepening Fund (CMDF) project, which was to serve as a surrogate for the sinking fund. The main activities earmarked for funding by the CMDC fund, and which are currently under-developed include: underwriting, discounting and secondary market trading through market making, *inter alia*. It needs to be noted that the first two institutions in the committee are capital markets' regulatory agencies, while the latter institutions are involved in the development and issuance of financial products and/or are institutional investors. These are therefore the institutions whose services are significantly constrained by lack of an efficient and liquid capital market. The move that led to taking over of the investor compensation fund of the NSE and CMA by the CDSC guarantee funds is a right move towards establishing a sinking fund.

In Korea, for example, a majority of corporate bond issues are guaranteed by commercial banks, hence being regarded as some form of bank loan. Companies issuing corporate bonds but do not meet certain requirements may seek guarantee from commercial banks. Sinking fund provisions and bank guarantees for companies issuing debt securities

instill investor confidence in these securities, since investors can be compensated from funds accumulated in the fund or by the guarantor.

### *(j) Transaction costs*

There are various charges that investors and issuing firms face in bonds market. For new issues of corporate bonds, the approval fee for trading in NSE corporate bonds is 0.1 per cent of the value of the bond, while for treasury bonds is 0.075 per cent of the value. The initial listing fee charged by NSE is currently 0.0125 per cent subject to a minimum of Ksh 100,000 and a maximum of Ksh 1 million, with annual listing fee of 0.0125 per cent. Treasury bonds, on the other hand, attract an initial listing fee of 0.0125 per cent and an annual listing fee of the same percentage subject to a minimum of Ksh 100,000 and a maximum of Ksh 2,500,000. NSE does not currently charge any transaction levy. Sponsoring fee for the sponsoring stockbroker is negotiated with the issuer. The placing commission for stockbrokers is 1.5 per cent of the value of the successful application subject to a minimum of Ksh 500. In the case of participating banks acting as agents of the issuer, the commission is 1 per cent of the value of successful applications. In the secondary market, trades up to or equal to Ksh 5 million for fixed income securities are commissioned at 1/8 per cent the value traded while for those above Ksh 5 million, the rate of commission is negotiable.

### *(k) Yield curve*

The leading stockbrokers, a group of bank traders and institutional fund managers, have been working with Reuters Limited towards developing a generally acceptable and credible 'market yield curve'. One of the principal requirements driving the need to develop a yield curve arises from the requirement of International Accounting Standard (IAS) 39 for investors in fixed income instruments to value their portfolios at fair market value. The yield curve is expected to facilitate fair valuation of listed fixed interest rate instruments. The development of the Kenya treasury yield curve is expected to place Kenya among the few countries in Africa to have a live yield curve. However, the group of market participants identified the limitation of prices reported on the NSE and decided not to use the prices for arriving at the yield curve. The yields applied instead are derived from a cross-section of key market players who have been posting their quotes on Reuters assigned pages, out of

which aggregate yields are derived. The yield curve will primarily be available through Reuters as a media channel dedicated to providing market data in the international financial markets. The data will also be disseminated locally.

### *(l) Primary Dealers (PDs)*

Many countries have established a system of licensed PDs in government securities as important intermediaries to promote activity in government securities market. Typically, PDs are assigned specific responsibilities such as minimum bidding requirements, giving two-way quotes and providing market information to the Central Bank. In some cases, PDs have been given exclusive rights to primary auctions, or some special facilities in money market operations, open market operations and underwriting commission. Primary Dealers can play a vital role in the development of the secondary market. By being in the market, their prices discount all available information, they take up trading positions, and also render valuable assistance to the Central Bank by providing it with latest market information, and designing new instruments, among others. Since PDs are generally highly leveraged, regulatory oversight over PDs appears to be warranted and a common feature among central banks has been to periodically review the performance of PDs and make the continuation of their operations performance-based.

The institution of PDs is yet to be adopted in Kenya for developing both primary and secondary markets in treasury bonds. The main objectives of advocating for the institutional mechanism of PDs should be to strengthen institutional infrastructure in the government bonds market in order to make it vibrant, liquid and broad-based and to ensure development of underwriting and market making capabilities for government bonds outside the CBK so that the latter could gradually shed these functions. In other words, the marketisation of government borrowings and vacation of CBK from primary market in an environment of large borrowing programme are to be facilitated by a conscious development of the institution of PDs. Primary Dealers obligations include giving annual bidding commitment, underwriting the primary issuance, and offering two-way quotes. In return, the PDs would extend liquidity support by the CBK and access to call money market as borrowers and lenders. The Central Bank of Kenya could also

experiment with a system of Satellite Dealers (SDs) to serve as a second tier to PDs in the government bonds market with the particular objective of promoting retail segment.

**Table 3.1: Evolution of Kenyan bonds' market institutional infrastructure**

| Period | Types of bond | Institutions | Regulatory system | Listing rules | Trading & settlement system | Investor protection | Pricing | Tax incentives |
|---|---|---|---|---|---|---|---|---|
| 1986-1990 (pre-CMA era) | Treasury | CBK | Self | Nil | Nil | Nil | Negotiation | Nil |
| 1991-1995 (CMA era) | Treasury | CMA<br>CBK | Statutory<br>Self | Nil | Nil | Nil | Negotiation | Nil |
| 1996-2000 (Introduction of corporate bonds) | Treasury (1 yr FR)<br>corporate | CMA<br>NSE CBK<br>Arrangers<br>Stockbrokers | Statutory<br>Self | Indebtedness not exceeding 400%<br>Certificate of comfort<br>Minimum lot of Ksh 100,000 | Open outcry<br>T+3<br>CDS account<br>Periodic auction system | Nil | Pegging to a % above 91-day or 182-day treasury bills moving average (Both)<br>Negotiation between stockbroker, buyer and seller | CGT removed<br>Withholding tax fixed at 15%<br>Expenses on credit rating made tax deductible |
| 2001-current (new Vista) | Treasury (1-10 yrs)<br>corporate | CMA<br>CBK<br>NSE<br>FISMS<br>Arrangers<br>Stockbrokers | Statutory<br>Self | Minimum capital Ksh 50 million<br>Minimum authorized capital Ksh 100 million<br>Initial listing fees 0.0125% subject to Min. of 100,000 & max.of 1 million (CB)<br>Initial listing fees 0.0125% subject to Min. of 100,000 & max. of 2.5 million (TB)<br>Placing commission of 1.5% of the value of the application for stockbroker and 1% for agents of the issuer subject to min. of Ksh 500 | Trading on bonds moved to FISMS<br>Open outcry<br>Delivery T+2<br>Settlement T+3<br>Penalty of Ksh 3,000 on default (CB)<br>Commission of 1/8% of the value traded up to max. of Ksh 5million. Above 5 million, Commission is negotiable (CB)<br>Competitive/non competitive bidding (CB)<br>Brokers not allowed to but on their own accord (No dealership) | Publication of prospectus showing 5 yrs financial statements (CB)<br>Advertisement through local dailies (TB)<br>Invitation of credit rating (CB) | Pegging to a % above 91-day or 182-day treasury bills moving average (Both)<br>Negotiation between stockbroker, buyer and seller | No transaction levy (CB) |

Source: Own compilation

# 4. Performance of the Bonds Market

## 4.1 Type of Securities Listed

The listing of treasury bonds shows an increasing diversity in maturity of the listed bonds. The maturity increasingly lengthened in the 2000s when the government took deliberate effort to grow the market. At the moment, the treasury bonds maturity range between 1 year and 10 years. Corporate bonds have not diversified significantly like treasury bonds.

Treasury bonds include those with fixed interest rates, floating rates and the special ones. The market also had the municipal bonds that have since stopped trading in the market. Special bonds are issued by the government to pay for services rendered, instead of paying cash or by cheque especially where the government may not have funds to pay the service providers. These may also be issued to finance special projects such as housing and infrastructure. Once issued, these are tradable in the secondary market.

Municipal bonds are risky bonds issued by city and municipal councils. Interest rates on these bonds are usually higher than that of treasury bonds at a given time because of the risk. Generally, interest rates on bonds is influenced by a bond's default risk–the chance that the issuer of the bond will default, or be unable to make interest payments or pay the face value when the bond matures. Risk premium indicates how much additional interest investors must earn to be willing to hold a risky bond. Municipal bonds, although more risky, are tax-free and despite having a lower interest rate than treasury bonds usually promise a higher return, sometimes being preferred to treasury bonds by investors.

In Kenya, municipal bonds were used to raise funds for the city and municipal councils. Due to mismanagement of municipal and city councils, municipal bonds lost popularity and investors no longer believed that these government organs could honour their obligations when they fall due. Before these debt instruments were discontinued, risk was mainly borne by parastatals and a few other companies that the government could coerce to invest in the bonds. Quite a number of these companies were not paid when the municipal bonds matured, which led to lack of investor confidence in these debt instruments.

There are five companies that have issued corporate bonds in the Kenyan bond market: East Africa Development Bank (EADB), Safaricom, Shelter Afrique, Faulu Kenya and Mabati Rolling Mills. Only EADB and Shelter Afrique have made four and two issues, respectively; the rest have made only one issue. As indicated in Table 4.1, the bond issues are all medium term with maturities of between 3 to 7 years. Volumes raised are significant, with most issues running in terms of billions in each issue except for Shelter Afrique and Faulu Kenya, whose issue amounted to Ksh 350 million and Ksh 500 million, respectively. The bond issues by Safaricom and Mabati Rolling Mills promised higher yields of 91 day T-Bill+1% and 91-day T-Bill+1.25%, respectively, compared to moving average +0.75% and 91 day T-Bill+0.75% for earlier issues of EADB and Shelter Afrique, respectively. This might be a clear indication that investors expect a higher return from subsequent issues of corporate bonds because of their high risk. Notably, the three latest bonds are bank guaranteed giving more confidence to investors and, thus, making the bonds more attractive.

The East African Development Bank after realizing that Kenyan borrowers were not keen on its hard currency loans went ahead and raised, on a private placement basis, Ksh 0.8 billion by lending to local companies through a three year bond. At the request by Capital Markets Authority, EADB agreed that the bond be listed at the stock exchange. Capital Market Authority then approved the bond and NSE consented to its being listed, thus becoming the first corporate bond to be issued and listed in the market. This achievement was an important milestone in the Kenyan financial market. After its first bond issue, EADB went ahead and issued a three-year bond in 1999 that raised Ksh 1.2 billion. The third bond was Ksh 2 billion, a 5-year bond that was to mature in 2006. Faced with similar problems such as EADB, Shelter Afrique, the Pan African Shelter Financing Organization owned by 41 African governments came to the market in December 2001 and raised Ksh 350 million through a three year floating rate bond that helped provide funds for financing housing construction in the country. The second important milestone in the corporate bonds market was laid when Safaricom, a newly established company, came to the market in 2001 and raised Ksh 4 billion to help it roll out its mobile telephone network. The issuance of the bond was made possible by a bank guarantee that was provided by Citibank N.A. Another issue was done by Mabati Rolling Mills in 2002. The company raised Ksh 1 billion through a 5-year floating rate bond to help it meet its working capital needs. The bond is 75 per cent

## Table 4.1: Approved and outstanding corporate bonds as at 2004

| Company | Amount raised (Ksh million) | Date of approval | Interest rate | Tenor | Redemption date | Subscription level (%) | Use of funds |
|---|---|---|---|---|---|---|---|
| Shelter Afrique MTN (Housing finance institution) | 150<br>200 | November 2000<br>9 July 2001 | 91 day TBILL + 0.75% | 3 yr | Nov. 2003<br>9 July 2004 | 137.33<br>76.5 | Mobilize and lend in Kenya shillings<br>Develop a sustainable tool for alleviating the exchange risk associated with medium and long-term lending in foreign currency<br>Participate in the development of the Kenyan capital markets through the issuance of securities |
| EADB MTN (Development bank) | 800<br>1,200<br>2,000<br>800 | Nov. 1996<br>Jan. 1999<br>25 April 2001<br>June '04 | MA + 0.75% | 3 yr<br>3 yr<br>4 yr<br>7 yr | Nov. 1999<br>Jan. 2003<br>25 April 2006<br>June 2011 | 100<br>100<br>100<br>100 | Mobilize and lend in Kenya shillings<br>Develop a sustainable tool for alleviating the exchange risk associated with medium and long-term lending in foreign currency<br>Participate in the development of the Kenyan capital markets through the issuance of securities |
| **Safaricom Ltd MTN (Mobile provider) | 4,000 | 11 June 2001 | 91 day TBILL + 1% | 5 yr | 31 March 2006 | 100 | Finance capital expenditure for the expansion of the Safaricom mobile telephone network in Kenya<br>Repay outstanding suppliers' credit<br>Pay insurance cover to be given by the Belgian Export Credit Authority as part of the security arrangements for the issue |
| **Mabati Rolling Mills Ltd (Manufacturing company) | 1,000 | 14 Oct. 2002 | 91 day TBILL + 0.75% | 5 yr | 8 Oct. 2007 | 112 | Reduction in the foreign currency exposure within the overall funding mix, thereby reducing foreign exchange risk and<br>Reduction of the existing level of Commercial Paper indebtedness |
| Faulu Kenya MTN (Micro finance) | 500 | 22 March 2005 | 91 day TBILL + 0.50% | 5 yr | 22 March 2010 | 100 | Deepening of the institution's lending to micro businesses in Kenya |
| Total | 10,650 | | | | | | |

Source: Capital Markets Authority data

Key: EADB–East Africa Development Bank; MTN-Medium Term Notes; Bank Guaranteed

guaranteed by Barclays Bank. The latest corporate bond in the market is the one that was issued by Faulu Kenya in March 2005 and listed in the exchange in April 2005. The issue, which opened for application on 21 March 2005 is 75 per cent guaranteed by the French Development Agency (AfD) and arranged by Stanbic Bank. Suntra Investment Bank is the sponsoring broker and placing agent.

Listing of some corporate bond issues has failed due to inability of the issuers to meet the eligibility criteria of CMA (Barclays Bank failed due to inability to meet the debt ratios. Being a financial institution, customer deposits form a huge liability, which tend to push the debt ratios high. The bank also provided for issue of asset backed securities, which was not recognized by law. For the financial institution to qualify to issue bonds, the regulator will need to review the eligibility criteria to accommodate the non-traditional new issuers. National Housing Corporation (NHC) was locked out because of lack of guarantee. The government could not guarantee itself since NHC is government-owned. Celtel did not meet the debt eligibility ratio. Being in the service industry, the debt ratio exceeded the criteria spelt out by CMA. Thus, Celtel faced the same problem as Barclays Bank. Equity Bank did not present a formal application for consideration for listing. In the early 1990s, Lonrho failed to honor its obligations as they fell due because of cash flow constrains, thus not being allowed to register the issue. Faulu Kenya, however, successfully issued a bond worth Ksh 500 million, an indication that even small issuers have room in the bonds market so long as they meet the eligibility criteria.

## 4.2 Listing of Bonds

Table 4.2 shows an increasing amount of funds raised through the bonds market. The subscription level is also very high, with an average of more than 90 per cent during the eight-year period except for the years 1999 and 2001 when the subscription level was 84.02 per cent and 59.69 percent, respectively. This shows that the public has confidence with government securities.

Comparing the performance of the bonds market with that of the shares, Table 4.3 shows that the largest proportion of funds raised during the eight-year period was through the issue of bonds. Amounts raised using equities are relatively small, constituting on average less than 10 per cent of the primary securities market. In 1997, the amount raised using

**Table 4.2: Listing of treasury bonds, 1997 to 2003**

| Year | Face value (Ksh) | Amount raised (Ksh) | Percentage (%) in amount raised based on 1997 issues (using 1997 as base year) | Percentage (%) change in amount raised on annual basis | Subscription level (%) | Outstanding stock as at December |
|---|---|---|---|---|---|---|
| 1997 | 15,000,000,000 | 15,000,000,000 | | | 100.00 | 44,400,000,000 |
| 1998 | 29,000,000,000 | 28,519,700,000 | 90 | 90 | 98.34 | 52,970,000,000 |
| 1999 | 29,415,836,227 | 24,716,435,793 | 65 | -13 | 84.02 | 29,650,000,000 |
| 2000 | 47,886,240,332 | 28,583,833,501 | 90 | 15.3 | 59.69 | 33,300,000,000 |
| 2001 | 78,866,956,064 | 69,795,743,621 | 378 | 145 | 88.50 | 78,730,000,000 |
| 2002 | 85,284,910,578 | 94,098,627,587 | 527 | 36.2 | 110.33 | 123,400,000,000 |
| 2003 | 95,928,650,000 | 94,535,985,129 | 530 | 0.04 | 98.55 | 178,352,320,000 |
| 2004 | 80,500,000,000 | 66,091,000,000 | 341 | -30 | 90.41 | 180,867,110,000 |

*Source: Central Bank of Kenya, statistical bulletin*

**Table 4.3: Bonds and commercial paper issues**

| Year | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|
| Corporate bonds (Ksh bn) | 0.54 | 0.27 | 1.05 | 1.10 | 6.80 | | 7.35 |
| Treasury bonds (Ksh bn) | 10.60 | 37.80 | 28.40 | 34.10 | 47.12 | 82.84 | 93.63 |
| Commercial paper (Ksh bn) | 0.50 | 0.45 | 10.65 | 0.60 | 0.80 | - | 2.90 |
| Total (Ksh bn) | 11.64 | 38.52 | 40.10 | 35.80 | 54.72 | | 103.88 |
| Bonds as % of total debt securities | 95.70 | 98.70 | 73.30 | 98.30 | 98.50 | | 97.20 |
| Corporate bonds as % of total private debt securities | 51.90 | 37.50 | 9.00 | 64.70 | 89.50 | | 71.70 |

*Source: Capital Markets Authority Annual Reports for 2002, 2003*

bonds stood at 88 per cent. Between 1998 and 2004, this proportion rose to between 96.3 per cent and 100 per cent. This emphasises the important role played by bonds in the Kenya capital market.

## 4.3 Holders of Bonds

Commercial banks, who are the main holders of government bonds in the Kenyan bonds market, hold almost half of all outstanding domestic bonds (Table 4.4). While they enjoy a relatively high income from government bonds, their large holdings of domestic bonds may also reflect some fundamental shortcomings in their commercial banking operations (World Bank and IMF, 2001). These shortcomings include institutional weaknesses that undermine lending to the private sector, given ineffective screening and monitoring capabilities of loans, a small amount of reliable information on creditworthy borrowers, and weak legal systems (such as the absence of commercial courts to settle payments disputes). In addition, the high holding partly satisfies the liquidity requirement by Central Bank of Kenya for commercial banks. Although banks, on average, hold the largest proportion of domestic bonds in Kenya, individuals are the second largest holders accounting for 27.2 per cent of outstanding debt as of June 2004. Non-bank institutional investors in bonds include insurance companies (14.1%), pension funds (4.2%) and building societies (1.3%). The National Social

**Table 4.4: Overall holdings of government bonds per investor category**

| Holders | June 2003 | | June 2004 | |
|---|---|---|---|---|
| Banking Institutions | (Ksh bn) | % | (Ksh bn) | % |
| Commercial banks | 74.5 | 46.1 | 79.0 | 43.8 |
| NBFIs | 2.1 | 1.3 | 2.2 | 1.2 |
| Pension Funds | 6.5 | 4.0 | 7.6 | 4.2 |
| Insurance Companies | 21.5 | 13.3 | 25.5 | 14.1 |
| NSSF | 0.8 | 0.5 | 2.2 | 1.2 |
| Building Societies | 2.1 | 1.3 | 2.4 | 1.3 |
| Individuals | 47.5 | 29.4 | 49.1 | 27.2 |
| TOTAL | 161.5 | 100.0 | 181.5 | 100.0 |

*Source: Central Bank of Kenya*

Security Fund (NSSF) singly held 1.2 per cent of the total treasury bonds by June 2004. The institutional investors are also slowly becoming key holders of domestic debt securities in Kenya. The limited role played by the non-bank sector compared with commercial banks may be due to the absence of large scale institutional investors in the non-bank sector.

Tables 4.5 and 4.6 illustrate the holding structure of corporate bonds in Kenya. Institutional investors play the key role in corporate bonds market, controlling almost 99.8 per cent of corporate bonds. The leading institutions in this respect are fund managers (49.5%), followed by banks and non-bank financial institutions (44.9%), with insurance companies controlling 5.4 per cent of the corporate bonds holdings. Individual investors control only 0.2 per cent of the corporate bonds holdings, an indication of their low participation in the market. However, it is argued that as individual investors, they have only a limited role in promoting liquidity, but instead play a much greater role in the local bonds market through mutual funds, which diversify risks on their behalf, and pension funds, where individuals participate by contributing to these institutions either directly or indirectly through their employer. Many countries, therefore, promote mutual funds and some have set up specialized gilt funds for promoting a small investor base. For instance, in Mexico, regulations that restricted mutual funds investment in short-term

**Table 4.5: Corporate bonds holding structure (investor class) as at the end of June 2004 in %**

| Class of investors | Number | Amount (Ksh million) | Percentage (%) |
|---|---|---|---|
| Individuals | 2 | 16 | 0.2 |
| Banks and non-bank financial institutions | 23 | 3,299 | 44.9 |
| Insurance companies | 15 | 400 | 5.4 |
| Fund managers | 23 | 3,635 | 49.5 |
| Total | | 7,350 | 100.0 |

*Source: Capital Markets Research Department*

**Table 4.6: Corporate bond holding (individual bonds) as at 31 December 2004 in (%)**

| | | Banks | Insurance companies | Fund managers | Investment companies | Individuals |
|---|---|---|---|---|---|---|
| 1 | EA Development Bank | 46.00 | 11.05 | 42.95 | 0.00 | 0.00 |
| 2 | **Mabati Rolling Mills Ltd | 36.42 | 3.00 | 59.95 | 0.63 | 0.00 |
| 3 | **Safaricom Ltd | 45.48 | 2.78 | 50.88 | 0.50 | 0.38 |
| 4 | EA Development Bank | 36.25 | 17.50 | 46.25 | 0.00 | 0.00 |

*Source: Capital Markets Research Department*

instruments have been relaxed recently to allow these funds to play a more active role in the government securities market. In Kenya, the holding structure points towards that direction, even though there is no official policy to that effect. Others have argued for a more direct participation of individual investors in developing bond markets on the grounds that this would reduce the reliance of government on captive investors, promote a fixed income investment culture among households, and increase competition in the deposit market.

Individual investors are usually locked out of action especially in the primary market by the high rates at which the issues are denominated. Besides, the common philosophy in Kenya's corporate bonds market is to hold to maturity. There is no trading in corporate bonds as there are no alternative instruments to invest in.

Bonds in mature markets are mainly bought and sold when there is a change of price. The price of bond is determined by change of long-term interest rates, which is in turn determined by short-term rates (91-day). If the interest rates rise, price of bonds fall, and the reverse is true. This is because one needs less investment to achieve the higher rates of return. However, in Kenya with investors holding to maturity or up to when they need cash, there is little speculative activity and movement in the domestic bonds market.

## 4.4 Value of Bonds

Table 4.7 shows the trend of outstanding values of corporate and treasury bonds in Kenya between 1996 and 2003. In terms of volume, the value of treasury bond issues is much higher than that of corporate bonds. From the data, it is clearly evident that treasury bonds are growing at a faster rate than corporate bonds. Whereas the value of treasury bonds stood at zero in 1996, the value grew to Ksh 161.6 billion in 2003. On average, the value of treasury bonds consistently increased over the eight-year period. Considering the period 1997 to 2003, treasury bonds increased from Ksh 10.6 billion to Ksh 161.6 billion, indicating an increase of 1,425 per cent. On the contrary, corporate bonds increased from Ksh 0.82 billion in 1996 to Ksh 7.35 billion in 2003, representing an increase of 796 per cent. The corporate bonds value as a percentage of total value decreased from 100 per cent in 1996 to 4.35 per cent in 2003, further evidencing the fact that treasury bonds are growing at a faster rate than corporate bonds.

**Table 4.7: Outstanding values (Ksh billion) of corporate and treasury bonds**

| | | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|---|
| Value of bonds (Ksh billion) | Government | 0.00 | 10.6 | 37.8 | 28.4 | 34.1 | 80.3 | 130.5 | 0161.6 |
| | Corporate | 0.82 | 0.54 | 0.27 | 1.05 | 1.1 | 6.8 | 8.5 | 7.35 |
| | Total | 0.82 | 11.14 | 38.07 | 29.45 | 35.2 | 87.1 | 139.0 | 168.95 |

*Source: Annual Reports for 2001, 2002, 2003 and CMA Research Department*

Considering the composition of the debt market, Table 4.8 shows that bonds make a huge proportion of the total. The proportion of bonds to total debt securities increased from 95.7 per cent in 1997 to 98.7 per cent in 1998, declined drastically to 73.3 per cent in 1999, but increased to 98.5 per cent in 2001, before decreasing to 97.2 per cent in 2003. This indicates that the debt securities market in Kenya is, to a large extent, controlled by both treasury and corporate bonds, with treasury bonds taking the bigger part of the bonds market. In the private securities market, corporate bonds constitute the larger part. Except for 1998 and 1999 when the proportion of corporate bonds to total debt market securities was 37.5 per cent and 9 per cent, respectively, this proportion exceeded 50 per cent during each of the other five years, with the highest proportion being 89.5 per cent in 2001. This underscores the role corporate bonds market plays in Kenya's private debt securities market.

Table 4.9 indicates the shift of emphasis from short term borrowing in form of treasury bills to medium and long term borrowing in bonds between 1997 and 2003, with the upsurge in the bonds market being a very recent phenomenon. Central Bank's target is to shift borrowing ratio of bills to bonds from 70:30 to 30:70. The government bond programme has been a useful training ground for investors. It is quite clear that if we can manage to maintain a stable interest rate regime, investors would have no difficulties offering their funds for longer periods or even up to 20 and 30 years.

**Table 4.8: Analysis of government domestic debt**

| As of June (End of the government financial year) | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|
| Treasury bills | 117.50 | 111.70 | 110.70 | 96.80 | 82.90 | 78.70 |
| Treasury bonds | 37.80 | 28.40 | 34.10 | 80.30 | 130.50 | 161.60 |
| Long term stocks | 2.70 | 3.00 | 1.90 | 1.50 | 1.50 | 1.10 |
| Others* | 7.80 | 47.10 | 46.00 | 43.40 | 44.90 | 38.00 |
| Total debt | 165.80 | 190.20 | 192.70 | 222.00 | 259.80 | 279.40 |

* Includes non-interest bearing treasury bonds/bills

*Source: Central Bank of Kenya Monthly Economic Review (various)*

**Table 4.9: Equities and bonds market capitalization 1997-December 2004**

| Year | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|---|---|
| Equities (Ksh billion) | 114.30 | 128.94 | 106.70 | 104.40 | 86.1 | 112.05 | 317.53 | 314.15 |
| Bonds (Ksh billion) | 15.08 | 28.52 | 24.72 | 28.58 | 69.8 | 94.10 | 94.54 | 66.09 |
| Total (Ksh billion) | 129.18 | 156.46 | 131.42 | 132.98 | 155.9 | 206.15 | 411.07 | 370.24 |
| % of bonds to the total | 11.60 | 18.30 | 18.80 | 21.50 | 44.8 | 45.60 | 23.00 | 17.90 |

*Source: Capital Markets Authority Annual Reports for 2002, 2003*

## 4.5 Market Capitalization

The growth in bond market activity is an indication of the increasingly important role played by bonds in activating the capital market. However, compared to the amount of bond issues, the secondary market lags far behind the equity market in terms of capitalization. Secondary trading in the capital market over the eight-year period as shown in Table 4.10 is dominated by equities. In 1997, the proportion of bonds to equities amounted to 11.6 per cent, which gradually increased to 45.6 per cent in 2002 before declining to 23 per cent in 2003 and further to 17.9 per cent in 2004. The high proportions of 44.8 per cent and 45.6 per cent in 2001 and 2002, respectively, may be explained by the anxieties that faced investors over political transition that posed an investment risk, resulting to sale of share holdings.

Therefore, the government needs to come up with policies to enhance trading of bonds in the capital market so as to achieve faster development of the market.

**Table 4.10: Equities and Bonds market capitalization (Ksh billion) 1997- December 2004**

| Year | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|---|---|
| Equities | 114.3 | 128.94 | 106.7 | 104.4 | 86.1 | 112.05 | 317.53 | 314.15 |
| Bonds | 15.08 | 28.52 | 24.72 | 28.58 | 69.8 | 94.10 | 94.54 | 66.09 |
| Total | 129.18 | 156.46 | 131.42 | 132.98 | 155.9 | 206.15 | 411.07 | 370.24 |
| % of bonds to total | 11.6 | 18.3 | 18.8 | 21.5 | 44.8 | 45.6 | 23.0 | 17.9 |

*Source: Capital markets Authority Annual Reports for 2002, 2003*

**Table 4.11: Bonds and equities turnover, 1997 to December 2004**

| Year | Bond Turnover (Ksh million) | Percentage of outstanding | Equities Turnover (Ksh million) |
|---|---|---|---|
| 1997 | 15,080 | 33.96 | 6,145 |
| 1998 | 8,217 | 15.51 | 4,584 |
| 1999 | 6,913 | 23.32 | 5,152 |
| 2000 | 5,880 | 17.66 | 3,631 |
| 2001 | 14,076 | 17.88 | 3,090 |
| 2002 | 33,629 | 27.25 | 2,921 |
| 2003 | 42,276 | 23.70 | 15,250 |
| 2004 | 33,150 | 18.33 | 22,321 |

*Source: NSE; Capital Markets Authority Annual Reports, 2001, 2002, 2003, and CMA Research Division*

## 4.6 Turnover

Following Central Bank's withdrawal in 1997 from market making in treasury bonds, secondary market turnover on the NSE plummeted by 57 per cent from Ksh 15.08 billion in 1997 to Ksh 5.88 billion in 2000 (Table 4.11), although bond listings rose 15 times. Existing market makers at the time, namely Citibank and Standard Chartered Bank for the East African Development Bank (EADB) bond and Akiba Bank for treasury bonds did not make much impact. Equally, CFC Financial Services, the only licensed securities dealer, was yet to develop adequate dealing capacity. The investment in bonds was curtailed by the significant liquidity risk that investors faced.

Introduction of corporate and treasury bonds in Kenya was expected to enhance competition among financial assets and reduce the risk factor to investors as they would diversify their portfolio. Ngugi (2003) observed a decline in the volume of shares traded at the Nairobi Stock Exchange in the period following the introduction of bonds, which was attributed to higher yields and lower risk in bonds market. An increase in long term treasury bond yields could cause investors to re-allocate wealth between equity and debt instruments, stimulating trading activity and therefore affecting liquidity.

## 5. Conclusions and Recommendations

As part of continuing efforts to promote growth in bonds market as well as dynamic and performance-based dealer system, several measures have to be introduced:

*System of Principal Dealers*

A clear system of Principal Dealers (PD) should be introduced in the Kenyan capital market to develop a more dynamic and performance-oriented market makers. Their roles should expand from mere compulsory bidding in the primary issues and provide two-way price quotations to participate in the money market auctions, continuously quoting selected benchmark securities and maintaining a minimum trading volume for selected papers. Primary Dealers should also be entrusted with improving the secondary trading of the market, especially the government securities market, to build the benchmark yield curve.

*Credit rating system*

As part of a continuing effort to develop Private Debt Securities (PDS) market, the government should create a national credit rating agency that would serve as an intermediary between the users and providers of finance. This also would help in establishing a cost efficient means of financing the country's private sector. Rating of all tradable PDS should be made compulsory to ensure confidence and assist in the investment decision making process.

*Establishment of the National Bonds Market Committee*

A National Bonds Market Committee (NBMC) should be established to provide the overall policy direction and rationalize the regulatory framework for the orderly development of the market. This should be chaired by the Permanent Secretary of the Ministry of Finance and consist of representatives from CBK, CMA, Economic Planning Unit, Registrar of Companies and Nairobi Stock Exchange. It should establish working groups such as Legal and Regulatory Reform Committee, Product and Institutional Development Committee and Infrastructure and Operation Work Group.

*Development of a government securities benchmark yield curve*

The prerequisite for the development of any bond market is the existence of a benchmark. A significant, liquid, efficient and market-oriented government securities market would contribute to more efficient sovereign debt management, effective monetary operations and financial stability. For the market participants, a benchmark is necessary to price issues. It would also facilitate the intermediation process through efficient market pricing, borrowing and lending decisions in the primary and secondary markets. There should be a published auction calendar for the issuance of government securities on an annual basis. This would improve the transparency of the issuance and assist the market players.

To facilitate the creation of the benchmark yield curve, parallel measures such as opening of the off-the-run government security issues, implementation of transparent and highly active two-way prices for the benchmark securities and closer monitoring of the market activities and PD performance should be taken.

*Establishing a bond sinking fund*

This would instill confidence in the bonds market, particularly for the corporate issues. Should the issuer be unable to redeem the bond holders, the fund can bail out the issuer. Investors will also be more motivated to take risks if it is borne by the issuing company. The company will be required to establish a sinking fund.

*Investor base*

There should be a ceiling-limiting holding of bonds by institutional investors to pave way for participation by individual investors. This might call for investor education on benefits that can be derived from investing in bonds. It might also involve review of the regulations for insurance companies, pension funds and commercial banks on holding of both corporate and treasury bonds. In the case of fund managers, the law might need to be revised to encourage more fund managers to gain entry in the capital market to allow competition. With many fund managers, the pension funds would have a wider choice other than accumulating the moneys with a few managers. This competition would

also probably challenge the fund managers to identify alternative investments other than extensively relying on bonds and treasury bills. As it is at the moment, most fund managers do not purchase bonds for trading but for holding, usually till maturity.

*Information disclosure*

Information accumulation and dissemination to educate the market on bond basics—bond pricing, bond return, trading and so on—would enable the investors to make informed choices. Currently, information available in relation to bonds is very scanty. Information on bond rating (if this is made a requirement) would be useful in instilling investor confidence on bonds.

*Corporate bonds*

There is need to encourage issuance of more bonds, especially corporate bonds, in the market to increase the products available to investors. The many institutional investors in the bonds market will then have a variety of bond products to invest in. This calls for the government to provide an enabling environment for issuance of corporate bonds to encourage private companies to raise funds from the private debt market.

*Bond pricing*

A bond pricing model for the market as whole should be developed to improve on the efficiency of the pricing process. The same model should be used for pricing both treasury and corporate bonds.

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