STRENGTHENING THE MARKETPLACE FOR TRADING BONDS IN KENYA

Market Model Report

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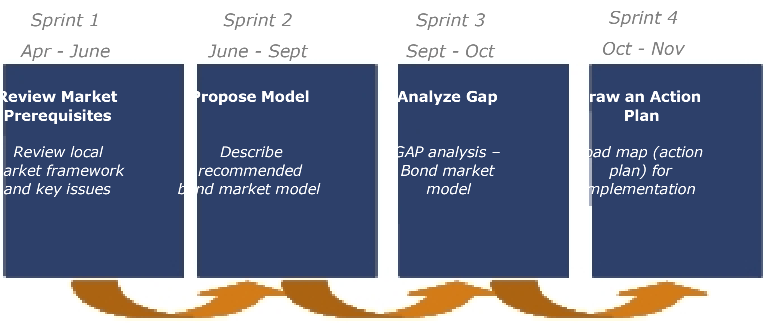
NASDAQOMX Advisory
Martin Andersson
Erik Thedeen
Lotta Tullila Persson
Helena Wedin
Sarah McWirther

1 Introduction

1.1 Project Purpose Report structure

At the request of IFC and ESMID, Africa, the Advisory team of NASDAQ OMX is carrying out a project with the objective of strengthening the marketplace for trading bonds in Kenya, Uganda, Tanzania and Rwanda. The project's main focus will be to provide input on the market structure for trading and settling corporate bonds in the secondary market for these countries.

The project is being carried out in four sprints as shown in the picture below:



Picture 1. The Project is being carried out in four sprints (time plan preliminary)

This is the second report following Sprint 2 which describes and recommend a new market model for trading, clearing and settling of bonds.

All findings are based on off-site and on-site research combined with our own market development experience. The bulk of the material discussed in this report was gathered during meetings held in Kenya, Tanzania and Uganda in April-2008 and in workshops in July-2008. Interviews were carried out with a broad group of market participants and operators, such as Central Banks and The Exchanges, market regulators and authorities, and participants trading in the market.

During this second sprint Rwanda was visited and the bond model described. Given the small size of its capital market and that it has started this year only, it is natural to start with the other countries, letting them set the arena for further work. Rwanda can learn from the others experiences and perhaps jump directly to the best solutions, so it is natural to see them as followers in these capital market development issues.

The next step in the project is to identify the gaps and actions needed to reach the model recommended. This will be done during September and October.

This report is built up in three sections. In the first we summarize the findings from our Initial Findings report and the recommendations for new market model for trading, clearing and settlement. In the second section we give a description of the market model for bond trading. In the third section we give a description of the market model for clearing and settlement.

1.2 Adjacent projects and coordination

Although we acknowledge that a well functioning and supporting regulatory framework is essential for the development of the market we have not given any recommendations in this area since another project carried out by ISC is focusing and on this.

In the same way we see that the lack of issuers in the corporate bond segment is one of the main reasons behind the slow development of the market. However the primary bond market is also in focus for another project assigned to ISC.

In order to handle the slightly overlapping scope between the projects within ESMID coordination has been made with ISC for the abovementioned assignments and with Cadogen on the post trade side which also is discussed within the Regionalization projects. Given differences in scope our emphasis diverts in certain areas. The goal with the coordination is to find pragmatic solutions feasible to achieve for the markets stakeholder

The EA bond markets are at different stages of development with different domestic prerequisites within the region. However, the framework of the proposed model is the same for all four countries and will over time allow the EA bond markets to come together and contribute to future regionalization.

2 Summary of findings

Our research findings are described in our Initial Findings report from May 2008. In this section we summarize the most important findings.

2.1 Corporate bond markets are small in all three countries

As we concluded in the earlier Initial Findings report the markets in all three countries are small and thin. There are few listings in the primary market and the turnover in the secondary market is insignificant. [Aggregated picture?] There are several reasons behind this and many of the more significant ones are not related to the model for trading, clearing and settling of bonds but instead related to lack of some fundamental business drivers which is the foundation of any market.
Although the focuses for our recommendations are the model, some issues important to mention preventing development of the bond markets are:

2.1.1 Highly liquid banks creating a disincentive to issue bonds

Banks in East Africa, bearing a dominant position in the financial market, have little or no incentive to encourage corporations to issue bonds. Neither do they see any need to develop a more widely distributed investor segments. Current business with deposits from the retail segment, building overliquidity that can be lent directly to the corporate segment is profitable. Increased competition in this segment will most likely over time force the players to increase the service level towards both issuers and investors.

2.1.2 Corporations not prepared to meet information disclosure requirements

The number of corporations with the financial and organizational procedures in place to disclose appropriate and required information to the market on a regular basis is limited. The situation is better in Kenya but coming from a barter economy, the steps to fulfill the requirements set up by professional investors and executed through legislation and rules by market organizers are many. The ease with which funding can be raised through bank borrowing does not create the incentives to go to the market.

2.1.3 Investor concentration, lacking institutional investors (pension funds/mutual funds)

The institutional investor segment needs to be developed in especially Tanzania and Uganda where there also is a potential to further develop the pension system. Without a diversified investor segment, with diverting risk and placement preferences, all participants in the market will apply a "follow the herd" behavior. The prevailing investor behavior among professional investors is to buy and hold the security which is creating a vicious circle for the secondary market of any security.

2.1.4 Understanding of fixed income markets

The knowledge of fixed income instrument and markets are limited and fragmented among market participants, which is hampering the development. The banks, trading government securities have an advantage over the brokerage firms. However some brokers in Kenya have chosen to take a special interest in fixed income markets and by that achieved a position in the segment. Similar initiatives would be beneficial for the development of the bonds markets in Uganda and Tanzania as well.

2.2 Market model issues preventing growth

2.2.1 The Exchange has difficulties in finding a natural role in the bond segment given that most of trading is initiated by the banks

Today, fixed income markets are dominated by the banks. The trading carried out is between banks although through regulation in Kenya and Tanzania the trades are formally executed through a brokerage firm on the exchange. Fees are paid sometimes to brokerage firms without any other services being provided than trade reporting, which is questioned by the banks. The brokerage firms, representing the exchange, in many cases lack the knowledge and capital (and thereby the trust) to become a sophisticated counterparty in the bond market. Normally bond markets are traded OTC. In East Africa all trading is in practical terms carried out outside the exchange but reported to the exchange. The role of the exchange is limited to capturing and reporting of trades to clearing and settlement organizations and to the market to provide post trade transparency. Given the limited trading there is no financial incentive for the exchange to develop this business. An investment in a trading module that would support bond trading is avoided and market data distributed from the exchange has from time to time been reported to be erroneous (here specifically the Nairobi Stock Exchange was mentioned from market participants).

2.2.2 Splitting fixed income competence and operation (trading and C&S) between government and corporate bond markets preventing scale

There is a separation between the operation of the government bonds and corporate bonds which is natural given the differences of purpose between these instruments (non commercial organization vs. commercial). However, this separation fragmentize resources used for operation and development of the market. Capital needed for investments in technology to improve the services in trading and clearing and settlement as well as competence needed to develop and educate the market needs to come together to create scale.

2.2.3 The post trade infrastructure is currently fragmented and thereby less efficient.

In all four East African countries there is an infrastructure for equities and another for government bonds and bills. The corporate bonds are, or are planned to be, a part of the equities infrastructure. In practice, this fragmentations leads to a need for double, or triple investments. Given the high fixed costs in establishing a post trade infrastructure, the present set up does not realize the economies of scale attached to all infrastructure investments. The result will therefore most likely be that there will be too little investment in the post trade infrastructure and too small amount of trading due to market players concerns about the costs and risks in the infrastructure.

2.2.4 There is currently too much settlement risk in the post trade infrastructures in East Africa.

There is no delivery versus payment (DVP) mechanism making payments and delivery of securities conditional upon each other. This expose all participants to a credit risk equal to the full amount of trading with each counterpart respectively. Anecdotal evidence from contacts with market participants in e.g. Kenya express concerns that the CSDC are too low capitalized to bear the associated risks in the equities and corporate bond trading, although these risks should be borne by the counterparties themselves.

3 Summary of recommendations

In order to increase the market attractiveness and trading activity we would like to propose the following model for the fixed Income market of Kenya, Uganda, Tanzania and Rwanda

- **Allow OTC type of trading, following international best praxis.**
  Seen from an international perspective, most debt instruments are traded by investment banks "making markets" for specific bond issues and types. Bonds do not usually trade on formal exchanges and are therefore considered "OTC" securities. The phrase "over-the-counter" can be used to refer to instruments that trade via different counterparties directly or through a dealer network as opposed to on a centralized exchange. The model suggested is more in detailed described in section 4.1.

- **Also in an OTC market the role of the exchange is important as a listing venue providing company disclosure and listing surveillance.**
  Listing of the security is important in order to secure a regular disclosure of information to the investors in order for them to evaluate the company and price the security at every given point of time. It is also a common regulatory prerequisite for institutional investors internationally to be able to invest in the security. The advantages with listing are described in section 4.3.

- **Improve transparency to increase trading activity.**

  Both pre trade and post trade transparency should be improved for government and corporate bonds in order to increase trust in the market and to enable a fair and transparent price discovery process.

- **Allow banks with trading authorization to trade all bonds including both government and corporate bonds without brokerage intervention.**

  Banks in East Africa have the financial strength and the competence to trade bonds. Currently they are officially not allowed to trade without intervention of a brokerage firm. By including the banks in the trading directly the number of players in the market will increase.

- **Encourage the creation of a Bond Association, upholding and encouraging issues of fixed income interest.**

  A bond association encompassing market stakeholder with fixed income market interest can be a vital mean to share and increase the knowledge among participants. The association can fulfill a role as speaking partner, decision influencer and developer and upholder of market best praxis.

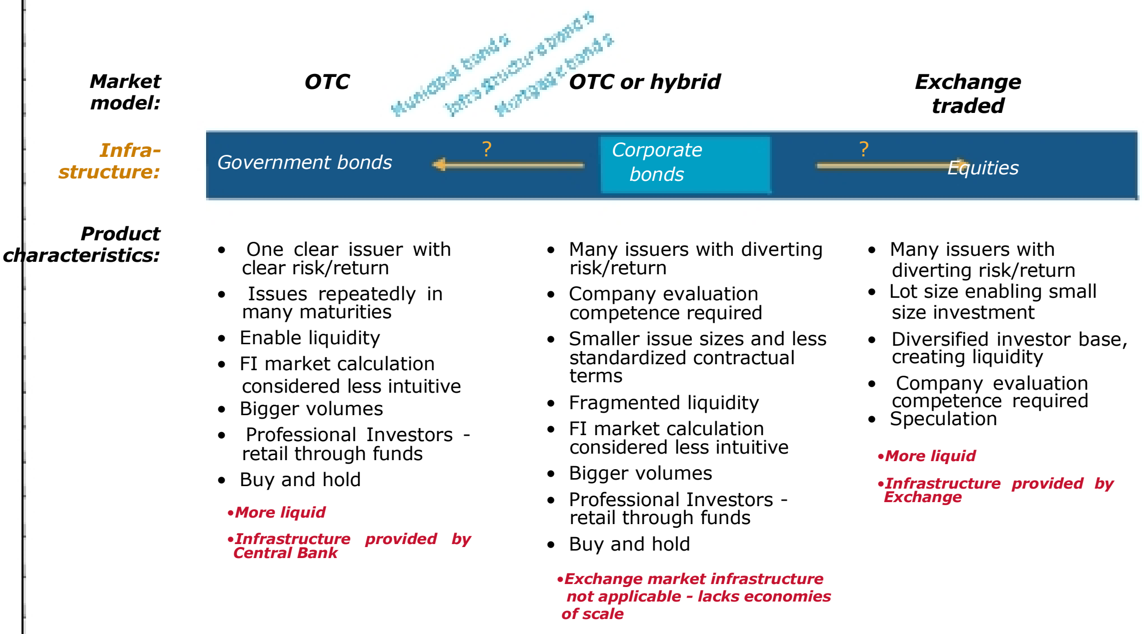
- **Although there is a clear regional ambition in East Africa the initial focus should be on developing the domestic CSD infrastructures.** Experiences from other countries shows how difficult it is to find regional solutions in the post trading area. But where such exists, they are all based on connecting national CSDs. Section 5.2 elaborates on this and presents some suggestions for a step wise regionalization.

- **In both the fixed income and the equities area clearing and settlement needs to be developed in order to achieve DVP.** As being discussed in section 5.3 it is vital to establish DVP in order to have a credible market. This is also important in order to broaden the market for a wider community to trade than just the biggest banks that already knows and trust each other. Remaining settlement risks should be borne by the counterparties themselves and under no circumstances by the CSD.

- **The corporate bond market is currently too thin to justify a tailor made infrastructure - integrate fixed income operational infrastructure and systems in order to increase cost efficiency**. The bond market would benefit from integration of operational infrastructure of government and corporate bond markets on especially the post trade side in which we consider investments to support DVP introduction necessary. There are different ways to achieve this that will be discussed in more detail in section 5.1. One way is to first merge all fixed income processes into the same CSD. Another way is to merge all equities and bonds into the same CSD. This should be the long term objective, but there are different paths to come there. Also in the area of transparency, where capacity is needed to develop the market the possibility to centralize development of procedures should be evaluated.

BOX1: Corporate bond markets falls in between OTC and exchange traded markets

The table below illustrates the characteristics of government bond trading on the one end of the spectrum and equity trading on the other side, somewhere in between fall corporate bonds.



Picture 2. Characteristics of different instruments.

Especially government bonds have clear characteristics and the instruments are very familiar to the investor. These bonds have one clear and known issuer - the government, and are mainly traded by institutional investors. Another characteristic of secondary government bond markets are few but large volume trades which make it more natural to negotiate the price and trade without disclosing the order to a wider market.

At the other end of the spectrum, equity trades are usually higher in number, but with lower volumes and they are also traded electronically on the exchange. It should be noted that most exchange traded initiatives for bonds have not been successful, even when mandatory, with the exception of some highly liquid bonds (e.g. the Bund contract).

So where do corporate bonds fit into all of this? On the one hand, they are issued by corporations to raise capital and therefore evaluated on similar grounds as stocks. Corporate bonds can be attractive to investors because they provide much higher yields than for example government bonds. The higher yield is however also followed by higher risk. On the other hand they are however still debt instruments and the price of a bond is derived based on a bond pricing model. The majority of corporate bonds that are issued by private and public corporations are traded OTC rather than on exchanges. Trades are negotiated between buyer and seller, perhaps with the help of a broker, and are mainly bought and sold between large institutions. Similar to government bonds, corporate bonds most often are bought as a buy-and-hold investment strategy. For a general summary of different market models, see Appendix 1.