Government debt issuance and central banks – Kenya's experience

Government debt issuance in Kenya

The issuance of government debt is managed by the Central Bank of Kenya (CBK) acting as an agent for the National Treasury. The Treasury retains ultimate responsibility for the final decisions regarding the overall size of borrowing, with the CBK taking decisions on issues relating to size and the details of the individual auctions.

Linking debt strategy to borrowing process

The Treasury publishes a Medium Term Debt Strategy (MTDS) that addresses the projected three-year requirements and guides the financing of the budget deficit. The MTDS is a public management tool that is linked to the medium-term fiscal framework based on revenue projections and planned expenditures consistent with economic growth estimates. The strategy takes into account the cost and risk trade-offs in setting sustainable borrowing limits, ensuring full debt service irrespective of a wide range of shocks.

The MTDS is a critical tool for informing policy decisions, avoiding any onerous debt burden or fiscal vulnerability and improving investor relations, including those with development partners. In addition, the strategy incorporates initiatives to develop a vibrant domestic debt market.

Once the fiscal framework has been adopted, the CBK designs a borrowing programme based on the MTDS that specifies the required amount and at the same time redeems the maturing securities at the optimal cost. In the preparation of the borrowing programmes the following considerations are taken into account: the direction of interest rates, market conditions and domestic debt maturity profile. The current issuance calendar is to offer all Treasury paper; 91-, 182- and 364-day bills weekly and Treasury bonds once a month.

The securities are issued using a multi-price auction based on the interest rates offered by the bidders. This boosts price discovery, which is critical for secondary market trading. In bidding for Treasury bonds with maturities of 10 years and below, the market is allowed to set the coupon for bonds, hence revealing key pricing information that is taken into account in the formulation and implementation of monetary policy, thus creating an implicit yield curve.

1. Lengthening the maturity of government debt issued in local markets

Government debt issuance in local markets has largely been driven by the fiscal objective to finance government deficits at the lowest cost possible, with a prudent degree of risk. One of the most important factors influencing the borrowing strategy is *refinancing risk*. Therefore, lengthening the maturity profile of debt is an outcome of deliberate borrowing initiatives meant to limit the impact of refinancing risk.

In the last decade, the CBK embarked on a reform path aimed at developing the country's debt markets. Following the re-launch of the Treasury Bonds Programme and in partnership with the National Treasury and market participants, the CBK initiated the creation of a Market Leaders Forum. At the time, the aim of the Treasury bonds programme was to restructure the domestic debt portfolio, which had a composition ratio of 24:76 Treasury bonds to bills.

The Market Leaders Forum hence set out as its objectives: first, to market government securities through direct linkage with potential investors; second, to advise the CBK and Treasury on various developments in the debt and money markets that have direct bearing on the performance of the new issues; and third, to propose the floating of suitable debt instruments to diversify the product range and as result ensure stability in the financial markets. This has been the bedrock for future reform measures.

As a result of the CBK's reform programme and the efforts of the Market Leaders Forum, the Kenyan bond market has been rated as one of the fastest growing bond markets in sub-Saharan Africa. Some of the initiatives undertaken to lengthen the maturity profile of government-issued local debt include the following.

a. Implementation of benchmark bonds programme

In the initial periods of the bond programme, the issuance of fixed coupon bonds (including zero coupon) of different maturities was being done without much attention to the deliberate objective of lengthening maturities. However, with the recent drive towards developing secondary markets for government securities, specific maturities of two, five, 10, 15 and 20 years were earmarked benchmark bonds. This was a critical step towards addressing the problem of bond market fragmentation and creating the liquidity necessary for developing a firm and reliable yield curve. It was also important to reduce refinancing risks by increasing the average maturity profile of domestic debt.

b. Elongation of the yield curve

Cognisant of the need to provide an appropriate pricing benchmark for the private sector, particularly those inclining to offer long-term financing, the CBK in 2010 and 2011 extended the yield curve to 25 years and then to 30 years, respectively. This initiative has not only provided confidence to the private sector, but has also contributed to lengthening the maturity of the government's domestic debt.

c. Reopening medium- to long-term bonds

In September 2007, the Market Leaders Forum noted that Kenya's bond market was highly fragmented, with many small bonds scattered along the yield curve. Fragmentation made the bond market illiquid, causing volatility and hence hampering the process of market deepening.

The CBK successfully started reopening Treasury bonds in April 2009. The first candidate bond for reopening was a five-year bond. After reopening, liquidity rose from KES 4.4 billion to KES 10 billion. Since the commencement of this programme, the reopened issues have recorded increased trading activity on the Nairobi Stock Exchange (NSE), which has contributed to the main objective of secondary market development. Because the reopening focused on medium- to long-term bonds, as a subsequent benefit the bulk of government debt is now well spread between 2013 and 2041.

d. Infrastructure bonds

A highly successful new instrument with long maturity was introduced in December 2009. This instrument, which was exempt from withholding tax, was to finance identified priority projects in the infrastructure sector of the government.

e. Investor base diversification

The processes of lengthening the maturity of government debt would not be successful were it not for the liberalisation of both the pensions and insurance sectors. Kenya began to reform the retirement benefits industry by establishing the Retirement Benefits Authority in 1997, to guide the developments within the industry. This was a significant development since previously there were private and public pensions and provident schemes operating in the country without clear regulatory guidelines.

In addition to securing the funds from contributors, it was evident that the industry was a significant growth area that had long been neglected, and that there was need for a change in the governance structure. At the time, the National Social Security Fund (NSSF) was the main public retirement benefits scheme in the country and handled all the statutory contributions. In addition, the coverage by the existing schemes was so low that there was a need to begin to extend the coverage to ensure that a greater population was covered.

This was a significant step in market development as the effort by government to structure and reform the pensions sector resulted in greater participation of pension schemes, both NSSF and private, in debt markets. The new legal regulatory framework provided investment guidelines that established limits on a variety of investments. Of significance was a requirement that pension funds invest up to 70% of their assets in government securities. This requirement helped open the debt markets to a new category of investor, keen on medium- to long-term investment. This same strategy was adopted during the reform of the insurance industry.

In January 2009, in an effort to increase participation from the retail sector, the CBK reduced the minimum amounts required to invest in Treasury bills and bonds from KES 1 million for both to KES 100,000 and KES 50,000, respectively. The purpose of this initiative was to encourage retail investors to increase their levels of savings by providing wider investment options, as well as the larger objective of promoting financial inclusion.

Initially, public corporations were required to hold significant quantities of government paper; with liberalisation, the market brought in many other players, in particular commercial banks, pension funds and insurance companies. The current diversified investor base includes commercial banks, pension funds, insurance companies, parastatals and retail investors.

f. Debt strategy

In June 2009, the financial authorities produced the first formal MTDS ("2009 MTDS"), covering FY 2009/10–FY 2011/12. The key driver of the strategy was a desire to reduce refinancing risk, particularly in the domestic debt portfolio, and to develop the domestic debt market further; the authorities highlighted a desire to reduce the degree of exchange rate exposure in the portfolio. Consequently, the

MTDS envisaged significant reliance on domestic debt to meet the financing requirement.

The debt strategy has provided the key guideposts for supporting the goal of lengthening the maturity of government securities. The strategy has helped align domestic borrowing towards issuance of more medium- to long-term Treasury bonds than Treasury bills. The result of this has been the lengthening of debt maturities from about 4.7 years in 2009 to 6.6 years in 2012.

2. Impact of debt issuance on the structure of market interest rates and the liquidity of the banking system

With an increasingly integrated global financial landscape, and the resulting increase in competitive conditions to achieve the cheapest funding, debt issuance has moved to the use of broadly similar issuance procedures and policies that facilitate or encourage liquid markets and a predictable interest rate structure.

Apart from debt management objectives, the maturity structure of debt affects the transmission mechanism of monetary policy. In this regard, the CBK has continued to pursue various initiatives to boost market liquidity and consequently affect the structure of market interest rates positively. These initiatives are as follows.

a. Improved market infrastructure

In November 2009, the CBK facilitated the setting-up of a functioning Automated Bonds Trading and Settlement System (ATS). ATS linkage between the Securities Exchange and the CBK enables simultaneous exchange of securities and cash settlement using the KEPSS (RTGS) infrastructure on a delivery versus payment (DvP) basis, ensuring efficiency of trading in terms of safety of transactions and price discovery. Since then, daily bond turnovers have significantly increased. Turnover has increased to monthly highs of more than KES 30 billion since the introduction of ATS, up from less than KES 10 billion per month on average before November 2009. Turnover on the NSE has risen from KES 108 billion in 2009 to KES 530 billion in 2012. This has resulted in a more firmed-up yield curve, oversubscriptions in primary auctions and a decline in bond yields due to improved market confidence. This development has enhanced bond market confidence, increased transparency and stirred vibrancy at the bourse, which is a major milestone for the general growth of the bond market.

b. Horizontal repos

The horizontal repo facility was rolled out in September 2008 as a platform to aid in liquidity distribution, and has helped to improve on the range of credit line arrangements among commercial banks. Despite some bottlenecks, this platform has provided an additional avenue for liquidity distribution in the market and banking system.

The introduction of the horizontal repo, along with other initiatives related to lengthening the maturity profile of debt and monetary policy reforms, has boosted market liquidity and created a structure of market interest rates that is more responsive to monetary policy.

How is this coordinated with the central bank?

Coordination between debt managers and monetary authorities is essential, not just for the smooth operation of various monetary transmission mechanisms but also for monetary and financial system stability.

The CBK acts as fiscal agent for the government and the National Treasury. It works hand in hand to meet fiscal objectives set by the Treasury, despite playing the key monetary policy role. These authorities work together in preparing the medium-term debt strategy and managing auctions.

In terms of issuance planning, the Treasury sets the borrowing target and the CBK provides a borrowing programme to meet the target. This calendar is then taken into account when implementing the monetary operation targets.

The Auction Management Committee (AMC), which is responsible for determining individual auction results, draws its membership from the Treasury and the CBK departments responsible for economic research, banking, monetary policy formulation and implementation.

Circumstances when the central bank should issue its own debt, and at what maturity

Central banks around the world are faced with the challenge of implementing monetary policy goals in the presence of excess liquidity in domestic banking systems. Within the range of instruments available, the issuance of central bank securities is one policy option that has been used effectively by a number of central banks.

In several countries, central banks have resorted to issuing their own securities in circumstances where the markets for government securities are undeveloped and where governments are reluctant to issue securities in sufficient amounts to deepen the bond market. Some central banks have resorted to own securities because of the unavailability of appropriate government securities that can be used to manage liquidity in the market.

In Kenya's case, the CBK does not issue central bank bills. One of the major drawbacks noted when this issue was considered was the likelihood that central bank bills would be viewed by the market as competing with the Treasury bills and thus confuse the market. That is why there should be emphasis on instruments for liquidity management by central banks and instruments to contract government debt, that is securities to deepen the bond market with risk-free assets and encourage the private sector to join and build a vibrant bond market for long-term finance.

Rather than issue its own bills, the CBK, in agreement with the National Treasury, converted debt owed to it by the Treasury into one-year Treasury bills that are used exclusively for open market operations. These securities are known as Central Bank Repo securities and they form part of the domestic holdings of debt.