

Njuguna Ndung'u: The Kenyan fixed income market (primary pricing) and the role of secondary market and automation for market integrity

Remarks by Professor Njuguna Ndung'u, Governor of the Central Bank of Kenya, at the Association Cambiste Internationale (ACI) Markets Information Sharing Forum, Nairobi, 17 September 2014.

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Distinguished Delegates,

I am delighted by the invitation to speak to members of the ACI during today's market information sharing forum. I do acknowledge that the Forum brings together key market players and interested parties, both from the African continent and beyond to share experiences and discuss important issues relevant to financial market development.

Ladies and Gentlemen: I will speak about the Kenyan fixed income market (primary pricing) and the role of secondary market and automation for market integrity.

Bond markets have always played a key role in financial markets globally; in fact bond markets are seen as the backbone of financial markets all over the world. Bond markets provide governments and corporate entities with funds for investments and grow the economies, provide investment vehicles for asset managers and provide a basis for evaluating other market products. For us here in Kenya and Africa in general, it is the market for long term finance.

The impact of the recent global financial crisis and the subsequent downturn in developed countries' economies and yields shifted investors to review other options such as developing and emerging markets. We need to position our markets strategically in order to take advantage of these options. By paying close attention to developments in both local and overseas financial markets we can innovate ways that will place our markets at the forefront of the emerging markets.

Over the past decade, Kenya has witnessed tremendous growth and diversification of the financial system especially in the fixed income securities market. This began in 2001 when the Central Bank re-launched the Treasury Bonds programme. At that time the proportion of Treasury Bonds to Bills was heavily skewed in favour of Treasury Bills at the ratio of 1 to 3 (24% bonds to 76% bills). The aim of the programme re-launch was to restructure the domestic debt portfolio to lengthen the maturity profiles.

In 2001, a consultative forum was set up comprising of Key players from the financial sector. The forum, known as Market Leaders Forum was meant to achieve the following objectives; firstly, Marketing of Government Securities through direct linkage with potential investors. Secondly, consult with the Central Bank and Government (Treasury) on various developments in the debt and money markets that have direct bearing on the performance of the new issues. Lastly, propose suitable debt instruments to diversify the range of securities available to investors and to deepen the financial markets as a way of entrenching financial stability.

Over the last decade, the Market Leaders Forum has successfully achieved these objectives and continues to set bolder targets for the development of our bonds market. In partnership with various players in the financial system including the Nairobi Securities Exchange, Capital Markets Authority, the National Treasury, KBA, pension funds and stock brokers, we have managed to achieve the following:

- ***Establishment of Benchmark Bonds Portfolio:*** Through this partnership we have managed to defragment outstanding securities issues by creating liquidity around the selected benchmark tenors leading to development of a firm and reliable yield

curve. Benchmark bonds are currently available in maturities of 2, 5, 10, 15, 20, 25 and 30 years.

- The Pension sector reforms implemented over the last 10 years have supported the absorption of these bonds.
- The Kenyan capital market has gained from the benchmark bonds program in the following ways:
 - Promoted price discovery for issuers of government securities as well as corporate instruments and investors.
 - Reduced bond market fragmentation problem (in terms of bond types, tenors, small volumes)
 - Stimulated robust secondary trading of bonds through increased liquidity around benchmark tenors.
 - Provided reliable investment choices to investors.
 - Lengthened the yield curve as benchmark for pricing other financial products.
 - Facilitated development of other financial market facilities including infrastructure bonds which have been tapped to finance mortgage facilities and long term development projects.

b. **Refinancing Risk in Domestic Debt Managed** – the average maturity profile of government domestic debt rose from 8 months in 2001 to 7 years in August 2014. The ratio of T-bills to T-bonds evolved from a ratio of 4:1 in 2001 to 1:3 in August 2014. With a functioning secondary bond market in place, the Government doesn't face any significant rollover risks in its domestic debt.

c. **Financing Kenya's Development Budget;** Building on the success of the debut Infrastructure Bond issued in February 2009, the Bank raised Ksh.32.9bn in the FY 2009/10 and Ksh.30.6bn in the FY 2010/11 through sale of Infrastructure Bonds to fund key infrastructure projects in the Roads, Energy and Water Sectors.

d. **Market Diversification:** As a result of the success of the IFB programme of the central government, big corporate issuers such as KenGen, Safaricom, some commercial banks and mortgage firms have taken advantage of the growing bond market to raise long-term resources to finance their capital projects. In FY 2011/12, the infrastructure bonds programme constituted 30% of total annual funding from domestic borrowing.

e. **Horizontal Repurchase Transactions (Horizontal Repos)** – In September 2008, the interbank repo backed by government securities as collateral was rolled out to facilitate liquidity re-distribution among commercial banks. However, uptake has not been vibrant, but the CBK is working on modalities that will resolve market constraints so far raised by participants.

f. **Revamping of Bonds Trading in the Secondary Market:** Secondary trading is a key channel for re-pricing of securities to provide updated or current benchmarking prices for use in valuation of other securities. This is where the market yield curve is refined. It also provides securities access to many investors who do not make purchases at the primary market.

g. **Lengthening the Yield Curve:** To minimize rollover risks and at the same time provide a benchmark for pricing long term capital, the CBK issued a 30-year bond, the longest security tenor in the region. The bond issued in February 2011 has actively been at the Nairobi Securities Exchange. We called it "Savings and Development bond" to encourage small savers to invest in it and use it as collateral. The Bond was re-opened in August to boost its size, encourage secondary trading and refine the yield curve.

With the adoption of the Automated Trading System (ATS) in November 2009 and increased liquidity of benchmark bonds, turnover at the NSE improved from Ksh.108bn in 2009 to Ksh.401bn for the period July 2013 to June 2014. In addition, reduced settlement time using the Kenya Payments and Settlement System (KEPSS) infrastructure delivery versus payment transaction mode (DvP), has ensured efficiency of trading transactions, price discovery and security. This has resulted in improved market confidence in securities trading and increased demand for securities in primary auctions.

Those are some of the milestones we have realized through the Market Leaders Forum and in partnership with other players.

But this is not to say there are no challenges

As I mentioned during the MLF annual dinner in July this year, the MLF has midwived the emergence of the Kenya Government securities market as the most sophisticated in Sub-Saharan Africa, second only to the South African market. We are however, now faced with two challenges of dealing with bullet maturities and need to smoothen the redemption profile. Over the Counter Trading (OTC) is not in place though the Capital Markets Authority (CMA) is working on modalities to enable bonds to trade outside of the exchange. Foreign investors hold about Ksh.80bn of total local currency outstanding Government securities.

We have been more successful in issuing large volumes in infrastructure bonds than in the conventional benchmark bonds. Ideally, we would have wished to issue at least one bond of each benchmark tenor once in a year to keep on refreshing pricing of money for every tenor along the curve.

But to cope with market developments and institutional reforms, we need MLF reforms

It is therefore imperative to set up a body that will provide more informed and objective decisions on securities issuance to support not only the annual borrowing program of the National Treasury in line with the rolling national Medium Term Debt Strategy and to support the strategic domestic debt market development that this economy can conveniently tap into in decades to come. MLF can position itself as an adviser to the National Debt Office.

Access to government securities

As many of you are aware, we have made access to Kenya Government securities easy for anyone, including corporates and individuals, both local and non-resident. All that an investor needs to do is to register a Government securities CDS account at any Branch of the Central Bank of Kenya or through authorized Agents. The details of this are available in the Central Bank of Kenya Website.

In spite of these milestones, a lot more remains outstanding or even unexplored. The level of automation for auction management and dissemination is still below best practice. We have neither provided alternative securities trading forums for bonds investors nor clear avenues for sharia compliant securities. The Securities market integration is still far from optimal and market indexation is not elaborate enough to attract foreign capital. It is however, encouraging to see programmes that identify strategies for deepening the local securities markets in the region by way of sensitization and capacity building support.

My hope is that as we deliberate on the relevant emerging issues and as we learn from shared experiences, we will work out innovative solutions that we can adapt in our respective financial systems. As has been rightly pointed out, it will take us, Africans to develop Africa; we have to develop our markets for these markets to serve us efficiently.

Thank you very much for your attention.