

BOND MARKET FORUM

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1.0 Introduction

Uganda has been developing both the government securities and the capital market, but progress has been slow which could be improved significantly by better coordination between the different government institutions and market participants.

The government securities and the corporate bond market are intertwined as there is significant overlap in investors, market infrastructure and regulatory requirements between the two markets. Furthermore, a well-functioning government securities market is necessary to develop an effective corporate debt market.

Currently there is limited and intermittent interaction between the regulatory institutions and market players. The main discussion forum with market players in the government securities market is the Treasurers Forum, where government securities are only discussed as a side issue, as the forum concentrates on the Treasury function of the banks. Furthermore, only the BoU and the banks attend the forum, which leaves out large investors such as NSSF as well as the Ministry of Finance and the CMA.

This lack of coordination has resulted in slow progress in reforming the government securities market and disregarded implications for the development of the corporate bond market.

For example, the effort to reform the Primary Dealership System has stalled and only limited progress has been made over the last 5 years. Only phase I of the reforms has been introduced which made all banks primary dealers. This however, does not give the banks any incentive to comply with their secondary market trading obligations, which has led to continued low liquidity and an uncompetitive environment. This in turn leads to higher financing costs for government. One of the main reasons behind the stalling of these reforms is the lack of coordination between the regulatory institutions and market players.

Another example are the duplicate efforts of the CMA and the BoU to work on securities lending and short selling regulations, where the BoU has recently entered into a Memorandum of Understanding with Frontclear.

With the current initiatives to allow government securities to trade on the USE, to allow retail investors to invest in government securities through mobile money and to issue infrastructure bonds, better coordination is required as the markets are becoming even more intertwined.

Therefore, coordination between the BoU, MoFPED, CMA and market players should be improved. This paper therefore highly recommends the creation of a Bond Market Forum.

2.0 Market Development

This section describes the importance of the development of the different fixed income market segments.

2.1 Money Market Development

The money market in Uganda is highly underdeveloped with the main product being government T-Bills as there is no commercial paper¹ market and the repurchase agreement (repo²) market is non-functioning.

The non-existence of the repo market inhibits the functioning of the monetary transmission mechanism, making it harder and more expensive for the BoU to keep inflation within its target range. Therefore, more attention needs to be paid to the development of the money market.

Furthermore, the lack of a repo market reduces liquidity on the secondary market for government securities. Primary dealers are obliged to make a market in government securities, however they cannot sell a security to a willing buyer when they do not own that security. A repo market would enable them to borrow the security and sell it to the investor, giving the primary dealer time to source the security.

2.2 Government Securities Market Development

Currently the Government spends more than 17% of its domestic revenue on interest payments which breaches its own benchmark of 15% set in the Public Debt Management Framework. Although fiscal indiscipline is the main reason for the high interest rates, secondary market development would reduce liquidity and risk premiums and therefore reduce the interest rates at which government is borrowing on the domestic debt market.

With the government feeling the pressure on the budget, it is paramount to progress faster with the development of the government securities market which would reduce some of the pressure on the budget through lower interest rates.

2.3 Capital Market Development

The capital market in Uganda has the potential to be a great economic growth catalyst by providing long term financing to the private sector and attract funding from foreign investors as the lack of access to capital is one of the main impediments to private sector growth.

¹ Unsecured short-term debt issued by companies, usually to finance liabilities of less than 1 year.

² A holder of a securities (usually T-Bills) sells the securities to a lender and agrees to repurchase them at an agreed future date at an agreed price.

In addition to these benefits by itself, it would also create competition for the banking sector as firms have alternative funding sources, forcing banks to reduce interest rates to the private sector. It would further reduce the crowding out effect from government borrowing as more funding sources for the private sector become available.

3.0 Need for Coordination between the Money, Government Securities and Corporate Debt Markets

“Debt markets require well-functioning money markets to create government bond markets, and they in turn are essential for corporate bond markets. Understanding the linkages between different segments of the market and their building blocks is critical to ensuring a proper sequencing of policy and regulatory reforms.”³

For example, development of the government bond market depends on a well-functioning money market and the ability to borrow/lend government securities and use them as collateral. Otherwise, the ability of primary dealers to fulfill their secondary market making obligations would be hampered as they might not be able to source the securities for a potential buyer without a repo market.

However, as it is not only possible to lend/borrow government securities, but also corporate bonds, it is important to create policies and regulations for government securities lending with the capital market in mind and adopt a consistent set of policies and regulations across both markets.

Furthermore, “local currency government bond markets can be a catalyst for the development of corporate bond markets by providing a yield curve benchmark against which to price bonds, market liquidity, and price revelation.”⁴

A well-functioning government securities market is a prerequisite for the development of the corporate bond market, as government securities are seen as credit risk-free instruments, so investors and issuers of corporate bonds use government securities as a benchmark for their pricing and trading decisions.

Therefore, when designing reforms to the government securities market, the impact on the development of the rest of the capital market should be taken into account and development initiatives should be coordinated.

Furthermore, it is good market practice to adopt similar market practices and regulations across both markets in order to facilitate investors to invest in both markets

³ IFC, EM Compass, January 2017

⁴ The Development of Local Capital Markets: Rationale and Challenges, IMF WP/14/234, 2014

and reduce transaction costs.

With the interlinkages between the money, government securities and corporate bond markets, it is important for all the main stakeholders to work together to facilitate the development of the three markets which makes the creation of a coordination forum necessary.

The Bond Market Forum should concentrate on the money and government securities market at first as the corporate bond market remains small and the development of the money and government securities markets are necessary for corporate bond market development. However, as one of the Government's financing priorities is to issue infrastructure bond, a regulatory framework for infrastructure bonds in the capital markets should be developed as a priority. Then, once the capital market develops further more emphasis should be given to the overall development of the corporate bond market.

Some of the areas that the Bond Market Forum should address are:

1. Primary Dealership reforms
 - a. Creating incentives for Primary Dealers to comply with their secondary market trading obligations
 - b. Encourage competition between the Primary Dealers
2. Creating a repo market
 - a. Legislative review to ensure a clear netting opinion
 - b. Develop securities lending regulations applicable both to government securities, corporate bonds, equities and other money or capital market securities
 - c. Adoption of a General Masters Repurchase Agreement (GMRA) across market participants
3. Establishing a Secondary Market Trading Platform
4. Allowing government securities to be traded on the USE
 - a. Linking the USE and BoU or establishing one Central Securities Depositories
 - b. Enabling cash settlement of USE trades at the BoU
5. Creating a unit trust to allow retail investors to invest in government securities using mobile money

6. Introducing infrastructure bonds
 - a. Creating an effective regulatory environment for Special Purpose Vehicles and their ability to issue corporate bonds and equity
7. Set-up of buy-back and switch auctions
8. Developing a holistic regulatory approach and harmonizing regulatory approaches between BoU and CMA

4.0 The Interaction with the Financial Market Development Strategy

The Financial Market Development Strategy highlights the importance of better coordination between regulators and market participants in order to develop the Ugandan financial system.

Access to long term financing for the public and private sector through the government securities and capital markets has been highlighted as one of the main areas in the strategy, including the specific development initiatives that the bond market forum should address mentioned in Section 3.

Therefore, the Bond Market Forum would work towards the implementation of the recommendations in the Financial Market Development Strategy regarding the government securities and capital markets and ensuring the development is done in a coordinated approach.

5.0 The Interaction with the Capital Markets Development Steering Committee

The Capital Markets Development Steering Committee was set up under Uganda's Capital Markets Development Master Plan in 2016 and is responsible for overseeing the implementation of the Master Plan.

The Steering Committee has an Investor and Infrastructure sub-committee which reports to the Steering Committee and is responsible to create an efficient environment for investors to operate in. However, the sub-committee largely concentrates on the development of the capital market and its members are made of regulatory institutions. This makes it less than ideal to drive the development of the money and government securities market.

However, as there is a significant overlap of goals, the Bond Market Forum should report to the Steering Committee and work closely with the Investor and Infrastructure sub-committees which can use the Bond Market Forum to better interact with a larger group

of investors and coordinate development initiatives.

6.0 Recommendation

The creation of a Bond Market Forum is highly recommended, where MoFPED, BoU, CMA, USE, institutional investors, Primary Dealers and other selected market players would meet on a quarterly basis to discuss and facilitate the development of the money, government securities and corporate debt markets.

Such coordination would speed up the implementation of the reforms and ensure that the reforms benefit the Ugandan financial system as a whole and spur economic growth by providing better and cheaper credit both to Government and the private sector.

7.0 Next steps

1. CMA to engage the Debt and Cash Policy Directorate (DDCP) at the Ministry of Finance (MoFPED) on the forum and obtain their buy-in.
2. DDCP to engage the Financial Markets Department (FMD) at the Bank of Uganda (BoU) on the forum and obtain their buy-in.
3. DDCP, FMD and CMA to agree on the terms of reference (the Appendix has draft terms of reference), the venue for the meetings and how to share the costs.
4. DDCP to invite the agreed members to the first forum meeting.

Appendix: DRAFT Terms of Reference - Bond Market Forum

The Bond Market Forum should be a coordinating body to facilitate the development of the money, government securities and capital markets. The forum should also act as a forum to facilitate the exchange of information between investors, regulators and market intermediaries.

The forum should meet on a quarterly basis and should produce an annual report on its progress which should be submitted to the PS/ST of the Ministry of Finance, the Governor of the Bank of Uganda, the Financial Market Development Committee and the Capital Markets Development Steering Committee.

Responsibilities:

- Coordinate regulatory approaches.
- Recommend and implement regulatory changes.
- Coordinate the development of the money, government securities and capital markets.
- Exchange information on recent market developments.
- Coordinate capacity building.
- Create awareness of the government securities and capital markets.

Members:

The following entities should be represented in the Bond Market Forum:

- Debt and Cash Policy Directorate, Ministry of Finance (Chair)
- Primary Dealers' representative
- National Social Security Fund
- CIS/fund/pension or provident fund managers' representative
- Insurance companies' representative
- Brokers' representative
- Capital Markets Authority
- Uganda Securities Exchange
- Financial Markets Department, Bank of Uganda (Secretary)

The Terms of Reference should be reviewed as necessary, but at least every 3 years.