CORPORATE BOND MARKET DEVELOPMENT IN KENYA

There are several good reasons for developing bond market. The most fundamental reason is to make financial and capital market more complete by generating market interest rates that reflect the opportunity cost of funds at each maturity. This is essential for efficient investment and financing decisions. Moreover the existence of tradable instruments helps risk management. Further the use of financial guarantees and other types of underwriting is becoming increasingly common in corporate debt market as financing deals become more complex. If borrowers have available to them only a narrow range of instruments (e.g. in terms of maturity, currency etc) then they can be exposed to significant mismatches between their assets and their liabilities.

The risks entailed by such mismatches have to be managed and the ability to do so will often depend on whether certain exposures can be adequately hedged. Liquid markets help capital market participants to hedge their exposures. If bond market is not well developed for instance firms may have to finance the acquisition of long-term assets by incurring short-term debts. As a result their investment policies may be biased in favour of short-term projects and a way from entrepreneurial ventures.

The relationship between intermediation through banks and disintermediation through capital markets is controversial. Even in developed economies this two rather distinct systems have grown up one where capital markets are very important and one where banks dominate. A question that arises concerns the role commercial banks can play in developing our bond markets. The view that increased corporate bond issuance just takes away profitable business from commercial banks is oversimplified.

One implication often drawn from developed market experience is that a key prerequisite for the development of a corporate bond market is the existence of some form of independent credit risk assessment. How successfully can this be done and reinforced in our capital market is yet to be seen besides having only one approved South Africa based Credit Rating Agency by Capital Market Authority (CMA). But let me quickly point out that the Athi River Mining Limited five-year unsecured corporate bond issued on strength of its grade A investment credit rating from the Global Crediting Company of South Africa is a step in the right direction. The question for the policy makers is can independent credit rating be reconciled with provisions that allow some regulators of institutional investors i.e. Central Bank, Commissioner of Insurance, Retirement Benefits Authority (RBA) etc to themselves determine credit ratings of the debt instruments “their” firms can invest in?

Central bank of Kenya has multiple interests in the development of bond markets. At a fundamental level the government Treasury bond helps to fund budget deficits. It is important to note that Central Bank of Kenya has increased its issuance of long-term Treasury bonds currently with 12-year tenor thus increasing the maturity period of government debt. Also Central Bank acts as agents for the government in various aspects of the management of government debt. They oversee clearance and settlement system and they are responsible for the stability of the financial system often directly supervising banks. This multiplicity of interest means that the policy issues that arise are very diverse.

Though Kenya’s financial sector is well diversified, it needs to be developed further. The banking sector is dominated by ten largest commercial banks, which accounts for over 77% of all deposits held by banking institutions. Insurance and banking sector's are quite competitive, but need to be restructured so that we have competitive bidding for government Treasury bills auction. The assertion is that "limiting" participation in the Treasury bill auction to only a few players would restrict competition and consequently the result not market driven. A developed Treasury bond market has a direct impact on the capital market. The two sectors could be strengthened through more mergers and consolidations, which will ensure efficient competition and further deepening of the capital market

Without a functioning bond market firms lack a clear measure of the opportunity cost of funds. They will rely on commercial banks for debt financing. The same constraint that prevents the development of bond markets also leads banks to prefer short term credit which implies higher risks for business. The government massive infrastructure development i.e. reconstruction of our depilated roads network can be privately funded. Often in such cases the commercial feasibility depends on the funding structure that minimizes considerably risks. This requires long term (usually 20 years or longer) flexible or fixed interest rate, attractively priced debt instruments. Debts of this nature can be provided by a liquid traded bond.

Moreover in the 2005/2006 budget speech by the Minister of Finance securitization based on bankable assets were a given a boost particularly for institution offering infrastructural services to raise long term capital by encouraging such institution to set up special purpose vehicles (SPV) for the purpose of issuing asset backed securities. The Minister proposal that income from SPV to be exempted from income tax is highly commendable. Now that the Minister paved the way in the budget speech we would see more of structured corporate bonds issued through a special purpose vehicles (SPV) i.e. securitization of credit card receivables, infrastructure bond and mortgage backed bonds in our capital market. It is equally important to note that the limited role of corporate bond market is a function of how companies have been financing their investments projects-especially medium to long term fixed investments. The yield of a bond has to compensate investor for the opportunity cost of funds, default and liquidity risk If the return of the bond is distorted among clients and there is no active secondary market investors will be reluctant to participate in the development of the corporate bond market.
In any case a flourishing corporate bond market contributes to deepening of the capital market, is a source of fund for infrastructure and facilitates competition in the financial services. With developed bonds market banks can price debt more efficiently.

The writer is a Manager, Corporate Finance, with Loita Capital partners Limited