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Abbreviations

AFMI	African Financial Markets Initiative
ATS	Automated Trading System
BESA	Bond Exchange of South Africa
BoB	Bank of Botswana
BoT	Bank of Tanzania
BoU	Bank of Uganda
BoZ	Bank of Zambia
BSE	Botswana Stock Exchange
CBK	Central Bank of Kenya
CCBG	Committee of Central Bank Governors
CISNA	Committee of Insurance, Securities and Non-Banking Financial
COSSE	Authorities Committee of SADC Stock Exchanges
CMA	Common Monetary Area
CMAC	Capital Markets Advisory Committee
COMESA	Common Market for Eastern and Southern Africa
DSE	Dar es Salaam Stock Exchange
DVP	Delivery versus Payment
EASRA	East African Securities Regulators Association
ESMID	Efficient Securities Markets Institutional Development
FSB	Financial Services Board (South Africa)
IFC	International Finance Corporation
LuSE	Lusaka Stock Exchange
MAC	Monetary Affairs Committee
MFDP	Ministry of Finance and Development Planning (Botswana)
MFW4A	Making Finance Work for Africa
MSE	Malawi Stock Exchange
MZE	Mozambique Stock Exchange
NAMFISA	Namibia Financial Institutions Supervisory Authority
NBFIRA	Non-Bank Financial Institutions Regulatory Authority (Botswana)
NSE	Nairobi Stock Exchange
PD	Primary Dealer
RTGS	Real-time Gross Settlement
SADC	Southern African Development Community
SEC	Securities and Exchange Commission
SIDA	Swedish International Development Co-operation
SSX	Swaziland Stock Exchange
USE	Uganda Stock Exchange
WHT	Withholding Tax
ZSE	Zimbabwe Stock Exchange

Regional Financial Co-operation – Addressing Regulatory Gaps: The Development of Regional Bond Markets[1]

Introduction

Outside of South Africa, the capital markets of countries in Southern Africa are at fairly early stages of development, being generally small, illiquid and lacking in a full range of market, technical and institutional infrastructure. This characterisation applies especially to bond markets, which have lagged equity markets in the process of capital market development. However, it is increasingly being recognised that bond markets have a crucial role to play in the process of financial development. Fixed-income instruments have an important role as both an asset for savers and as a liability for investors, and of course ensuring that such instruments are marketable significantly increases both supply and demand. The ongoing global financial and economic crisis has if anything further increased the relevance and potential contribution of bond markets, given the reduction in international capital flows. Most countries in southern Africa will be more dependent upon domestic capital markets to finance fiscal deficits and private investment, and bond markets can provide a key channel for raising domestic finance. Second, by expanding the range of available financial instruments, they can contribute to raising the domestic savings rate, which is also an essential response to constrained access to international finance and reduced capital inflows.

In this paper we examine some of the constraints to bond market development in Southern Africa, and consider the scope for regional co-operation and integration to support this process, highlighting some of the regulatory issues that need to be addressed in the process.

Overview of Bond Markets in Southern Africa

Developing National Bond Markets

Generally, the development of bond markets follows a fairly well-established sequence, comprising the following steps (some of which may happen in parallel).

Establishing an appropriate macroeconomic and financial environment. For bond markets to thrive, the macroeconomic environment must be conducive. This includes having a broadly market-based economic system where prices provide appropriate signals and incentives, inflation is held at low-to-moderate levels, the exchange rate is not excessively over- or under-valued, and fiscal policy is sustainable. Monetary policy should ensure that interest rates are neither too high nor excessively volatile.

Establishing an equity market. It is generally necessary to have a functioning equity market and stock exchange prior to developing a bond market. A stock exchange forms an important part of the

[1] This paper draws heavily on the "SADC-COMESA Bond Market Mapping Study" prepared for the African Financial Markets Initiative (AFMI) by Keith Jefferis, funded by the USAID Southern African Trade Hub.

market infrastructure for bond trading, and also supports the development of an investor base as well as a culture of investing in market-based financial instruments.

Establishing a government bond market. The first part of the bond market to be established is typically the market for government bonds. This reflects the fact that governments are usually the largest borrowers in an economy, and as well that government bonds are usually the most attractive fixed income instruments for investors due to their "risk-free" status. Governments will typically issue bonds fairly regularly, which provides constant stimulation to the market. If appropriately structured, government bonds can provide depth and liquidity to the market, and stimulate the emergence of supportive institutions and infrastructure. It is difficult (but not impossible) to establish a corporate bond market in the absence of a government bond market.

Developing market institutions and infrastructure. An efficient bond market requires a range of institutions and market infrastructure. These include institutions that can handle primary issues and ensure that bonds offered for sale can find buyers at a reasonable price. But more importantly, for a fully developed bond market, secondary market trading should be active. An existing stock exchange with a network of brokers can play an role here, especially when corporate bonds are available. For government bonds, primary dealers (PDs) typically play an important role in both primary and secondary markets. Primary dealers will typically play a crucial role in ensuring the success of primary government bond issues, and have responsibilities for market-making (in the secondary market) through having bonds available sale and quoting two-way (buy and sell) prices. Other important components of market infrastructure include securities depositories (where records of ownership of bonds, which are usually dematerialised, are kept), and settlement and payment systems (for transmitting changes of ownership and related payments).

Developing legal and regulatory frameworks. Bond markets are unlikely to develop unless there are certain legal and regulatory pre-requisites in place. Besides general requirements such as the rule of law and a (at least moderately) well-functioning legal system, there are certain specific requirements for bond markets to develop. These include laws that provide certainty as to the status of bondholders in the hierarchy of creditors in the event of default, and laws relating specifically to asset-backed securities (where the general legal framework may not be clear). It is also important to have a well-functioning regulatory system, relating to the licensing and supervision of securities markets (stock and bond markets), the licensing and supervision of market participants (such as brokers, pension funds, unit trusts, financial advisors, asset managers, primary dealers etc.), and the approval of bond issues. Regulators have to tread a fine line between ensuring that the regulatory framework protects investors (and issuers) and supports market integrity, while at the same time avoiding a regulatory framework that is so strict that market activity is discouraged and the market does not develop. Regulators and market participants will typically share market development and awareness-raising activities.

Developing an investor base. A bond market cannot function without an effective investor base, both for primary issues and secondary market trading. The investor base comprises banks, institutional investors such as pension funds and insurance companies, foreign investors, and retail investors. Developing an investor base is a long-term process, which depends on the development of the broader financial sector, as well as appropriate liberalisation and regulation. If the pension sector is dominated by statutory funds, the investor base is unlikely to contribute to a vibrant bond market unless fund management is contracted out to independent, competing asset managers. It is also unlikely that a vibrant bond market will develop without the active participation of foreign investors.

Developing skills and capacity. Issuing and trading bonds (and related activities such as pricing) are highly specialised activities that require commensurate skills and capacity in both market participants (brokers, dealers, investors, financial advisors etc.) and regulators. The private sector will develop or hire such skills given adequate financial incentives, but it is also important that the public sector provides sufficient resources for regulators.

Establishing a corporate bond market. The issuance and trading of corporate bonds generally follows once an effective market for government bonds has been established. The latter provides a risk-free yield curve against which corporate bonds (and associated risks) can be priced, as well as stimulating the development of all of the above requirements for an effective market. Other pre-requisites include appropriate pricing of bonds vis-a-vis bank loans, a developed corporate finance advisory capacity, and awareness on the part of corporates of key issues around bond finance. The establishment of a credit rating system for corporates can also assist the development of the corporate bond market.

Building market liquidity, breadth and depth. Once the above requirements are in place market development can focus on extending the market with a broader range of bond issues, and promoting liquidity to deepen the market through trading activity – processes that reinforce each other in a virtuous circle and strengthen the role of the bond market as a vehicle for the deployment of savings and as a source of finance for investment, as well as being an important vehicle for the transmission of macroeconomic signals and the implementation of monetary policy.

Characterising SADC/COMESA Bond Markets[2]

SADC and COMESA bond markets can be divided into four groups, according to their level of development in line with the above sequence:

1. Bond markets that are fully developed and have global significance: South Africa;
2. Bond markets that are reasonably well-established, or have been operating for some time: Egypt, Kenya, Zimbabwe;
3. Bond markets that are newly established: Angola, Botswana, Malawi, Mauritius, Mozambique, Namibia, Rwanda, Seychelles, Swaziland, Tanzania, Uganda, Zambia; and
4. Countries intending to establish bond markets: Lesotho.

The issues affecting these countries and markets comprise a number of general issues relating to the development of bond markets, as well as country-specific issues. The constraints to bond market development relate to the implementation of the various steps laid out above.

Fully developed bond markets: the **South African** bond market (operated by the Bond Exchange of South Africa) has a well-developed legal and regulatory structure and very good market infrastructure. The market is large (capitalisation equals 31% of Gross Domestic Product - GDP) and extremely liquid (liquidity was over 2000% in 2008). The main issues facing the market include improving liquidity in corporate bonds, dealing with the consequences of the proposed takeover of the Bond Exchange of South Africa (BESA) by the Johannesburg Stock Exchange (JSE), and coping with the volatility induced by inflows and outflows of foreign investment. On the latter point, foreign investment has made a major contribution to improving market liquidity (as well as financing the South African current account deficit), but is highly subject to broader macroeconomic developments and changed perceptions of risk relating to South Africa in particular and emerging

[2] See Table 1 for further information

markets in general. Recent global financial and economic turmoil has led to an outflow of foreign portfolio investment from the BESA.

Established bond markets: the Nairobi Stock Exchange (NSE) in **Kenya** has been operating since the 1950s and is well established. The bond market is reasonably large (at 18% of GDP) and reasonably liquid (25%). The government bond market is split between the Central Bank of Kenya (CBK), which holds the depository and deals with settlement and payment) and the stock exchange (where all bonds are listed, and all trades must go through NSE brokers). There is no primary dealer system for government bonds and trading is paper-based and slow, and there have been market integrity issues that have undermined confidence in the market. Trading in government bonds is hampered by a lack of consolidation and benchmark issues. There is a moderately active institutional investment sector, although statutory funds dominate. There are very few corporate bonds; the few that do exist are floating rate and there is virtually no secondary market trading. New corporate bond issues are discouraged by competition from syndicated bank loans, a lengthy regulatory and approval process, and a lack of understanding of bond markets amongst potential issuers.

The **Zimbabwe** Stock Exchange (ZSE) is also long-established and has traded bonds for many years. However, the country's economic crisis, hyperinflation and collapse have destroyed the market for fixed income instruments, and the ZSE was closed for several months in late 2008 and early 2009. Hyperinflation has reduced the value of existing bonds to zero (along with the debt obligations of issuers). Issues related to the bond market are at this time subsidiary to more pressing macroeconomic stabilisation and recovery issues.

Newly-established bond markets: these vary considerably in their stage of development. The **Mauritius** bond market is relatively large (at an estimated 48% of GDP). It is dominated by government bonds and there are few corporate issues, and liquidity is generally low. **Namibia** has a medium-sized bond market (12% of GDP) but low liquidity (7%); it too is dominated by government bonds. Generally there is considered to be a shortage of government bonds (in recent years there has been a fiscal surplus) and hence "buy and hold" strategies predominate. The **Botswana** bond market is quite small (7% of GDP) and has low liquidity (5%). As in Namibia, there is a shortage of government bonds due to budget surpluses and the government's lack of need for bond finance, and hence a "buy and hold" strategy by institutional investors. Government bonds are managed by the Bank of Botswana (BoB) and trades are reported to the Botswana Stock Exchange (BSE), while corporate bonds are handled entirely by the BSE. There are concerns about whether the primary dealer system for government bonds is working effectively, and whether the brokers have sufficient incentive and capacity to undertake bond trading. The distinguishing feature of the Botswana bond market is the large number of non-government bonds (comprising bonds issued by corporates, parastatals and other quasi-government institutions). Capitalisation of these bonds exceeds those of government bonds, although secondary market activity is dominated by government bonds and liquidity in non-government bonds is virtually non-existent. Issuance of non-government bonds was stimulated by the issuance of government bonds – which was purely for market development purposes – and the establishment of a risk-free yield curve. There is a large institutional investor sector, with recent growth stimulated by the establishment of a funded, defined-contribution pension scheme for public sector employees; pension funds are required to invest a minimum of 30% of their assets locally.

Angola has an embryonic bond market with a number of government bonds denominated in both local currency and US dollars. However, the market is somewhat distorted by the exchange rate and

monetary policy regime, which comprises a pegged exchange rate and managed interest rates, and which can sometimes yield inconsistent price signals. Angola is intending to establish a stock exchange during 2009. However, the Angolan economy is heavily government-controlled, and market processes are weak. The institutional investor sector is undeveloped, and foreign participation in the bond market is highly restricted.

In **Uganda**, the bond market shows a stark contrast between a moderately active government bond sector and almost non-existent corporate bond sector. While the market is not particularly large (6% of GDP) it is highly liquid by the standards of the region (28%). The market is new, but is hampered by fragmentation of government bonds and a lack of benchmark issues. A primary dealer system exists for government bonds but there are mixed views about its effectiveness. The Bank of Uganda (BoU) handles the government bond market, with trades reported to the Uganda Securities Exchange (USE), while the USE handles corporate bonds. The pension sector is dominated by statutory funds and the private asset management sector is tiny. Foreign investors are permitted, and have been important in building market liquidity. The development of corporate bonds is hampered by a lack of capacity and understanding in the corporate sector, perceptions that bond issues are expensive and difficult, and competition from bank loans. **Tanzania** has a very small bond market (4.1% of GDP), dominated by government bonds, and with virtually no secondary market activity. The Bank of Tanzania (BoT) handles government bonds, although trades have to be booked through the Dar Stock Exchange (DSE), which handles corporate bonds. The market is new, but is hampered by fragmentation of government bonds and a lack of benchmark issues. There used to be a Primary Dealer system, but it was suspended following concerns that it was ineffective. The pension sector is dominated by statutory funds and the private asset management sector is tiny. Foreign investors are not permitted in the bond market. The development of corporate bonds is hampered by a lack of capacity and understanding in the corporate sector, perceptions that bond issues are expensive and difficult, and competition from bank loans.

Malawi has a very small and embryonic bond market, with just one central bank bond, issued in 2008. The bond is issued and managed by the Reserve Bank of Malawi (RBM), and will be listed and traded on the Malawi Stock Exchange (MSE). There are no corporate bonds. **Mozambique** also has a relatively new bond market, with six government bonds and nine corporate bonds in issue. The market is small (3% of GDP) and liquidity is low (1.6%). The development of the government bond market is inhibited because the government has access to concessional donor funds. Corporate bonds are inhibited by the lack of expertise in the market and competition from bank loans. The bond market falls under the Mozambique Stock Exchange, which promotes the development of both government and corporate bond markets. **Zambia** has a large number of government bonds in issue, although the bond market is of medium size (15% of GDP), it is highly illiquid (0.2%). The government bond market is run by the Bank of Zambia, through primary dealers, although there are concerns about the effectiveness of the PD system. The government bond market is fragmented, with a lack of benchmark issues which contributed to the lack of liquidity.

The remaining markets are very small. **Rwanda** has three government and one corporate bonds, with capitalisation amounting to 0.8% of GDP. A newly-established stock exchange is hoping to develop the bond market, under the auspices of the Capital Markets Advisory Committee (CMAC). The **Seychelles** has a limited bond market with a few government bonds; there is no stock exchange. The country is in default on an international sovereign bond. **Swaziland** has two government and seven corporate bonds in issue, with capitalisation amounting to 2% of GDP. The bonds are traded through the Swaziland Stock Exchange (SSX), but liquidity is very low. **Lesotho** has no government

bonds, but is intending to commence bond issues in the near future. There are no active capital markets in Madagascar, Burundi or the Democratic Republic of Congo.

Constraints

The review of SADC and COMESA bond markets – which primarily comprise developing or "frontier" markets – indicates that there a number of common problems. With regard to government bond markets, the most common problems are:

- Fragmentation of the market (an excessive number of bonds in issue), with no benchmark bonds and insufficient liquidity in each of the issues;
- Lack of government bond issues, typically because governments either run budget surpluses, or have access to concessional donor funds at much lower costs;
- Dissatisfaction with the primary dealer system, where it exists, with concerns amongst issuers (typically central banks) that PDs do not discharge their market making function, and concern amongst PDs that there are insufficient financial incentives for them to invest in the skills, systems and capital needed to effectively discharge market-making functions; where there are no PD systems, countries usually wish to establish such systems;
- Lack of issuance programmes, so that potential investors (and PDs) cannot anticipate the future supply of securities;
- A predominant "buy and hold" strategy by investors.

With regard to corporate bonds, the main concerns are:

- A lack of corporate issues, reflecting:
    - Competition from bank loans (often syndicated), which in turn reflects conflict between the dual roles of banks, i.e., seeking lending opportunities and developing the bond market;
    - Underdeveloped corporate advisory and credit rating services; and
    - Excessive costs of issuing bonds, and restrictive conditions set by regulators.
- Very low liquidity, reflecting:
    - "Buy and hold" strategies amongst institutional investors;
    - Lack of capacity amongst brokers for bond pricing and trading activities;
    - Lack of capital for market-making activities.

In many countries, both government and corporate bond markets are constrained by a narrow investor base, which may reflect the institutional investment sector being dominated by government-run statutory funds and a legal framework that does not encourage the emergence of private pension funds and asset managers, and/or restrictions on the entry of foreign investors. Other constraints include withholding tax (especially when applied to foreign investors, when it typically becomes a final tax); asymmetry in taxation regulations applying to government and corporate bonds; and high transactions costs.

Regulatory issues

Regulatory environments very considerably across SADC and COMESA in terms of both the structure and capacity of regulators. In most countries, central banks play a key role in government bond markets, through handling primary issues/auctions and appointing primary dealers, usually as agents on behalf of Ministries of Finance/Treasuries. Trading regimes vary: in some countries government bonds trade on an Over-The-Counter (OTC) market, with trading and settlement handled by the central bank and reporting of trades to the stock exchange. In other countries, OTC markets do not

exist and listing regulations require that all trades go through accredited brokers and the stock exchange. Besides playing key roles in government bond markets both as regulators and as managers of bond registries, central banks play a broader role as regulators and/or managers of payments systems.

Beyond this, there are major differences in regulatory structures between Southern and Eastern Africa. Southern African countries tend to have "universal" non-bank regulators (such as the Financial Services Board (FSB) in South Africa, Namibia Financial Institutions Supervisory Authority (NAMFISA) in Namibia and Non-Bank Financial Institutions Regulatory Authority (NBIFIRA) in Botswana), with banking sectors regulated by the respective central banks. East Africa tends to have "fragmented" non-bank regulators, with separate regulators for securities markets, pension & provident funds, and insurance activities (this is the structure in Kenya, and seems likely to be followed in Tanzania and Uganda). On the face of it, the fragmented structure seems less desirable, especially in small economies, as it is likely to lead to higher costs (regulatory agencies have considerable fixed costs), a worsening of skill shortages, information gaps, and "turf battles" between regulators (and between their parent government departments). It is unlikely that fragmented regulators will help bond markets develop.

Generally, regulators perform a difficult role. They are typically short of resources, and being tied to government pay scales often cannot recruit the most talented individuals, who can usually earn more money in private financial institutions. In the consultations conducted for the preparation of this report, concerns were frequently expressed that regulators lacked the necessary capacity. In many countries, regulatory structures are being developed from scratch, while innovation takes place in financial markets and instruments. In several countries, regulations developed for equity markets are applied to bond markets, even though they are often not appropriate. Regulators often have to perform a dual role, those of market development and risk mitigation/consumer protection, and these roles can be difficult to balance. An excessive focus on risk mitigation and the protection of retail investors, perhaps through the application of equity market regulations to bond markets, can lead to excessive costs of bond issues and inhibition of the corporate bond market.

Regional co-operation between supervisors is developing slowly. The SADC Committee of Insurance, Securities and Non-Banking Financial Authorities (CISNA) aims to harmonise the regulatory frameworks for securities markets across the region. This is similar to the arrangement in East Africa, where the regional body of securities markets regulators - the East African Securities Regulators Association, EASRA – is already in the process of harmonising listing rules for equities and bonds across the East African Community.

Challenges for Reform

At a national level, the main challenges with respect to bond market development are as follows:

- Reforming the government bond system, including the consolidation of bonds into benchmark issues, re-opening of issues instead of always issuing new bonds at auctions, in order to focus trading on a small number of benchmark issues and promote liquidity;
- Improving trading and settlement systems, and reducing risk;
- Promoting greater transparency in primary and secondary bond markets;
- Building links between issuers and regulatory authorities and market participants;
- Reforming primary dealer systems, so as to enhance incentives for PDs (whether by giving underwriting privileges, or developing incentives that would mimic such privileges) and strengthening the effective discharge of PD responsibilities, e.g. in market making;

- Marketing and awareness raising campaigns to encourage corporate bond issues;
- Legal and regulatory reforms, and shifting the balance of regulatory activities away from minimising risk and towards facilitating market development;
- Developing the legal and operational framework for the issuance of infrastructure and municipal bonds;
- Liberalisation of pensions sectors: pensions sectors in several countries are dominated by statutory provident funds that all employers must contribute to. These funds are parastatals and are generally run in a conservative manner without active asset management, and leave little space for private pension funds or the development of a private asset management industry.
- Developing regulatory structures and capacity for pension funds, to support the liberalisation of pension sectors in a way that will encourage the development of more active asset management and private pension funds;
- Encouraging credit ratings and the development of national or regional ratings scales.
- There is no single correct model for how a bond market should be structured and operated. However, there is substantial accumulated experience both in the region and elsewhere as to what works and what doesn't work in different circumstances, which can provide a guide to the development of new markets.

The Potential for Regional Financial Co-operation in Bond Markets

There are two main areas where a regional approach would help bond market development in southern Africa: *regional co-operation*, where there are benefits to be obtained in the development of national bond markets, and *regional integration*, through the development of a regional bond market.

Regional Co-operation

Apart from South Africa, the bond markets of southern Africa are small and underdeveloped, and many of them face similar problems, including:

- Low liquidity
- Lack of effective primary dealer systems for government bonds
- Fragmented government bond issues and lack of benchmark issues
- Lack of bond market-specific legislation and regulations
- Lack of bond market technical expertise
- Insufficient regulatory capacity
- Undeveloped investor base
- Lack of market infrastructure
- Low levels of corporate bond issuance

With a range of common or similar problems, there is much to be gained from regional co-operation in addressing these constraints to bond market. At the most basic level, there is no point in each country "reinventing the wheel" individually; there are many fixed costs in bond market development (and financial market development more generally), which are less of a burden when shared, and this is especially true for relatively small and/or poor economies. This is most obviously the case with respect to training and capacity building, which is much more cost-effective when carried out regionally. Similarly with common problems such as consolidating fragmented government bond issues and developing benchmark issues, developing model legislation, or the

design of effective primary dealer systems; solutions are likely to be of general relevance and applicability across a number of countries. A regionally co-operative approach is likely to bring about faster development and be more cost-effective.

An example of such a regionally co-operative approach addressing some of the above issues is the ESMID Project in East Africa. The Efficient Securities Markets Institutional Development (ESMID) initiative, is a partnership between Swedish International Development Co-operation (SIDA), the International Finance Corporation (IFC) and the World Bank. ESMID works with securities markets in Kenya, Tanzania, Uganda and Rwanda, and its programme has five components:

- Assistance to regulators (improving the approval process; reducing costs; developing frameworks for new products);
- Strengthening the marketplace (reforming market structures; improving secondary market liquidity);
- Capacity building/training (certification; training on bonds);
- Regionalisation (broadening and deepening regional markets; harmonisation)
- Processing transactions (support for replicable transactions, new and innovative products).

The ESMID initiative is relatively new pilot project that has still to undergo its first review. However, initial impressions are that the initiative is well structured and targeted; many of the issues that are being addressed are common across countries (e.g., the need for capacity building), and there is significant potential for economies of scale and delivering much needed technical support across a range of countries.

An alternative approach in Southern Africa may be to use the expertise and experience of the Bond Exchange of South Africa (BESA). The South African bond market is large and liquid, and has achieved world-class standards relating to trading, investor protection and risk-management. In achieving this position, it has in the past addressed many of the issues currently facing the smaller and newer markets. BESA is therefore in a strong position to provide advice, training and technical expertise to other SADC bond markets and the relevant authorities.

A further area where regional co-operation could pay off relates to credit ratings. The more widespread use of credit ratings could assist the development of corporate bonds by increasing transparency and reducing risk for investors. However outside of South Africa there is virtually no use of credit ratings by corporates. What is more, there is a “chicken and egg” problem; credit ratings are more effective when conducted against a local (national) scale – e.g. relative to “risk-free” government issues – but it requires around six issues for such a scale to be developed, and yet those issues are less likely in the absence of a scale. For small economies, it may not even be possible to get six corporates large enough (there are high fixed costs associated with obtaining a credit rating) and willing to obtain credit rating. Hence there may be merit in a regional approach, through the development of a regional ratings scale applicable to a number of countries, where it should be more feasible to obtain the minimum number of corporates willing to obtain a rating.

Regional Integration

The second potential area relates to the regional integration of national bond markets in such a way that they (ultimately) function as a single, integrated regional bond market. There are considerable potential benefits from such an approach, especially for countries with small economies and capital markets. The potential benefits (which apply as much to equities as to bonds) include:

- a broader range of marketable financial instruments, both in terms of the number of instruments and the range of issuers (thus facilitating portfolio diversification)
- a broader range of investors that can be tapped by issuers
- improved liquidity
- reduced risk (through greater diversification and improved liquidity) and hence lower capital costs for issuers

Developing a regionally integrated bond market is not an easy task, and there is a range of pre-requisites:

- A harmonised regulatory framework, with – as a minimum, a common core set of key regulations; different regulations across national jurisdictions will undermine the concept of a single integrated market, and encourage regulatory arbitrage; consideration could even be given to a regional regulator, rather than (or in addition to) single national regulators;
- Harmonised tax treatment (particularly with regard to withholding tax rates across jurisdictions, but also ensuring common tax treatment across issuers and instruments, e.g. the same tax treatment for government and corporate bonds)
- For corporate bonds, a regional ratings scale, as discussed above
- Development of appropriate market infrastructure, including a regional trading system (which could be a common system shared with equities trading); this could take the form of integrated national systems, or countries sharing a single regional system;
- Development of appropriate payments infrastructure, including efficient mechanisms for payments clearing and settlement;
- Removal of relevant capital account controls

Regulatory Issues

There a several issues for regulators to address. First, the question of approval processes for the issuance of bonds. At present, these vary across jurisdictions. Some regulators undertake detailed appraisals of the risks associated with individual bond issues, from a consumer protection perspective, while others focus more on standards of transparency and disclosure, based upon which investors make their own judgements and risk assessment. These requirements, combined with the capacity of the regulator, affect the cost and speed of bond issues; if there are major differences between jurisdictions, and issuers are free to move between jurisdictions, then clearly jurisdictions with the least burdensome and cheapest approval processes will tend to attract the most issues. This may not be a bad thing: competition amongst regulatory regimes may bring benefits in the same way as competition elsewhere, but there must be caution about encouraging a "race to the bottom" and agreement on minimum regulatory standards. However, there is a strong argument that the regulations relating to bond issues should not aim to shield investors from risk (other than through disclosure requirements and accounting standards); most investors in the bond market are institutional, professional investors that are quite able to conduct their own risk assessments and form appropriate judgements, and retail investors should primarily be encouraged to invest in low-risk instruments such as government bonds or diversified bond CIUs.

A second regulatory issue relates to pension funds and related institutional investors, who in some markets are already the main purchasers of bonds, and are likely to be the main investors as markets develop. Pension funds are subject to various types of regulation, typically including stipulated limits on foreign investments. These vary considerably across jurisdictions: some countries do not allow any offshore investment by pension funds, while other have relatively generous limits; in some cases

these limits are implemented through controls on the capital account of the balance of payments, while in other cases they fall under dedicated legislation. Clearly such limits impose constraints on the emergence of regionally integrated bond markets (or regional capital markets more generally); in the extreme case where pension funds are not allowed to invest outside of the home country, cross border bond market activity would be highly constrained, especially if compounded by prudential banking regulations imposing similar limits on banks.

There are a number of reasons for such restrictions. Historically, when pension funds offered predominantly defined benefit (DB) schemes, it was prudent to keep a high proportion of domestic currency liabilities in order to avoid a currency mismatch between assets and liabilities. However, now that many pension funds have switched to a defined contribution (DC) basis, this issue no longer arises, and the only prudential argument for keeping a high proportion of domestic currency assets is to minimise volatility in pension values arising from exchange rate fluctuations (although this would be a weak argument when domestic capital markets are limited and domestic currencies are weak). In an era of DC pension schemes, the main argument for requiring pension funds to hold domestic currency assets is from an exchange control perspective of restricting capital outflows.

Arguments relating to capital controls will be touched upon below. However, for a regionally integrated bond market to develop, it would be necessary to allow pension funds to invest in regional assets as if they were domestic assets.

Trading/Payments/Settlements systems

Bond markets in the region currently have a range of trading, payment and settlement systems. The South African market has a fully automated trading system, a dematerialised bond depository, payments handled through the banks' RTGS system, immediate delivery of title vs. payment/settlement. However, this is not replicated elsewhere; more typical is a separation between a government bond registry (usually held at the central bank) and corporate bonds that are not dematerialised, with no central depository; trading systems that are not automated and retain elements of manual or paper-based processes; slow payment and settlement systems, DVP risks. Bond trading systems are often less developed than equities systems, and while most countries are modernising their equity trading systems, bond systems are often left behind. In principle, however, bonds can generally be incorporated into automated equity trading, depository and settlement systems.

One important point is that small countries with new markets do not need to spend money on expensive trading systems of their own, as they can piggyback on systems in other countries. This approach is much cheaper and more affordable, as it can take advantage of spare capacity in existing systems. Developing expensive national systems can either result in high fees (which will discourage market development) or reliance on government subsidies, which may not be realistic in the medium term.

Payments systems are also being modernised, and the SADC Payments Systems Project (under the auspices of the Committee of Central Bank Governors) has promoted common systems and regulatory frameworks. While this lays the basis for a regionally-integrated payments system, as yet such a system does not exist. Cross-border payments can be made through the SWIFT system, and any delays are not so much due to technical constraints `as the need to secure exchange control approval, where such controls exist.

Capital controls

The existing system of exchange controls is a major impediment to any regional integration of capital markets. Most countries in Southern Africa retain some degree of exchange controls, typically restricting capital inflows and/or outflows rather than current account transactions. Restrictions on capital movements, which require regulatory approval (typically from central banks, although this may sometimes be delegated to commercial banks), fragment the regional capital market, restrict permissible transactions, delay those transactions that are permitted, and prevent the proper operation of the price system.

Apart from the regional market integration issue, capital controls that restrict the ability of non-residents to purchase securities in national capital markets severely inhibit the potential for market development; it is difficult to find an example of a bond market in a developing country that has developed without the active and reasonably extensive participation of foreigners. Certainly, the entry of active foreign investors was one of the factors that stimulated to development of the South African bond market to reach the advanced stage that it is in today. East Africa provides further illustration of this: Kenya and Uganda have reasonably active and liquid bond markets, and both have high levels of foreign participation, whereas the Tanzanian bond market, which does not permit foreign investment, is stagnant.

Most countries have progressively liberalised exchange controls: Botswana and Mauritius have completely abolished exchange controls, and there are no controls between the countries of the Common Monetary Area (CMA) – South Africa, Lesotho, Namibia and Swaziland. Two main arguments are generally presented for the retention of exchange controls on capital movements. The first, relating to controls on capital inflows, considers that in countries with low savings rates and a shortage of finance for investment, domestic financial resources should be restricted from flowing out of the country in order to close the savings-investment gap (and thereby reduce the reliance on foreign capital inflows). Such restrictions are fairly common in the countries of Southern Africa. The second, relating to controls on capital inflows, considers that large inflows, particularly of short-term portfolio investment, are potentially destabilising as such flows can easily be reversed, putting pressure on capital markets and exchange rates.

While there is much evidence that controls on capital outflows are not particularly effective – individuals and companies can often find ways around these restrictions – it is widely accepted that the relaxation of capital controls needs to be properly sequenced; for instance, the banking supervision infrastructure needs to be able to monitor the currency exposure and possible mismatches on bank balance sheets.

Controls on capital inflows as a way of reducing the volatility of short-term portfolio investment are not particularly common. The Chilean experience is a frequently citied example, where short-term inflows were taxed, and assessments suggest that the effectiveness of the controls diminished over time. For countries that are crucially dependent on inflows of foreign capital – i.e. all countries with deficits on the current account of the Balance of payments, which applies to almost all countries in Southern Africa – restricting capital inflows may be highly counterproductive.

Conclusion

Regulators and policymakers have an extensive agenda facing them in order to support the development of national bond markets and extending regional co-operation and capital market integration. Key next steps include:

- Reform of government bond markets, with a view to making them more liquid and efficient; this mostly applies to central banks, and includes consolidating fragmented issues and developing large benchmark issues with sufficient liquidity; developing issuance calendars with frequent, regular issues, and publicising the same;
- Encouraging the development of appropriate primary dealer systems;
- Encouraging the participation of foreign investors through reform of exchange controls and tax systems;
- Ensuring that tax regimes do not discriminate between government and corporate bonds
- Reviewing regulatory systems for bond issuance and striking an appropriate balance between risk management and market development;
- Reforming and modernising pension systems so as to encourage the development of private sector asset managers

From a regional co-operation and integration perspective, the following reforms should be considered. With respect to regional co-operation:

- Harmonisation of regulations (e.g. relating to issuance, listing etc.) across countries, as this lays the foundation for eventual market integration (COSSE has made progress on this in the SADC region, with regard to listing requirements in equity markets, but has not yet addressed bond markets, while CISNA is addressing regulatory harmonisation in SADC); even once a harmonisation agenda has been identified, implementation may be slow if it requires statutory reforms at a national level;
- Using the experience of more developed markets to promote the development of smaller, newer markets;
- Seeking opportunities for cost-sharing and securing economies of scale, whether through common training programmes for market participants, or sharing expensive infrastructure;
- Engaging with credit rating agencies to develop regional ratings scales, and engaging with donors to support the financing of some initial "benchmark" corporate ratings for the purposes of market development;

Regional integration of capital markets is a longer-term programme, as it requires deeper reforms, including

- the abolition of exchange controls on capital movements, at the very least within the region where market integration is taking place;
- consideration of developing integrated trading/depository/settlement systems;
- relaxing restrictions on institutional investors so that regional investments are deemed domestic for regulatory purposes;
- harmonisation of tax regimes with regard to capital markets.

Table 1: SADC-COMESA Bond Market Data (2008)

	Nominal value outstanding		Value traded		Liquidity			GDP	Market
	Govt bonds	Other [1]	Govt bonds	Other	Govt bonds	Other	Overall		Capitalisation
	US$ mn	US$ mn	US$ mn	US$ mn	(%)			$mn	% GDP
Angola	*2,796*	n/a	n/a	n/a	n/a	n/a	n/a	61.3	*4.6%*
Botswana	306	533	39	4	12.8%	0.8%	5.2%	12.4	6.8%
Kenya	4,777	112	1,227	[2]	[2]	[2]	25.1%	27.0	18.1%
Lesotho	0	0	0	0	0	0	0	1.6	0.0%
Malawi	36	0	0	0	0	0	0.0%	3.6	1.0%
Mauritius	3,330	n/a	*154*	..	*13.2%*	n/a	n/a	6.9	48.1%
Mozambique	154	55	2.64	0.66	1.7%	1.2%	1.6%	8.1	2.6%
Namibia	633	246	43	15	6.8%	6.2%	6.6%	7.4	11.8%
Rwanda	25	2	0.9	0.3	3.4%	15.0%	4%	3.3	0.8%
South Africa	47,035	41,199	1,923,697	143,935	4089.9%	349.4%	2343.3%	283.1	31.2%
Swaziland	50	10	..	..	..	..	..	2.9	2.1%
Tanzania	650	37	..	..	..	..	..	16.7	4.1%
Uganda	718	43	214	..	29.8%	..	28.2%	11.8	6.5%
Zambia	1,7220	268	1.2	0.0	0.1%	0.0%	0.1%	11.4	15.1%

Notes

[1] "Other" includes quasi-government, municipal, parastatals, corporate, banks etc.

[2] data includes both government and corporate bonds

.. close to zero *n/a not available*

Source: country visits and questionnaires; JP Morgan; African Alliance; national stock exchanges

Data in italics are from secondary sources