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CLOSING THE DIVIDE - ISSUES WHEN DEVELOPING A BOND MARKET: THE CASE OF SRI LANKA

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ABSTRACT

Since the Asian economic crisis of the late 1990s, many countries in the region are embarking on programs to develop their financial systems to minimise or prevent such an incident in the future. This paper looks at Sri Lanka as an example of an underdeveloped bond market and its progress to date in reducing the divide. Comparisons and advice can be sought from developed economies, however the implementation of a progressive financial structure is unique to a country's own environment. In this instance the civil conflict and lingering cultural idiosyncrasies are impediments to progress.

Keywords: Sri Lankan Bond Market, Developing Nations, Fixed Income

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1. Introduction

Benefits of a vibrant and effective bond market in government securities with a wide variety of maturities includes the ability to set a benchmark for risk free interest rates and also to set a benchmark for corporate bond rates (Emery, 1997; International Finance Corporation, 2000; Herring and Chatusripitak, 2000; Yoshitomi and Shirai, 2000), and that a well functioning bond market will help overcome the mismatched financing of long-term projects by short-term loans (Asian Development Bank Institute, 2000a). Figure 1 provides an overview of the current position, processes required for development and future positions. The lack of relevant and reliable information impedes confidence in financial markets.

<insert Figure 1 about here>

Hakansson (1999) claims that the presence of a strong corporate bond market has a strong positive effect on an economy as it reduces the domination of banks in corporate lending. Reasons for a lower private sector bond issuance in Asia is attributed to poor credit ratings, which makes investment less attractive. Disadvantages of developing corporate bond markets in Asian economies are that it can take a long time, as demonstrated by many countries, and secondly, that the disclosure requirements applied to corporate bond issuers are considerably more strict than those applied to banks (Asian Development Bank Institute, 2000b).

Since the Asian financial crises in the late 1990s, effected economies have taken necessary steps to improve financing options including improving the bond markets as an alternative source of finance to traditional equity financing or bank financing. An economy can grow rapidly without an active bond market, but the cost is an increased vulnerability to a financial crisis and a loss of information to guide savings and investment decisions (Herring and Chatusripitak, 2000). Heavy reliance on banks means a correspondingly heavy exposure to banking crises and without other financing sources banks tend to dominate. Khan and Senhadji (2000) found a strong positive relationship between financial depth and growth which suggests that improved financing options will also help an economy to grow stronger.

International Finance Corporation (2000) suggest that emerging market economies should look at the experiences of other emerging market economies for guidance on what works in particular conditions. The Sri Lankan government has been studying the bond market in South Korea and Thailand (Jayawardena, 1999). The development of corporate bond markets are relatively new for emerging economies and therefore experiences are limited. Emerging market countries need to find ways to manage the risks, and hence benefit from international capital flows. Local-currency bonds can help dampen the effects of crises created by international capital flows by locking in interest rates and local-currency funding. Borrowers can then hold onto their funds and work their way through a crisis.

The fixed income market for Sri Lanka is approximately 9% of GDP as compared to Singapore 68%, South Korea 51%, India 32%, Thailand 12% and Indonesia 15% (Königson and Nystrand, 1999). In fact, the only other country in the region with a similar level of market participation is China.

The main objective of the present study is to investigate the Sri Lankan bond market as an example of a small under-developed bond market and its progress to date in becoming more developed. The paper is organised as follows. This section provides an introduction to the Sri Lankan debt market, and looks at the reasons for developing a bond market. Section 3 analyses the size of the market and suggest some reasons for the lack of development. Section 4 concludes the paper and provides some recommendations to improve the bond market infrastructure in Sri Lanka.

2. Sri Lanka Debt Markets

Government Bonds

There is an active trade in government securities in both the primary and secondary markets and they dominate the bond market in Sri Lanka .The lack of a benchmark for government bonds has slowed development of the local debt market. The bond program for 2000 was set at around 80 billion rupees (compared with LKR63.4 billion in 1999). Bonds of up to 10 years have recently been issued in an attempt to help set a yield curve. A sustainable supply of government bonds is required whilst still balancing bonds outstanding and keeping fiscal discipline. Total government debt at the end of 1998 was Rs. 924,699 (million) or approximately US$14,226 (million) with Rs. 463,426 (million) as domestic debt and Rs.461,273 (million) as foreign debt. Total debt as a percentage of GDP was 89.4 for 1998. The outstanding government debt at end October 2000 stood at Rs. 1,167.5 billion consisting of Rs.643.8 billion (55%) of domestic debt and Rs.523.7 billion (45%) of foreign debt (US$6.8 bn).

There is an interest rate price/risk anomaly between government securities and bank investments. The reason for this is due to the fact that two major banks owned predominantly by the government invest heavily in Treasury Bills and Bonds using funds received from bank deposits. Until the investor base is broadened to increase competition this phenomena will remain. The allocation of financial capital at prices that reflect the riskiness of an investment is at the heart of healthy, sustainable economic development (Asian Development Bank Institute, 2000c).

The Sri Lankan government planned a $150m to $200m major international bond issue to form the beginnings of a full yield curve for the country. Having hoped to set a sovereign benchmark since the beginning of 1998, the government has, however pulled back from advancing its ambition in the face of a deteriorating market. The government was first forced to put its plans on hold in May 1998 when nuclear testing by India and Pakistan blew spreads on issues from the sub-continent wide open.

Medium-term bonds starting from three-year maturities are usually subscribed by state-managed companies, which bid at lower levels to reduce the cost of borrowing. As a result, corporations often play a passive role in the bond market. It is expected that as interest rates fall, more corporations will enter the bond market. In 1999 the government introduced 5-and 6- year bonds for the first time as part of efforts to extend maturities and develop the debt market. Companies are expected to issue more debt into the local market as Duff and Phelps Credit Rating Agency Lanka assign more ratings to local companies.

Treasury Bills

The recurrent budget deficit of the government has necessitated the continuous issue of new treasury bills while reissuing the maturing bills. The first Treasury Bill was issued in 1923 but regular issues did not occur until 1941. The primary issue of treasury bills is made by auction by the Public Debt Department of the CBSL. Tenders are called for through Notices placed in national newspapers from primary dealers. Although the process is called an auction the Central Bank decides how much to accept after offers have been made which is sometimes above the limit set on offer. From October 20, 1999 the CBSL of Sri Lanka issued Treasury Bills with maturities of 91 days, 182 days and 364 days in place of Treasury Bills with 3 month, 6 month and 12-month maturities to introduce conformity with market practices (Central Bank of Sri Lanka, 1999). Treasury Bills are issued under the provisions of Local Treasury Bills Ordinance No. 8 of 1923 as amended by Act No. 35 of 1953, Act No. 35 of 1992 and Act No. 31 of 1995.

Treasury Bond Market

Treasury bonds were first issued in 1997 under the provisions of Registered Stock and Securities Ordinance No. 7 of 1937. Treasury bonds with maturities of 2, 3 and 4 years were issued in 1997. The government has had a favourable response to longer-term bonds and in 2000 issued 4, 5 and 6-year bonds. Given the sharp increase in interest rates in early 2001, a decision was made to drop the maximum maturity to 2 years until rates again become more favourable. Recent prominent achievements included the development of a long-term debt market by increasing Treasury bond issues and mobilizing resources in the international debt market. In this regard, the Development Finance Corporation of Ceylon, one of Sri Lanka's two development finance organizations (which are largely private sector institutions), issued a $65 million ten-year floating rate note at LIBOR plus 2 percent. The first ever auctioning of a 6-year Treasury bond occurred in September 1999.

Rupee Loans

Since 1998 the government has continued to move away from nonmarketable rupee securities. Approximately LKR 27.1 billion was allocated as rupee loans for 2000, compared with LKR 23 billion in 1999 and about LKR 56 billion of rupee securities in 1998. Rupee loans are issued on a long-term basis up to 30 years, but in practice the maturities are generally 2 - 10 years. The loans are floated on the basis of the governments financing requirements. They are transferable by registration with the Registrar of Public Debts and therefore they are not marketable instruments. They are the largest component of government debt and are almost exclusively owned by public institutions (95.4% as at August 1999) such as NSB, Employees' Provident Fund and Employees' Trust Fund. Private investors have not taken them up because the interest rate is generally lower than market rates, there is no secondary market, have a long term maturity and high volatility. Rupee loans are generally non-negotiable and the amount outstanding is approximately 50% of treasury bonds.

Primary Dealers

Primary dealers were first introduced in 1992 with 18 dealers. CBSL appointed 8 dedicated primary dealers with effect from 1 March 2000 under the new Local Treasury Bills (Primary Dealers Regulation No. 1 of 2000) that leaves out foreign banks and a few non-banking financial institutions. Primary dealers are required to form a public limited liability company with a minimum capital of Rs. 150million. The capital requirements are expected to increase to Rs. 200million by 2000 and Rs. 500million by 2003.

Corporate Bonds

The issuance of corporate bonds to the general public began in 1996 and since then 10 companies have risen about Rs. 6.7 billion (US$354 million) by 1999. There is a primary and secondary market for corporate bonds in Sri Lanka. The fees associated with the issuance of bonds include the coupon rate, cost of issuance (0.4%), annual bank guarantee fee 1.5% and taxes. Most corporate bonds are bank guaranteed. Corporate bonds have had their yields based on the risk free Treasury Bill and Bond rates, and then taking into account the credit risk associated with the instrument. The yields on commercial paper, which are unsecured promissory notes issued by companies to raise short-term funds, varied within a range of 12.00-18.00 per cent in the first half of 2000, in comparison to the range of 11.50-18.00 per cent in 1999. There were up to 11 issues of corporate bonds in 1998 due mainly to the banks covering their capital adequacy requirements. Banks and financial institutions have undertaken most issues.

3. Analysis

The total size of the market as at mid 1999 was approximately LKR 77 billion (USD$1.06 billion). In January 2001, there were only 2 US denominated (Eurobonds) bonds listed - the Hong Kong and Shanghai Banking Corporation and the other by Development Finance Corporation of Ceylon (DFCC) with a 10 year maturity. The average maturity is increasing over time as the government attempts to build a yield curve.

The overall fixed income market for Sri Lanka is 9% of GDP which is extremely low when compared to Korea 52%, Thailand 12% and Hong Kong 29%. The dominance of the banking sector is illustrated with provision of domestic bank credit at 72.7% of GDP, the stock market capitalization at only 29.8% of GDP and the total fixed income market at only 9% of GDP. The stock market is underdeveloped as borrowers have generally used finance companies.

Jayawardena (1999), the Governor of the Central Bank of Sri Lanka, suggests that impediments to bond market development and hence possible reasons for its small size are: the laws, the conventions, the customs, the culture, and other attitudes to public and private sector development. Problems remain in getting the public and private sector to talk with one another which again follows on from the socialistic period. Also financial analysts in the market have little understanding of the markets. This could be because of the size and hence lack of experience and that talented financial analysts leave the country for more lucrative careers elsewhere. Additionally, with the lack of freedom of the press, generally only facts are reported and not necessarily opinions. This may stem from cultural aspects as well.

La Porta et. al. (1997) show that countries with poor investor protections have significantly smaller debt and equity markets and that religious traditions such as Hindu or Muslim law appear to be less relevant in matters of investor protection. The law for Sri Lanka is adequate for investor protection but the enforcement may be a problem due inpart to the fact that corruption is still prevalent. Countries develop substitute mechanisms for poor investor protection. Some mechanisms are statutory, whilst another adaptive response is ownership concentration. Common law countries the average is 43%. In the case of Sri Lanka the concentration is extreme with the top three shareholders owning on average 60% of the company (Table 1). This concentration of ownership may be a reflection of poor investor protection suggesting inadequate corporate governance.

<Insert Table 1 about here>

In Panel B of Table 1, the level of market capitalization is shown. The average market capitalization for the top 10 Sri Lankan listed firms is only US$4 million which is insignificant in comparison to all other listed countries and again illustrates the underdevelopment of the stock market. The underdevelopment of the bond market is due to many factors apart from supporting infrastructure - lack of corporate governance ie. adequate investor protection, overriding domination of the state owned entities, lingering socialist attitudes of the people in a supposedly market free environment, lack of development of the economy (especially the stock market), brain drain leaving the country, corruption, civil conflict, an inadequate number of accountants and enforcement of accounting standards. Also restriction of the press to comment on government actions does not hold them accountable.

4. Conclusion

To create the necessary infrastructure for a corporate bond market certain conditions must apply. A genuine corporate bond market should be free from government interference so that investors can make decisions on economic criteria alone (Hakansson, 1998). Currently in Sri Lanka, this is not the case. Most corporate bonds are backed by the government which means that it is questionable whether they are in fact 'corporate' bonds. The credit rating agency should help to overcome the lack of confidence that investors have in the market but to date has only issued a rating for Sri Lanka Telecom issues. Another element required for a well-functioning bond market is a relevant and reliable financial reporting system. As previously discussed it was only since 1998 that companies were required to follow accounting standards which are now the International Accounting Standards. Still with corruption prevalent in the country and limited number of accountants, it is questionable how reliable the financial reports will be. Another element required is financial analysts that can supply independent advice to investors.

Boyagoda (2000) has proposed that the authorities should set up a robust clearing and settlement system (with the possibility of using the Colombo Stock Exchange's central depository system) and a screen based system to facilitate transparency of the bids/offers quoted by the dealers and order matching system. Boyagoda also recommends government commitment in the following areas: a) facilitating the development of the secondary market infrastructure and efficient regulatory framework; b) strengthening the intermediaries such as Primary Dealers to enable them to compete with retail commercial bank network by providing access to adequate resources and increasing the public awareness of the government securities; c) continued commitment for financial sector reforms towards broad-basing the market participation and ensuring their independent decision making and thereby avoiding market distortions created due to the impact of captive sources.

In 1983 the CBSL owned 99% of the Treasury Bills but by June 1999, 88.4% were owned by commercial banks and the non-bank sector. Given that the government still has large stakes in the commercial banks, pension funds and insurance companies the government still indirectly owns a large proportion of government debt. Without the complete privatisation of large sectors of the economy it is difficult to see how the bond markets and economy can move forward with any speed as people still expect to be able to fall back on the government for support.

Even given the small size, the progress made towards developing a corporate bond market and a stronger government debt market are commendable. They have issued some longer-term maturity bonds to try to extend the benchmark yield curve, approved a debt-rating agency and are also improving supporting infrastructure and settlement systems. Without outside support and assistance by the International Finance Corporation, an arm of the World Bank, and the Asian Development Bank, the Sri Lankan program would not otherwise be as well developed. The move to a market-based economy is slow and dogged by past socialistic expectations of the government. The dominance of the government remains in so many prominent financial institutions. The lack of corporate governance, poor accounting enforcement, the civil conflict and prevalence of corruption even given the good legal system, means that the Sri Lankan economic environment is difficult to move forward.

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Table 1 Ownership of 10 Largest Nonfinancial Domestic Firms by Large Shareholders

Panel A	Ownership by Three Largest Shareholders	
Country	Mean	Median
Australia	.28	.28
United States	.20	.12
India	.40	.43
Indonesia	.58	.62
South Korea	.23	.20
Pakistan	.37	.41
Philippines	.57	.51
Sri Lanka	.60	.61
Thailand	.47	.48
Common-law average	.43	.42

Country (Panel B)	Average Market Capitalization of Firms (Millions of U.S.$)
Australia	5,943
United States	71,650
India	1,721
Indonesia	882
South Korea	1,034
Pakistan	49
Philippines	156
Sri Lanka	4
Thailand	996
Common-law average	6,586

Source: La Porta et.al. (1998), Table 7

Figure 1 Present position of the Sri Lankan market