BANK OF NAMIBIA

ANNUAL SYMPOSIUM 2004

"THE CHALLENGES FOR THE DEVELOPMENT OF NAMIBIAN BOND MARKET: LESSONS FROM OTHER SMALLER ECONOMIES"

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PREFACE AND OVERVIEW

PREFACE

The sixth Annual Symposium of the Bank of Namibia was held on August 19, 2004 in Windhoek under the theme, the "Challenges for the Development of Namibian Bond Market: Lessons from other smaller economies". The event took place at Safari Hotel and Conference Centre. The objective of the symposium was to exchange views and to take stock of the existing arrangements, instruments and markets and to pave the way forward for enhancement of the effectiveness and liquidity of the Namibian bond market.

The symposium was addressed by three prominent speakers. These were Mr. Tom Lawless, Chief Executive Officer of the Bond Exchange of South Africa, Mr. Mike Sandler from Full Value Financial Services in South Africa and Prof. Nicholas Biekpe from the Africa Centre for Investment Analysis at the University of Stellenbosch. These presenters' papers are published herein.

Three main issues formed the core of discussions during the symposium. The first paper dealt with the issue of the development of a broad based and well functioning primary bond market in Namibia. More particularly, it emphasizes the role of the primary market dealers in the development of a broad based, efficiently functioning bond market. The second paper looked at the development of an efficient secondary market in Namibia. On this issue, the concern was about the need for formal market making. The final paper focussed on the general policy environment for the development of the bond market: lessons from other developing countries. The paper suggests that the development of a sustainable and "independent" bond market require an adequate institutional investor base. Furthermore, it requires the availability of a variety of instruments of differing maturities and a supporting infrastructure. The policy efforts should deal with both demand and supply side impediments as well as infrastructure problems.

OVERVIEW AND REFLECTIONS

In his opening remarks the Governor of the Bank of Namibia, Mr. Tom Alweendo alluded to the significance of a well-functioning and developed bond market in stimulating economic activities through the provision of appropriate finances to various development projects. The bond market provides a more transparent and effective way of pricing and distribution of risks. A well functioning bond market is expected to help retain substantial domestic savings currently invested abroad. However, the Governor stressed that, in Namibia the bond market is experiencing a number of developmental challenges. These challenges include the lack of a policy environment for the development of the bond market, limited size of the domestic market, which has limitations on the amounts of funds that the market need, and the lack of both a true benchmark yield curve and liquidity in the market.

In his presentation on the overview of the Namibian Bond Market, Mr. Phillip Shiimi, Senior Manager for the Financial Markets Department at the Bank of Namibia highlighted that the main issuers of bonds in the market are the Government of Namibia, parastatals and commercial banks. The main instruments used in the bond market include the Government of Namibia's Internal Registered Stocks (IRS), debentures issued by parastatals and private sector bonds. Government papers account for a large proportion of papers issued in the long term securities' market. The paper argued that liquidity, transparency, efficient trading and infrastructure, number and size of the local market are the main challenges affecting the efficiency of the bond market in Namibia.

Mr. Mike Sandler reaffirmed the significance of a well functional bond market. He stressed that without liquidity, bond market, would not be considered to be efficient or well functioning. A well functioning bond market is directly reliant on the liquidity within that market. The functions of the bonds market include the provision of alternative source of funding debt, reducing the cost of capital, expanding the choice of assets for investors and improving the pricing for risk. In order to further develop the primary market, the government of Namibia should play a significant role by appointing primary dealers and seeking credit rating for the country.

The paper above was discussed by Mr. Festus Hangula, the Treasurer for First National Bank (Namibia). The discussant paper acknowledged that most of the key issues necessary for appointing primary dealers in the bond market are currently in place in Namibia. The paper cited the low volumes of bonds on issue as a possible impediment to the effective market making and a formal set-up of primary dealer system. It further cautioned that credit rating may not provide immediate benefit to the bond market beyond the possible investors in neighbouring countries. Lastly given the size of the bond market, the paper suggested that Namibia engage a non-formal agreement between the private sector and the government/central bank for primary dealers and market making.

In his paper, Mr. Tom Lawless focused on developing an efficient secondary market in Namibia. Bond markets are crucial catalysts for a country to achieve sustainable development. This paper suggested that the Namibian Bond Market Association (NBMA) should be established. The NBMA could draw its representatives from the following bodies: The Registrar of Financial Markets, Bank of Namibia, Investment Management Industry, Issuers, Commercial and Investment Banks, Intermediaries/brokers, Custody Services/Transfer Secretary and Auditing or Legal firms.

The paper presented by Mr. Lawless, was discussed by Mr Tony Edmunds. The discussant paper cited the fragmentation of the market participants as a key issue curtailing liquidity in the market. Furthermore, the paper highlighted the need for intermediaries to bridge market segments and positions of different players, as well as the need for market making by either the private sector or the Bank of Namibia. The paper concluded by emphasising that for efficient trading in the market, the Bank of Namibia and NAMFISA would need to devise a proactive regulatory approach.

The last paper presented by Professor Nicholas Biekpe, dealt with the "General policy environment for the development of a bond market: Lessons from other developing countries". It suggested that the way forward in terms of developing the bond market in Namibia is to conduct a feasibility study to determine whether there is a financial or economic need to establish a bond market.

The paper by Prof. Biekpe, was discussed by Mr. Tom Minney. The discussant argued that most of the necessary conditions of the development of the bonds market are already in existence in Namibia. The paper echoed the lack of liquidity as a serious constraint to the development of the market. Further the paper suggested the following measures to address the liquidity constraints. There is a need to develop and reward

Namibian skills in the local capital market. Government should concentrate on encouraging demand for capital, through investment facilitation and tax incentives for profitable investment. There is a need to make the market accessible by creating mechanisms through which all interested parties who have sufficient resources to settle their trades can be allowed to participate in the market. There is a need to build common and accessible trading platforms and market and allow access to the widest possible range of participants including players in neighbouring countries.

OPENING REMARKS BY MR. TOM ALWEENDO

GOVERNOR OF THE BANK OF NAMIBIA

AT THE SIXTH ANNUAL SYMPOSIUM

Board Members of the Bank of Namibia, Distinguished Guests, Ladies and Gentlemen, it is with great pleasure that I welcome you all to the sixth in the series of Bank of Namibia Annual Symposia. First, allow me to extend my very warm greetings to all our guest speakers. We are very fortunate to have two practitioners in the field from the South African bond market, Mr. Tom Lawless and Mr. Mike Sandler and a well-known professor in this field from the University of Stellenbosch in South Africa, Professor Biekpe. To our discussants and invited guests, let me thank you for honouring our invitation. I also want to acknowledge the presence of our guests from South Africa who have shown a keen interest in this very important event.

The theme for this year's annual symposium is "The Challenges for the development of Namibian bond market: Lessons from other smaller economies". It is a challenging subject in an increasing globalising world, but certainly not new to the Bank, in its capacity as advisor to Government, and as issuer and manager of government debt instruments. The Bank has chosen this theme with a view of taking stock of the existing arrangements, instruments and markets and to pave the way forward for enhancement of effective and liquid bond market in Namibia.

The role and importance of the bond market in economic growth and development is well documented in the economic and financial literature. A well-functioning and developed bond market stimulates economic activities through the provision of appropriate finance to various development projects that are crucial to economic growth. By providing an appropriate framework for the trading of long-term securities, it creates a favourable and pivotal platform for the development of a stable and efficient financial market. A sound bond market provides a stable and reliable source of finance for both government and non-government borrowers and a secure and flexible investment mechanism for investors.

Furthermore, the bond market provides a more transparent and in some ways more effective way of pricing and distributing risk. An effective bond market contributes towards financial system diversification, and reduces the concentration of risk in the banking system. Furthermore, it facilitates the repricing and reallocation of risk as economic and financial circumstances change. Therefore, in the Namibian context, there is no gainsaying that a well-developed bond market will help to retain substantial domestic savings currently invested abroad. In addition, it will also attract more foreign investors. Moreover, it will address the problem of over-reliance on short-term funds and bring a balance in the financial sector between banking system, i.e. the money market, and the capital market.

We must realise that the absence of a well-developed bond market of sufficient size could have adverse effects on the economy, especially in the event that the economy is confronted with a financial crisis. For instance, it has been argued that the absence of a well-developed and deep bond market was one of the main factors behind the extreme volatility that precipitated the Asian financial crisis. The aftermath of the crisis had spurred governments in the region (especially in Asia) to focus on bond market developments. I believe all of us have that recollection of the adverse effect the crisis has had on our economy.

However, our focus today is not merely on the role of bond market in the process of economic development, but also on the challenges and policy environment for the development of the bond market. Among the challenges facing Namibia in developing her bond market is the small size of the domestic market, which limits the amount of funds that our government and local corporation would need. Other challenges include a need to have a true benchmark yield curve, a more liquid market, a widened issuer and investor base, and risk management instruments, which are critical to the success of the bond market.

Ladies and gentlemen in conclusion, it is my sincere belief that through our interaction today, very useful policy deductions will emerge that will assist in addressing the challenges facing Namibia in developing our bond market. Finally, let me also add that the development of bond market should be rather seen as a collective effort between the Bank of Namibia, Government and all market participants.

I wish you all very fruitful deliberations.

Thank you.

AN OVERVIEW OF THE NAMIBIAN BOND MARKET

PHILLIP SHIIMI

BANK OF NAMIBIA

1. INTRODUCTION

At independence the bond market in Namibia was virtually non-existent as there were neither bonds on issue nor any form of market infrastructure. To aid the development and growth of the local economy, the Government of the Republic of Namibia in conjunction with local market participants from various sectors in the economy has been aiming at developing the local bond market. More specifically, the Government put the development of the local money and capital markets in the national development agenda in the First National Development Plan (NDP1). As a result Government instituted several measures to develop the market. The ultimate objective of developing the local bond market is to ensure continuous access to funds in the market at affordable prices to develop the real economy.

The challenge of bond market development in Namibia is best appreciated from a historical perspective. Prior to independence Namibia was administered as a province of the then South Africa. However, investment in financial market infrastructure and human resources and the welfare of the majority of its people were not a priority and the citizens were deprived of economic opportunities. This culminated into a small economy dependent on imports from South Africa, whose growth was largely a function of the primary and Government sectors. The financial and payment systems were heavily integrated with those of South Africa, and ownership of productive assets by Namibians was limited.

Bond market in Namibia was virtually non-existent and the financial system was dominated by urban based commercial banks, and insurance and pension funds that mobilized deposits and contractual savings that were hardly put into productive use in Namibia’s real sector but were rather directed to uses in the South African economy.

This resulted in a peculiar situation where Namibia became a net exporter of capital to South Africa and importer of consumer goods.

At independence, therefore, the Namibian Government inherited an economy that presented challenges of reviving and sustaining economic growth, creating employment, reducing inequalities in income distribution and reducing poverty. These challenges formed the basis of national objectives and strategies as outlined in the First National Development Plan (NDP1).

These historical developments left Namibia with an enormous task to develop its financial markets to a level that makes it instrumental to the process of economic growth and development. For these reasons, Namibia identified the following objectives of developing its financial system in NDP1: to maintain a stable, sound, competitive and efficient financial system that enjoys national and international confidence, and facilitates economic development consistent with national development objectives. Other objectives were to develop Namibia as a financial centre that provides a full range of financial services to the Southern African region, encourage high rates of savings and investment in Namibia, and secure equitable access to financial services.

This paper aims at providing a descriptive overview of the Namibian bond market which is the market for long-term debt. In the section two the paper looks at current state of the local bond market, followed by an outline of measures taken to develop Namibian capital market discussed in section three. Section four outlines current challenges, while section five concludes the paper.

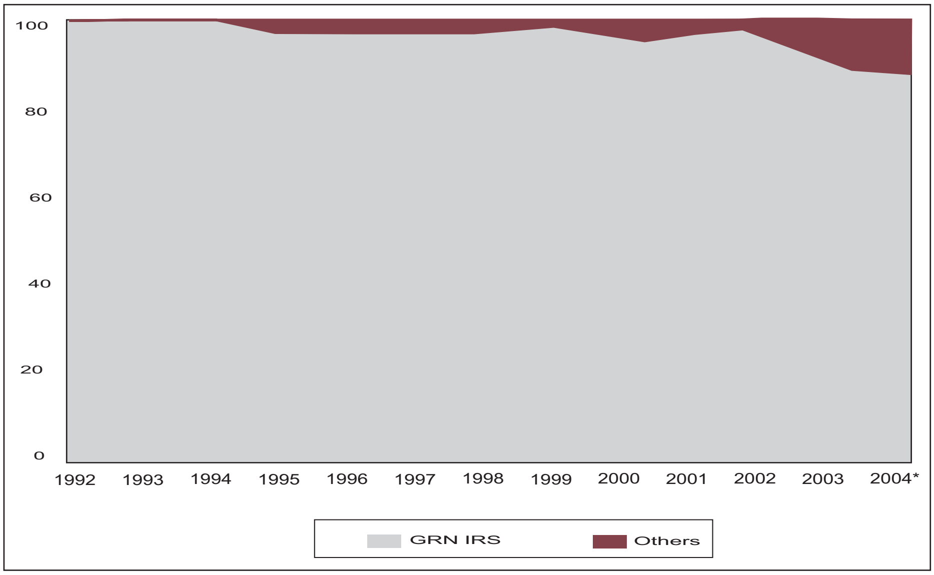
2. CURRENT STATE OF THE NAMIBIAN BOND MARKET[1]

Debt securities issued in the local capital market increased and some financial institutions emerged as a result. Now the Namibian capital market offers a range of long-term financing instruments. Major interest-bearing securities issued in the Namibian capital

[1] Due to limited information, this section may not necessarily cover the entire bond market in Namibia. However, it covers largest known issuers.

market are Government of the Republic of Namibia's Internal Registered Stocks (IRS) and debentures issued by parastatals such as Agricultural Bank of Namibia, Road Fund Administration, National Housing Enterprise and Air Namibia. The private sector has also issued some bonds in the market. However, the Government papers take up a large proportion of papers issued in the long-term securities market in Namibia (Chart 1).

Chart 1: Total composition of debt (percentage)



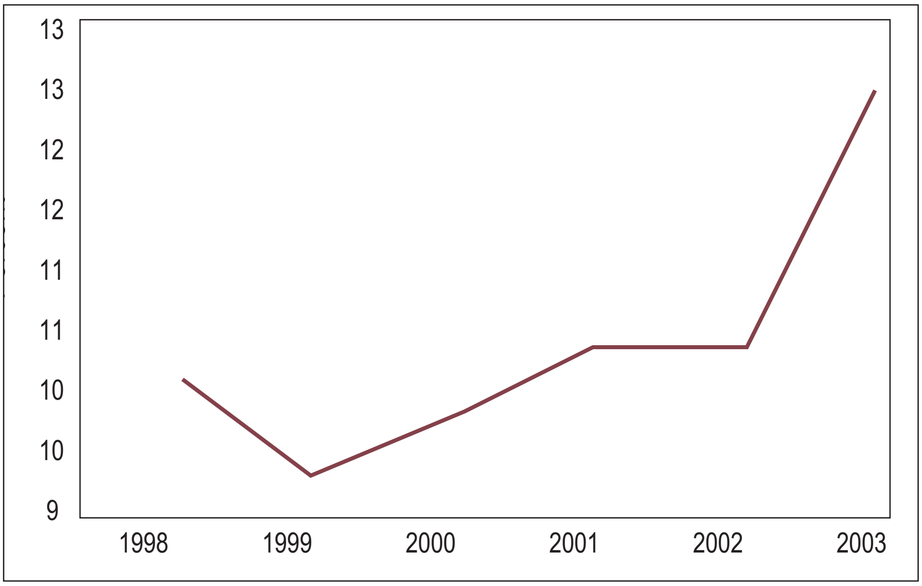
Source: Bank of Namibia, Brokers & Issuers

Deficit units (borrowers) in Namibia are the Government of the Republic of Namibia, parastatals, and private and public enterprises. Surplus units (lenders) include the Government Institutions Pension Fund, other parastatals, development funding agencies, private and public institutions, and individuals.

Between borrowers and lenders there are institutions that provide intermediary and auxiliary financial services. On the one hand, intermediary services are provided by commercial banks, building societies, pension funds, short and long-term insurance companies, mutual funds, unit trusts, etc. On the other hand, the Namibian Stock Exchange, stockbrokers, asset management companies, etc provide auxiliary services.

Except for 1999, the growth of amounts outstanding in Namibian bonds as a percentage of GDP has rather been gradually increasing (Chart 2). This indicates that relative role that the bond market plays in the Namibian markets has been increasing gradually.

Chart 2: Total amounts outstanding in bonds as a percentage of GDP



Source: Bank of Namibia

a. Government Bonds

As noted earlier, the Government adopted a policy to fund its deficit in the local market with the view to develop the local financial markets. The first Namibian bonds were issued in 1992. These bonds were initially issued with original maturities not exceeding 6 years.

By 1998, 13 Government Internal Registered Stocks with various maturities and coupon rates were issued, but secondary trading remained sporadic. In order to lengthen their maturity structure, to enhance their liquidity and create local benchmark instruments, most of these bonds were later consolidated in 1998 into three major bonds namely GC02, GC05 and GC10 maturing in 2002, 2005 and 2010, respectively. In April 2002, the Government issued GC07 and GC15 due in 2007 and 2015, respectively. Currently the Government has four bonds in issue (Table 1).

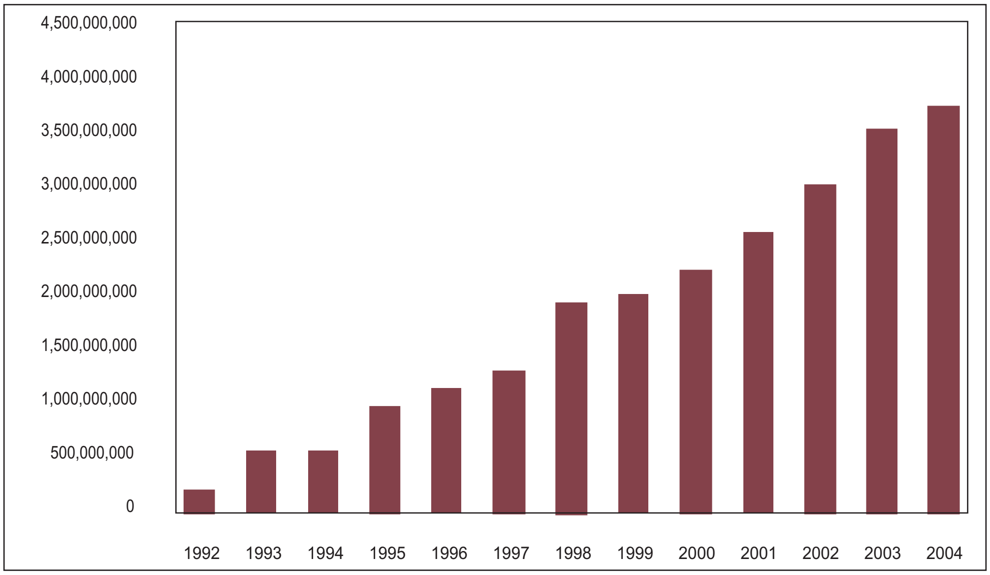
Table 1: Internal Registered Stock

IRS	GC05	GC07	GC10	GC15
Issue Date	May 1998	Apr 2002	May 1998	Apr 2002
Maturity Date	Apr 2005	Jul 2007	Jan 2010	Apr 2015
Coupon Rate	12.0%	12.50%	12.0%	13.0%
Coupon Dates	15 Apr 15 Oct	15 Jan 15 Jul	15 Jan 15 Jul	15 Apr 15 Oct
RSA benchmark	R150	R194	R153	R157

Source: Bank of Namibia

The amount outstanding in Government IRS has been increasing steadily since the first stock was issued in 1992. IRS increased from N$50 million in 1992 to N$4.1 billion in June 2004 (Chart 3).

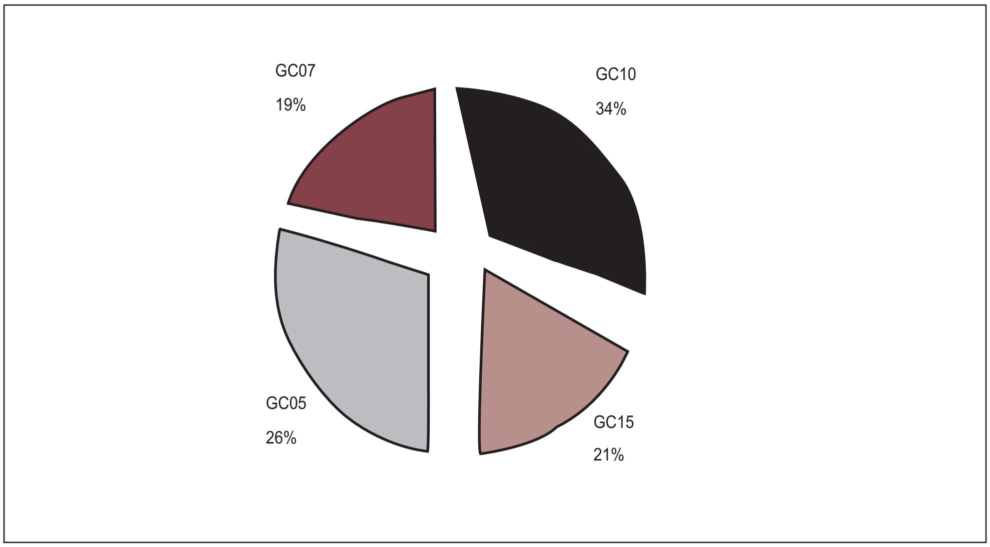
Chart 3: IRS Outstanding (in billion Namibia Dollar)



Source: Bank of Namibia.

At the end of May 2004, amounts outstanding in IRS are fairly evenly distributed across the four stocks in issues (Chart 4). GC10 has the largest share (34 percent) of the four bonds followed by GC05 (26 percent). GC15 and GC07 have the smallest share in the amounts outstanding of 21 per cent and 19 percent, respectively.

Chart 4: Distribution of amounts outstanding IRS (percentages)



Source: Bank of Namibia

b. Other Papers issued by Non-Central Government

Following the Government policy to provide guarantees on papers issued by the state-owned bodies, at least three Government-owned bodies issued some debentures in the local market (Table 2). In addition to parastatals issued bonds, two Namibian Banking Institutions have also issued bonds.

Table 2: Non-Government Bonds

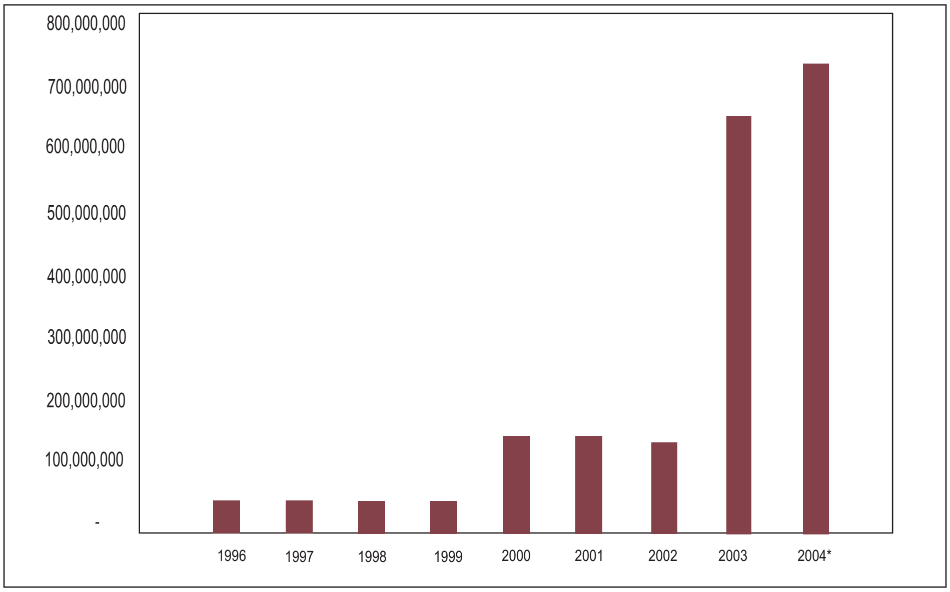
	Issue Date	Maturity	Coupon Rate	Coupon Dates
Air Namibia[2]	Apr 1999	Apr 2004	15% 29 Oct	29 Apr
Agricultural Bank	Jul 1996	Jul 2006	15% 15 Jul	15 Jan
Road Fund Administration	Feb 2003	Nov 2010	13% 21 Nov	21 May
Standard Bank Namibia	Nov 2000	Nov 2011	12% 20 Nov	20 May
Bank Windhoek	Feb 2004	Feb 2014	11% 04 Aug	04 Feb
National Housing Enterprise	Oct 1996	Oct 2006 STD prime rate	81% of 31 Oct	30 Apr

Source: IJG, NSX & Various issuers.

Amount issued in the Non-Government bonds have been growing steadily. However, there was rapid jump in amounts outstanding in 2003 and another increase in 2004 (Chart 5).

2 Air Namibia bonds matured in April 2004. It is worth noting that not all the total amounts or bonds were listed on the Namibian Stock Exchange.

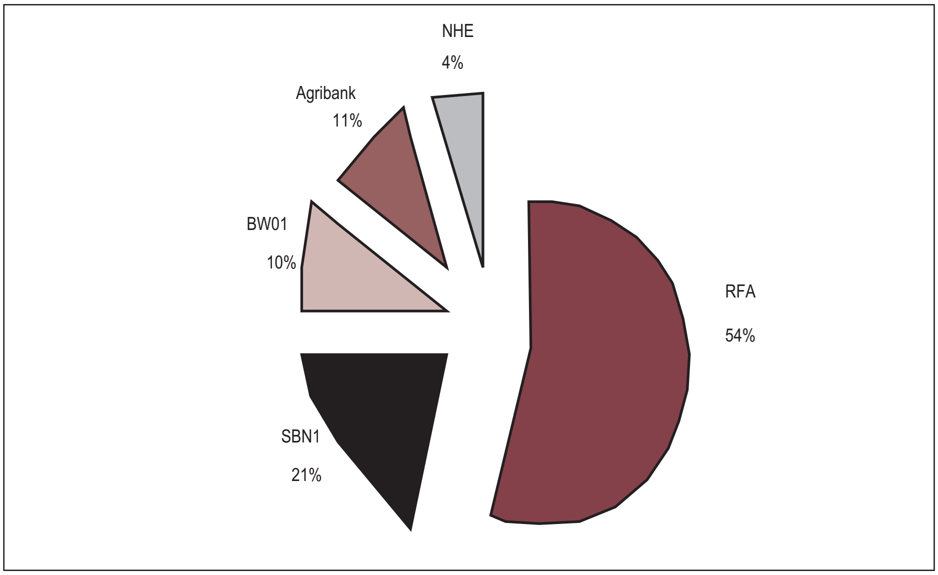
Chart 5: Amounts issued in Non-Government bonds (Namibia Dollar)



Source: IJG, NSX & Various issuers.

Non-Government paper issues are by far dominated by Road Fund Administration paper which takes up a 54 percent share in this category (Chart 6). A paper issued by Standard Bank of Namibia takes up 24 percent of the amount issued by Non-Government institutions.

Chart 6: Distribution of amounts outstanding in Non-Government bonds



Source: IJG, NSX & Various issuers

3. ORGANIZATION OF THE MARKET

The primary market practices for Non-Government bonds issued in Namibia varies from one issuer to another. In its role as the agent for issue and management of Government debt securities, the Bank of Namibia issues Government bonds on behalf of the Government of the Republic Namibia. Based on the pre-issued calendar, the Bank of Namibia invites tenders for Government securities in newspapers, by e-mail and on Reuters page (BONNA2). After receiving bids, the Bank of Namibia processes tenders in the Dutch Auction style and then the Government approves the tender results. The Bank of Namibia also performs the settlement agent role for Government debt securities. In addition, the Bank maintains a register for Government debt securities. Practices on Government debt securities market are summarised below (Table 3).

Table 3: Conventions in Government Debt securities Market

Item	Bond Market
Coupon	Semi-annual
Special price calculation	Yes
Ex-interest (days)	Yes
Accrual basis	Actual
Year basis	Actual/365
Settlement date	T+2
Value date	Settlement date
Settlement on coupon date	Cum-interest
Holidays	Namibian Public Holidays
Interest payments or maturities falling on non-working days and holidays	Payment made on next working day and no compensation
Quotation:	
Primary market	Yield to Maturity, settlement in values
Secondary market	Yield to maturity, settlement in values
Tick (quotation):	
Primary Market	Basis points (%)
Secondary market	Basis points (%)
Rounding Convention	
Primary Market	3 decimal places (%)
Secondary Market	3 decimal places (%)
Tax	Yes – according to Income Tax Act
Denomination:	
Primary Market	Minimum of N$50,000, Multiples of N$10,000
Secondary Market	Minimum of N$10,000, Multiples of N$10,000
Business Days	Monday – Friday
Issuance	Internal Registered Stock
Transaction costs	Varies
Limits to secondary trading days before maturity	No transfers allowed five working

Source: Bank of Namibia

Bonds in the Non-Government bond markets are issued through middlemen such as stockbrokers and/or issued directly by companies, banks or parastatals themselves. Settlement and custodian arrangements are agreed upon by parties and mostly made through settlements agents as appointed by contracting parties.

4. MEASURES TAKEN TO DEVELOP NAMIBIAN CAPITAL MARKETS

After independence, Namibia made considerable efforts to develop local capital market. Efforts to meet challenges of capital markets development include the following.

a. Liquid asset requirements

Liquid asset requirement compels banking institutions to hold cash, Government securities and parastatals' papers. The primary aim is to satisfy sound banking practices, while the secondary aim is to assist in developing local capital markets by encouraging the demand for local financial assets.

b. Domestic Investment Requirement

The Government introduced local investment requirements applicable to insurance companies and pension funds to invest 35 percent of their total assets in domestic assets[3]. The objective is to retain funds that go out of the country in the form of contractual savings and make such funds available for domestic investments. This regulation formed important pillar of the NSX, stock broking firms and has succeeded in the development of local asset management companies.

c. Issuing of Government Securities

In the early 1990s, the Government of the Republic of Namibia took a conscious decision to issue Internal Registered Stock (Government bonds) in local capital market. The objectives of this decision were twofold:

- to fund its budget deficit in the local market

3 Regulation 143 under the Short-term Insurance Act no. 4/1998 and Regulation 145 under the Long-term Insurance Act no. 5/1998, replacing Regulation34 under the Insurance Act no. 27/1943 (as amended in no. 59/1995); Regulation 28 under the Pension Fund Act no. 24/1956 (as amended in no. 103/1994).

- to facilitate the development of the local capital markets by issuing securities that would serve as a benchmark for private, corporate and public securities

d. Supporting the issuing of parastatal bonds

The Government does not only support the local bond market development by issuing its own papers, but also support the market development by providing guarantees on debt issued by parastatals. Through this process, the Government has facilitated the issue of non central Government papers which forms a significant part of bonds in issue in the local bond market.

e. Collective efforts with other stakeholders

The Government forged partnership with the private sector and other stakeholders in the Namibian economy to develop the local capital market. In 1997 stakeholders in the Namibian capital market collectively, through aid from an international funding agency SIDA, set up a country model plan called EMERGE 2001.

The aim was to “develop local capital market to make Namibia an investable country by 2001, and to develop the financial market to ultimately increase Namibia’s GDP per capita”. It was envisaged that this would be achieved by informing the general population, decision-makers and the market players about the characteristics of an efficient market and to be actively involved in the processes, which could stimulate the development of markets. However, this initiative was short-lived.

f. Pricing and Trading

To facilitate and improve pricing in the primary market and secondary market trading of the Government of the Republic of Namibia Internal Registered Stock (IRS), the Government has consolidated eleven outstanding IRS into four benchmark bonds in 1998. In addition, the Government has benchmarked these bonds against most liquid South African Government benchmark bonds. In addition, the authorities are considering the possibility of sovereign credit rating to improve pricing of IRS.

Furthermore, authorities are considering possible suitable model to develop secondary the secondary market through some form of market making or any hybrid form of market making. This could be done either by the private and/or Government through its agent – the Bank of Namibia.

5. CURRENT CHALLENGES

a. Liquidity[4]

Namibian capital markets are well developed in terms of existing infrastructure, but a number of challenges still have to be met. For example, we still have to activate secondary market trading and improve market liquidity. Although trading activities on the stock exchange have been rising in recent years, the ratio of bonds traded to amounts of bonds outstanding is still very low. The high ratios recorded were only 8 percent and 11 percent in 2002 and 2003, respectively (Chart 7). This ratio was below 1 percent in previous years.

Lack of liquidity can amongst others be attributed to:

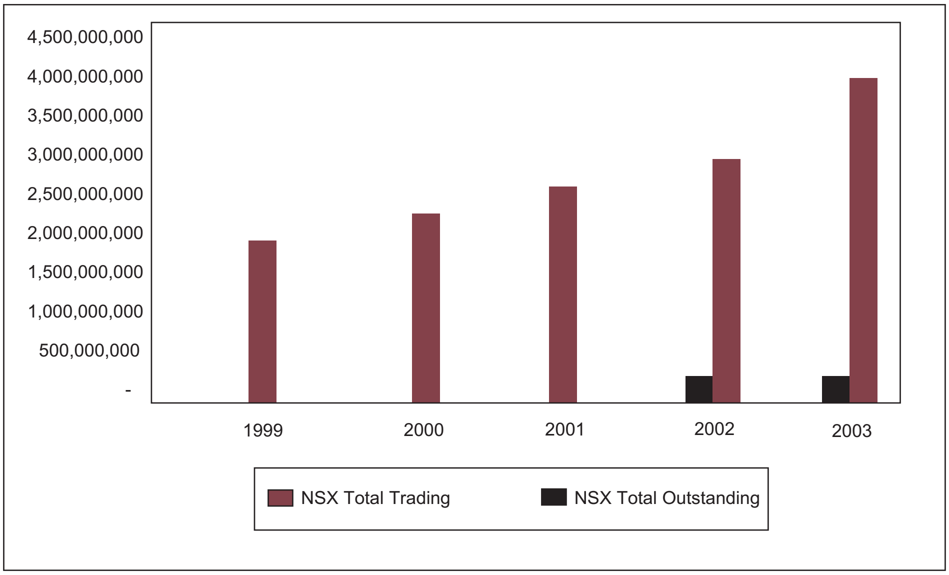
√ Domination by large institutional investors who have taken a buy and hold attitude following large demand for Namibian financial assets.

√ Limited number of issuers and narrow range of instruments available in the local capital market.

√ Lack of clear country benchmarking associated with absence of sovereign credit rating.

4 Liquidity is a measure of ease with which bonds can be traded in the secondary market. It is measured by the ratio of value traded in bonds to market capitalization or the market value of bonds in issue.

Chart 7: Total trading vs. Total Amounts Outstanding (in billion Namibia Dollar)



Source: Namibian Stock Exchange.

b. Transparent and Efficient Trading System

While most of the bonds issued in Namibia are listed on the Namibian Stock Exchange (NSX), trading remains sporadic and market is illiquid. In addition, there are bonds traded over-the-counter. This segregated the market such that there are neither fully transparent price indications in the entire market for bonds nor full information on volumes and values traded in the entire market[5]. For this reason, the market has no continuous access to market-wide historic and live market information.

c. Limited Supply of Bonds

The number and size of bonds available in the Namibian bond market are limited and their size relative to that of the Gross Domestic Product is limited to about 11 percent. It is probable that the limited bonds and other financial securities in the local market

5 However, the NSX ppublishes a part of market information on a daily basis and all historic database on these trading is available on the NSX website.

contribute to low levels of liquidity in the market as it results in buy and hold strategies by asset managers. This implies that a number of viable institutions and companies should be encouraged to issue bond in the market to increase the number of available bonds. This would not only increase the diverse number of bonds issued but may also improve liquidity in the market.

d. Foreign Participants

Currently there is said to be limited foreign participation that could introduce diversity in the market. Increasing the marketability of Namibian financial assets could be a solution to attracting active foreign participation in the local bond market. This may imply that the country may need to seek a sovereign credit rating to enhance the international benchmarking of the country. This would encourage foreign investors to invest in Namibian bond market and bring diverse views in the local market.

e. Market Making

While liquidity lacks in the Namibian bond market, there is no market making for any of the securities issued in the local market. Once again, issuers and prospective entrepreneurs should explore the possibility of any arrangements for market making in the market to improve market liquidity.

f. Outflow of funds

Traditionally, the CMA arrangement has motivated the flow of funds to the better-developed financial markets in the Republic of South Africa. Therefore, such funds do not have a multiplier effect on the local real sector. The country's developmental efforts suffered as a consequence and this restricted the development and diversification of the local capital markets.

6. CONCLUSION

Since independence, the Government of the Republic of Namibia has introduced policies, regulations and incentives to develop the local bond market. Fruits of these efforts manifest in growth of the local bond market from its nascent stage to its current state. Main issuers in the bond market are the Government of the Republic of Namibia, parastatals and banks. However, the Government bonds dominate the market by far.

Although the local bond market has grown significantly compared to independence, a lot is still left to be desired in terms of liquidity, transparency, efficient market trading and infrastructure, number and size of bonds in the local market. The limited market development is attributed to lack of active trading, limited supply of bonds, lack of skills and diversity in the market.

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END NOTES

[i] South African Bond Exchange formula is used for the Government of the Republic of Namibia Internal Registered Stock (IRS).
[ii] Securities are priced ex-interest during the period from the closing date of the register to the next coupon date. The register normally closes on the same calendar date of the preceding month to coupon payment date. E.g., if the coupon date is 15 April, the register would close on 15 March. Thus, in this example from 15 March to 15 April, securities would be priced ex-interest i.e., after the closure of the register, the IRS will be priced ex-interest. However, trade settling on the register closure date is cum-interest. When the stock is sold ex-interest, the buyer does not receive coupon interest, but is compensated by the seller by paying less i.e., clean price less accrued interest.
[iii] Individuals and non-resident entities are exempted from paying tax on the Government of the Republic of Namibia's Internal Registered Stock (Income Tax Act No. 24, 1981). See a section on taxation.
[iv] Exceptions might occur during Government debt restructuring e.g., switches, conversions, consolidations, etc.
[v] Government of the Republic of Namibia's Internal Registered Stock are listed on the Namibian Stock Exchange, while treasury bills are not traded on a formal platform.
[vi] see note no.9.

DEVELOPING A BROAD BASED AND WELL FUNCTIONING PRIMARY BOND MARKET IN NAMIBIA

MIKE SANDLER

MD, FULL VALUE FINANCIAL SERVICES, RSA

1. INTRODUCTION

Since the "Emerging market" crisis in 1998, an increasing amount of attention has been focused on the relative roles of the banking sector, the capital markets in general and the bond market in particular, in these developing or emerging economies.

The purpose of my discussion today is to share with you my views on how the bond market in Namibia can become more vibrant, thereby satisfying the needs of both the issuers as well as the investors.

The views expressed today are based upon my experiences over many years as a bond trader, as well as from my observations of bond markets in both developed and developing countries.

A Vibrant and Well Functioning Bond Market

Why is it necessary to have a vibrant and well functioning bond market? Is this market a "nice to have" or is it a "need to have"? I am sure that the academics amongst the audience can come up with a whole host of reasons. I have endeavoured to be as pragmatic as possible and have therefore summarised the main arguments as follows:

2. THE BOND MARKET OFFERS AN ALTERNATIVE SOURCE OF FUNDING DEBT

The crisis in 1998 reiterated the view that over reliance on bank lending for funding requirements exposes the economy to the risk of a failure in the banking system. The presence of an active and efficient bond market facilitates an alternative means of raising debt capital. Borrowers no longer have to rely on the banks for funding but can tap all available resources – life companies, fund managers, high net worth individuals etc.

3. LOWER COST OF CAPITAL

There have been many studies on the optimal and most cost efficient sources of funding in the corporate market. Many of these studies have shown that, generally speaking, the cost of debt is far lower than the cost of equity. This would certainly be the case where the bond market is efficient. In fact an efficient bond market could reduce this cost even further. Lower borrowing costs should have a complimentary spin off into the economy as a whole as it effectively means that prices should be lower and that there are more funds available for other investments.

4. DISINTERMEDIATION

By gaining direct access to the investors, issuers can bypass the banks, thereby further reducing their funding costs. There is another significant benefit to disintermediation. The banking sector per se, is typically loathe to lend unsecured funds for a long period of time. Banks generally like to lend short. Borrowers however, might require longer term funding for whatever reason. In other words there is an inherent funding mismatch – for which the borrowers are certainly paying a premium. An efficient bond market can facilitate this longer term borrowing without having to make use of the banking sector as there are always other sources of longer term funding – life companies, asset managers etc.

5. EXPAND THE CHOICE OF ASSETS FOR INVESTORS

Without a well functioning bond market, savers and investors face a relatively limited array of asset choices. As a result of this limited choice they may turn to other less liquid investments such as property and to (some extent) equities. An active and efficient bond market would broaden the capital markets by offering investors an opportunity to invest in a wider range of assets. Not only are the number of asset classes increased but the presence of a viable bond market allows financial institutions to better manage their maturity profiles. This is of particular importance for life assurance companies and pension funds. Their massive interest rate mismatch risk between short term assets and long term liabilities can now be managed far more efficiently. An efficient bond market also promotes financial stability by contributing to a more diverse financial system.

a. Improved pricing for risk

In a one dimensional market, the pricing for credit risk, market risk, liquidity risk and the like resides with the banks. Some market participants argue that bond traders assess these risks far more efficiently and effectively than banks. One only has to watch credit spreads to verify the truth of this statement. The existence of a well functioning bond market can lead to more efficient pricing for risk. The market will decide on where to price a bond based on their perception of the risks associated with that particular issue. The immense burden of credit risk can now be shared by various market participants and not borne entirely by the banking sector.

How does one develop this well functioning and broad based bond market that I have been alluding to?

There are a number of macro- and micro economic factors to consider. Factors such as the economic environment, the inflationary outlook, the political outlook, the availability of surplus funds etc are all vitally important and must all come into play. However, to my mind the most important factor is that of liquidity. Without liquidity, one could have a bond market, but it would not be considered to be efficient or well functioning. A well functioning bond market is directly reliant on the liquidity within that market. Conversely, a liquid market is directly reliant on a well functioning bond market. In other words effective and efficient primary and secondary markets are directly correlated and one cannot have the one without the other.

I am sure that there will be a number of commonalities between my observations and the topic to be addressed by Mr. Tom Lawless. I am going to focus on the development of the primary market. Broadly speaking, the development of the primary market is dependent upon the following factors:

• the involvement of government (as the major source of bonds),

• encouraging corporates and utility companies to enter the bond market by reducing the barriers to entry,

• an efficient and effective delivery system,

• the immergence of rating agencies,

• the appointment of market makers or primary dealers, and

• the development of a derivatives market.

6. MARKET REGULATION

Before each of these factors is discussed however, an extremely important aspect to be decided upon is that of "regulation" – who is going to regulate the market? Is it going to be centrally regulated via the Central Bank in other words a top down approach? Or is the market going to become a self regulatory organization with input from all stakeholders? Or is there scope for a bond exchange? Whatever format is decided upon I would stress employing a consultative approach. Consult all the stakeholders and obtain buy – in.

Having said this however, I believe that an evolutionary regulatory process be adopted. Initially the Central Bank, as agent of the Government plays a pivotal role. Once the market has been formalised and established they should relinquish this role to the market participants in general i.e. evolve into a self regulatory body. Only once the volumes warrant it would an exchange be viable and therefore be established.

a. Involvement of Government

A broad based market is just that – broad based. Broad in terms of the tenors (or time to maturity) of the issues as well as broad in terms of the number of issuers. The government is in the difficult position to decide what to issue and for how long. Government bonds are generally accepted as the benchmark issues. Too few maturities stifle or hamper the construction of the yield curve, whilst too many maturities can blur the focus thereby affecting liquidity etc. At present the Namibian government has been focusing its' maturities to almost mirror their South African counterparts. Initially this in itself is not a bad idea as the South African bonds almost act as a benchmark against which the Namibian stocks are priced. Essentially however the idea is for Namibian bonds to "stand on their own". A downside to this is the fact that these few maturities result in a relatively short yield curve with a number of large gaps. Government should also be at the forefront of developments such as the appointment of primary dealers and the immergence of a derivatives market – more on which will be discussed a little later on.

b. Corporate Bonds

Corporates, and here I include semi state owned bodies as well as utilities, should be encouraged to enter the market in order to plug a number of these gaps. In order to encourage them to do so, any current barriers to entry must be carefully reconsidered. The harmful barriers include factors such as stamp duties, unfriendly tax regimes etc. In the context of emerging bond markets, existing legal, regulatory and the tax framework needs to be facilitative and supportive of ongoing efforts to develop the market. One of the methods employed in a number of markets is to standardise pre-listing or offering documentation. This standardization serves to speed up the process and also reduce the admin costs etc. Not only should the pre-listing documentation be standardised but the issues themselves should be standardised. Initially only vanilla semi annual (or annual) coupon bonds should be encouraged. (Note I say "encouraged" and not permitted – let the market decide!). Standardised products assist all the stakeholders in becoming familiar with the market and the products on offer. Too great a variety of products initially can be counterproductive. Exotic instruments such as callable bonds, putable bonds and floating rate notes can come later.

c. The Role of Credit Rating Agencies

First and foremost I believe that it is essential for the government to obtain a sovereign rating. A sovereign rating could of course be a mixed blessing. A poor rating will impact upon the entire market. No individual issuer could have a superior national rating than the government. A good rating provides impetus to the establishment of a well functioning market. In order to attract foreign players, ratings are essential. Whether you like it or not, international players are crucial for a market to become more efficient.

The sooner the rating agencies become involved the better. Initially we believed that these agencies were a necessary evil. Nowadays however, in order to compete in the global market place one must make use of these agencies. The main purpose of a credit rating is to provide investors with an unbiased and objective opinion of the relative risk of the bond issue. By having a rating attached to an issue or issuer lends credibility and substance to the issue. Due to the size of the potential market here in Namibia, I believe that the established rating agencies would form strategic alliances with potential partners or operate out of South Africa – whichever method chosen, I believe that their establishment must be encouraged.

d. Efficient and Effective Delivery System

A robust clearing and settlement system is vital in the development of an efficient bond market. These are necessary in order to reduce the risks associated with settlement. I'm sure that Tom will mention this but a reliable system is also vital for secondary market trades. Remember that in order to develop a broadly based primary market there must also be an efficient and vibrant secondary market.

A number of countries have enhanced their clearing and settlement systems by initially demobilising their scrip and thereafter dematerialising the scrip altogether.

When scrip has to be physically delivered a number of risks are immediately evident. Demobilising entails the holding of all scrip in one area – a central scrip depository. This reduces the risk of fraud (in the form of tainted scrip), it reduces the risk of theft and also reduces the settlement period, as physical delivery no longer needs to take place. Dematerialisation takes this process one step further by doing away with physical scrip altogether. All trading and scrip holding accounts therefore become electronic accounts.

One may ask why this is necessary. Improved settlement efficiency will enhance and improve the secondary market which in turn will broaden the primary market. Investors no longer have to worry about holding and storing the physical scrip, settlement is enhanced and all stakeholders should be more comfortable with the entire process.

e. Appointment of Market Makers or Primary Dealers

Market makers or primary dealers fulfil an extremely important role in both the primary and secondary markets. From a primary market point of view, the primary dealer acts as the issuers interface into the market. The issuers generally consult with their primary dealers concerning new issues, strength of demand etc. All bids for bonds are channelled via the primary dealer. Primary dealers are compelled to bid for bonds – they almost underwrite the issue. In the secondary market their function is to continually make 2 way prices. To find primary dealers or market makers is not always an easy task. There are certain risks inherent to being a primary dealer. An interface is however required. Investors want to know that if they wish to purchase bonds – they will be able to do so. Conversely they want the comfort that if they require to dispose of these bonds, they will similarly be able to do so!

From the Government's point of view, being the largest issuer they should appoint two or three primary dealers. However in a small and illiquid market they will struggle to find the appropriate parties. I would therefore recommend that the Central Bank, acting as an agent temporarily fulfils this function i.e. create a market in government bonds. I must stress that this should only be a short term solution. It is not really the function of the central Bank. However, until the market participants get used to the idea of market makers they should act in this capacity. Another reason for this stop-gap approach is so that potential market makers will have some idea as to what will be expected of them, what the potential is for being a market maker as well as the potential pitfalls.

f. Development of a Derivatives Market

Before a number of you start shaking your heads because you have heard all the horror stories regarding this term "derivatives" allow me to qualify this statement. I believe that a derivatives market is a natural extension to an efficient primary bond market. Options, futures and floating rate notes will enhance and improve the market efficiency. I believe that the authorities have a responsibility to encourage the various stakeholders to think beyond vanilla products. Having said this however these are not necessarily the derivatives that I have in mind. The first derivative product that I believe should be encouraged is the development of a repo market. You are already familiar with repos – that is how commercial banks refinance themselves through the Central Bank. Repos in the bond market assists in two specific types of transactions. Firstly purchasers of bonds are able to refinance themselves using the bond as collateral, thereby improving liquidity. In other words purchasers can gear themselves and therefore could invest on multiple occasions rather than only on one occasion.

Repos also facilitate the shorting of bonds i.e. selling a bond that you do not own. This notion might be frowned upon. In a number of markets this ability to "short the market' is outlawed. I believe that it is a vital tool in sophisticated markets. If a trader believes that interest rates are about to increase he/she should be able to act on this view and be able to sell the market short. They must however deliver the bonds which they have sold. As they do not own the bonds they will have to borrow the scrip from a current bond holder. This would be facilitated via the repo market. In this case the cash will be used as collateral to borrow the bonds required for delivery. The authorities must make allowances for this to occur.

There are of course a number of other factors such as withholding tax on foreign investors, capital gains tax; the tax free status on certain bonds etc that time precludes me from discussing in detail. Perhaps I could just mention my ideas on tax free bonds. I believe that municipal authorities should be in a position to issue bonds having a tax free status. Municipal bond issues reduce the funding burden on the Central Government and will also ensure that the various authorities maintain a tight reign on their finances and financial control. Below par municipal authorities will find it difficult to raise funds in the market, despite their tax free status, and will therefore have to obtain more expensive funding from the Central Government itself.

To conclude therefore I have drawn up a short "to do" list which I believe should be immediately implemented.

1. Namibia must obtain a sovereign rating. Whilst this is neither quick nor easy, it is a vital aspect necessary to attract international interest in your market. Thereafter, I would strongly suggest that current and potential issuers also seek a credit rating.

2. Abolish any form of prescription regarding investments in government stock.

3. Government, the Central Bank as well as all other interested parties should get together to form an association of Bond Issuers and Dealers. This association should be tasked with formulating the requirements for issuing entities, the education or

qualification requirements for traders in the bond market and whether or not traders should be registered as such and also to discuss the aspect of how and by whom the markets will be regulated.

4. The delivery system should be reviewed and revised if necessary. Move away from physical scrip and into electronic or dematerialized scrip.

5. Standardise the documentation required from those entities wishing to issue bonds. This will shorten the entire process and make it cheaper for the issuers. What is also bound to happen is that a number of potential issuers will then put everything in place and maintain the issue as a shelf product – thereby having all the documentation already in place for when the opportune moment arrives for the issue to take place.

6. Allow for short selling to take place. Although this is essentially a secondary market issue, it certainly makes the market more sophisticated and improves the functioning of the market as a whole.

7. Finally another secondary market issue. The Central Bank must either appoint a market maker or primary dealer for Government stock, or they must themselves become this primary dealer.

What I have attempted to describe here today are pragmatic steps that can quite easily be implemented. A vibrant and broadly based bond market is vital for the evolution of the Namibian financial markets as a whole. The sooner these steps are implemented the better.

Thank you for inviting me to address you today and for listening to what I have had to say.

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COMMENTS ON DEVELOPING PRIMARY BOND MARKET IN NAMIBIA

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This discussion paper addresses key issues pertinent to bond market development. In particular it emphasises the role of the primary market dealers in the development of a broad based efficiently functioning bond market. The discussion paper is meant to emphasise certain issues that are already covered by other papers meant for this forum, on one hand. On the other, it attempts to cover gaps that others might have left or alternatively give a different angle of thinking on certain issues in the primary market dealership.

Before we go deep into the issues, it is best to cover the building blocks of the bond market, most of which are already in place in Namibia. This implies that a certain foundation is already in place and one may merely seek to strengthen or build on it.

Building blocks: Invariably, the following should be present or likely to be instituted before looking at appointment of primary dealers.

(a) there must be bonds issued or a credible sizable institution willing to issue bonds (this issuer is normally the government).

(b) the bonds must be of a relatively good quality

(c) the size must be enticing in the eyes of the primary dealer and other incentives should be in place.

(d) there should be borrowers that want funds, lenders seeking to invest, and facilitators (primary dealer) willing to facilitate or invest—the risk/return appetite of the lender and borrower must meet either immediately or in the near future.

(e) There is or there will be regularised issues and good volumes—if primary market is not properly structured, a proper secondary trading market will not develop. However, a properly structured primary market does not necessarily automatically lead to development of the secondary market.

Expected Outcome of Primary Dealership System: Suppose all the building blocks are in place or can be reasonably assumed that they can be put in place in a relatively short time, what is the expected outcome of a successful primary market dealership in government securities? The following issues may be regarded as key outcomes:

(a) Yield curve

(b) Real risk free interest rates serving as benchmark to the whole market

(c) Market liquidity

(d) Improve central bank's liquidity management efficiency

(e) increase in number of participants in the market

(f) improvement in debt profile

All the above are gains not only for the issuer but also the investors, other issuers, and the whole financial market.

Are There Impediments to Market Development?

(a) Volumes: does the Namibian market have necessary volumes that will prevent the attitude of buy-and-hold amongst investors? This question may best be answered by looking at the make-up and concentration of bonds with investor that may not be active traders in the secondary market.

(b) Concentration risk: see the point above.

(c) Foreign Investors: In many countries, foreign investors are credited with increasing liquidity in the domestic markets. But they are also often blamed or associated with increasing volatility in the market. One of the attractions and possible requirement of foreign investors is credit rating of the country. But would this really bring Namibia investors in the bond market? Two issues are worth looking at:

(i) Liquidity in the market: it is likely that if there is no liquidity in the market, foreign investors may not significantly enter that bond market—even after sovereign credit rating. A certain degree of liquidity is needed for foreign investors to meaningfully participate. In fact, foreign investors participating in an illiquid market are likely to be those who made a conscious decision to buy and hold other than wanting to sit around waiting for the market to become liquid. Thus their presence may not help liquidity.

(ii) Do we have volumes to wet the appetite of an international investor? This question needs to be considered. For example, putting N$50 million in a new issue in Namibia could well be taking up more than 1/3 of the issue. Most investors may not be comfortable with this. From another angle, N$50 million is about U$8 million. Since international investors with an appetite for emerging markets are likely to be big, this could hardly be an amount an international investor will consider putting outside the country of origin. The amount may be too little to make a meaningful impact on a sizable investment portfolio and to warrant putting aside resources to monitor the Namibian market.

(iii) Since, the investor demanding credit rating is likely to be sophisticated and the sophisticated investor looking into the emerging market is likely to be big. Sovereign credit rating may not significantly, help Namibia's bond market.

(iv) For Namibia's bond market to fully benefit from sovereign credit rating, there should be a conscious effort to market the Namibian securities to a target small section of the international market.

(d) At this stage I have probably developed or encouraged the development of a thinking that goes against sovereign credit rating. It is unquestionable that there are benefits from the country rating. What the above arguments are targeted at is the fact that the rating may not be a significant tool in liquidity development in the bond market.

If one is borrowing internationally, credit rating is required and is of assistance to create a uniform way of looking at the country and the issuer. Some of these gains go far beyond the bond market spilling onto other economic sectors of the country. As for the bond market, it will be useful for neighbouring countries, particularly South African investors, to see Namibia rated—it may just attract small investor with an appetite and can benefit from a small exposure to Namibia.

Below is Table 1 showing African countries with their credit ratings.

Table 1: Sovereign Credit Rated African Countries

	Rating By		
Country	**Moody's**	**S&P**	**Fitch**
Botswana	A2	A	Not Rated
Burkina Faso	Not Rated	B	Not Rated
Cameroon	Not Rated	Not Rated	B
Egypt	Ba1	BB+	BB+
Ghana	Not Rated	B+	B
Lesotho	Not Rated	Not Rated	B+
Mali	Not Rated	B	B
Mauritius	Baa2	BBB	Not Rated
Morocco	Ba1	BB	Not Rated
Senegal	Not Rated	B+	Not Rated
South Africa	Baa2	BBB	BBB
Tunisia	Baa3	BBB	BBB

Source: Bloomberg—10 August 2004.

(e) Structural issues: Let me also emphasise the need to ensure that structural issues are addressed. For example: dematerialization of securities and smoothening of the transfer process; relevant dispensation for market making and incentives attached there to; risk management systems; benchmark bonds; bond coupon stripping facilities, repo market, etc.

(f) Benchmark: Can Namibia have big issues that can satisfy to be benchmarks? And should that be done will be there enough to allow for an effective yield curve? What role can SA bonds as benchmark for Namibian bonds can they play? What could be done to make the role more effective? While no answers are provided to these questions here, they are relevant and should be considered.

Should there be a formal agreement for market making?

When market making is being talked about, the tendency is to think about watertight agreements demanding that market makers meet certain capital sizes, achieve certain volumes, tender for a specific minimum bond quantities, quote continuously firm two-way prices, etc. Meanwhile, the government gives an exclusive right to these entities, provide a facility to access securities easily, provide credit facilities, and pay them one way or the other for these service, etc.

There are essentially two extremes in market making and primary market development. On one extreme, we have tight agreements between government and private financial institutions. On the other, we have markets where market development is primarily driven by informal market initiatives with little government influence. Indeed, some of the markets, like Norway, that today have a formal agreement for market making come from a prolonged period of successful initiatives by the private sector.

It is a matter of choice, at tight primary market dealership and market-making agreement at the infancy of the bond market may discourage potential market makers from participating. It is also true that private initiatives without basic implicit government support and some basic incentives, disclosures, and issuance predictability may not work.

Looking at the size of the Namibian market, my inclination is to believe that a tight primary market dealership system like we see in South Africa, USA, Sweden, and other countries, may not work well in Namibia at this stage. The risk may be too high and the returns uncertain for a potential market maker/primary dealer to commit. At the same time, a more relaxed set-up as, for example, seen in Switzerland may also not work—the market may not be sufficiently properly structured and may be too small to commit resources profitably.

Therefore the country may wish to look at a system where the government gives some basic incentives that are needed for market making and the private sector pools together to make it work. Put differently, the government should merely assist the market to develop its own solutions without demanding some of the traditional tight provisions in formal primary dealership contracts.

Yes, there will be some risks to the government and generally to the market if the system is informal. For example:

(i) Market makers may abandon the activity once the yield move against them—in small markets susceptible to fluctuating and often one dimensional demand for securities, this can be a real problem.

(ii) Central bank/government will have less influence on the activities in the market.

(iii) Information may not be disseminated to government as in the formal set-up.

Below are Tables 2 and 3 showing countries that have formal market making structures and those that have/had more relaxed arrangements primarily driven by the private sector.

Table 1

Countries With Primary Dealers	Number of Dealers
Canada	45
USA	37
Ireland	6
Norway	8
UK	19

Invariably, the primary dealers have to make a market, have to participate in auctions, and some are paid for their services. Have to give specific inforation to government. May need to meet a specific size of balance sheet before participating. And may have to prove management experience in the area.

Table 2

Countries with No Primary[6] Dealers	**Observations/Arrangement**
Denmark	Market making controlled by "Voluntary market making Agreement". Securities dealers have a "Quote-on-Request Agreement"
Germany	Issues through the "Bund Issues Auction Group". Traded on stock exchange
Japan	Issues through syndication, auctions, and underwriting by MoF trust fund. Voluntarily, security dealers make the market. Government also has few brokers making market.
Holland	Issue by tap, tender, etc. Secondary trading is either between buyer and seller or through Inter Dealer Broker (a broker not allowed to take its own positions).
Switzerland	Auction free to all. Big institutions paid by government for mobilizing funds. Secondary activities left up to the market.

Objective of Primary Dealership system

Why would government want to have primary bond market dealers? With the ultimate objective of lower cost of funding, the government may pursue an agreement for primary market dealership for the following reasons.

(a) Authorities want to maximum participation in auctions, improvement of liquidity, greater competition;

6 Please note that the author did not check the latest position of these countries whether they still follow the informal set-up driven by the private sector. The point, however, is that private initiatives can go a long way to facilitate the development of the market before instituting tight primary dealership system that may be unacceptable in the initial market development stages.

(b) Want liquidity—obtained through market making continuously on demand irrespective of market conditions.

(c) Remove central bank from deal market maker once market gets going to prevent interference with monetary policy constraints and liquidity management.

(d) Prevent central bank from starting dictating prices of bonds in the market and ultimately overshadow market signals by showing prices.

Some Qualifying criteria

In variable, in most markets the following may serve as base for the selection of primary bond market dealers

- Sound financial capacity
- Be active in the market
- Have adequate management capacity
- Good relationship with authorities

Some Requirements/Obligations of Dealers:

In most instances the following form key roles expected of the primary market dealer:

- Make the market
- Support the auctions (submit bids minimum may be set)
- Stimulate retail market
- Stimulate repurchase market
- Provide the central bank with market information

Some issues that authorities may wish to know: having appointed primary market dealer, the authorities may have to deal with or face the following:

- May have to accept widening margins initially—wide spreads as market makers try to protect themselves.
- Auctions may be under-subscribed and central bank may have to support/pick-up what is under subscribed.
- May have to pay a fee if the primary dealers are underwriting the issue to cover their risk.
- If dealers are required to support retail market, authorities should ensure that that they are not under-cutting the dealers.
- May have to exclude certain institutions and individuals from participating at the primary level.
- Central bank may have to make a facility available to dealers to be able to carry out their functions. These dealers may not be banks requiring critical rethinking of exposure to non-banking institutions by a central bank.
- Keep in mind that this is a mutual dependency setup
- Too many primarily dealers lead to lower margins for participants, impairs transparency, and may become difficult to monitor. Fewer, may make it risky as due to concentration with say two dealers and may impair competition.
- May have to set a bid/ask spread—this move will be unpopular with primary dealers.

Managing Market Makers/Traders Relationship

The authorities need to manage "market makers" and bond traders in general. However, often governments assume a strong position as key player and may even call on their statutory powers. However, the tactic sometimes yields negative results. The government may therefore may wish to consider some of the mechanisms used by stock/bond issuers in the private sector who manager the relationship with their market makers who are much large then they are yet very successfully. These may, amongst others, entail getting closer to market makers, interact with them, and share with them as much information as possible.

CONCLUSION

- In this discussion paper, the key issues needed to be in place before considering appointing primary dealers in the bond market were highlighted. Most of these are currently in place in Namibia.

- It is indicated that the volumes of the Namibian government bonds on issue may be too low and therefore could be an impediment to effective market making and formal set-up of primary dealer system.

- Credit rating of the country was acknowledged as a helpful mechanism for the country to have. However, it was also indicated that due to the size of the country and the volumes on issue as well as the lack of liquidity, credit rating might not provide an immediate benefit to the bond market beyond the possible investors in neighbouring countries, South Africa in particular. The marketing drive may therefore be directed at the Common Monetary Area and the Southern African Development Community countries.

- It is suggested that Namibia engages on a non-formal agreement between the private sector and the government/central bank for primary dealers and market making. However, for this format to work there has to be some incentives from the government/central bank.

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DEVELOPING AN EFFICIENT SECONDARY MARKET IN NAMIBIA

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1. INTRODUCTION

This proposal document has been prepared for the development of a formal bond market in Namibia under the auspices of a Bond Market Association still to be formed.

The development of a bond market in Namibia deserves the high priority on the financial sector development agenda. Bond markets are a crucial catalyst for a country to achieve sustained development. Bond markets are essential to the country's financial system, adding resilience to the markets and insulating it against external shocks, contagion and providing a platform for the growth in domestic savings and a conduit for foreign investment.

The eruption of the Asian and South American crisis in the late 1990s has emphasised their importance. Over this period banks were the main conduits of foreign debt capital flows. The sudden reversal of flows through that channel caused great damage to currencies, domestic bank balance sheets and corporates. Had these funds been invested through a traded capital market outflows would have been reduced, and would have caused less harm? Since the crisis, building local currency bond markets has become an increasingly important topic for emerging markets.

The Namibian capital market has in recent years seen little progress in the way of constructive development and expansion. However, the South African bond market has shown its resilience and robustness in recent times.

The Bond Exchange of South Africa ("BESA") currently hosts one of the efficient bond markets in the world and the Namibian financial system could learn from its development as an example of what can be achieved for Namibia.

The Namibian financial market participants and regulators need to address the current impasse urgently.

2. OBJECTIVE OF THIS DOCUMENT

The objective of this document is that it could be used as a guideline by the different parties in establishing a forum to move the Namibian bond market forward as well as "check list of sorts" in order to reach consensus on the various issues which are currently delaying or in future could delay the development of the proposed NBMA and the market.

In order to achieve this it is necessary to, inter alia:-

- Define the objectives of the NBMA;
- Define a structure for the NBMA;
- Utilise this document for the development of the NBMA and the bond market;
- Identify the overall benefits of developing the bond market in Namibia;
- Address the issues of Risk Management;
- Examine the current settlement and future system; and
- Examine the trading platform available and discuss the way forward.

Bond markets are built on the premise that the needs of the various parties can be satisfied; namely:-

- a number of issuers with long–term financing needs;
- investors with a need to invest savings in interest–bearing securities;
- intermediaries that bring together investors and issuers; and
- infrastructure that provides a conducive environment for securities transactions, settlement, transparency.

3. USE OF THE DOCUMENT

This document could be used to fulfil a number of intentions:-

- To address the requirements for the NBMA within the broad macro ambit of, inter alia:-
  - Financial Markets Legislation;
  - The Registrar of Financial Markets;
  - The role of the Bank of Namibia;
  - The membership of NBMA when established;
  - The financial market structure; and the role of its participants
- To address the requirements of the NBMA in terms of:-
  - Structure;
  - Membership / users;
  - Rules & directives;
  - Trading, clearing, settlement and scrip depository systems;
  - Risk Management; and
  - Exemption until licensing.
- To examine the relative advantages and disadvantages of various markets participants;
- To identify means of reducing risk in the market;
- To examine the costs relative to the implementation of the NBMA; and
- To serve as a decision base for members, the executive committee and advisors to the authorities.

4. FORMALISATION OF BOND MARKET

The Namibian bond market requires the following official action regarding:-

- Frameworks within which suitable investor protection can be achieved;
- Guiding the evolution of the market;
- The introduction of appropriate capital adequacy requirements.

The current financial market:-

- Is underdeveloped;
- Is fragmented and poses a major obstacle to the development of active bond market;
- Does not have centralised reporting, clearing and settlement; and
- Exhibits limitations in current financial market legislation.

A solution to the current impasse should encompass:-

- Detailed discussions and debates with the market participants to determine the direction of the market development
- Stock Exchange Control Act to be amended to remove restrictions to allow a broader membership, or a new Act to be promulgated;
- Development of a centralised clearing system and settlement system or the rationalisation of the existing transfer secretary system to afford protection against settlement risks (i.e. tainted scrip, post settlement risk). The current system is fragmented with the Bank of Namibia the Central Scrip Depository for National Treasury and Bills and a prominent commercial bank fulfilling different roles in the overall depository system.

5. STRUCTURE OF THE NBMA

On the assumption that a bond market association is formed, which we would recommend, an executive committee should to be appointed initially under the guidance of the Registrar, with the authority to advise, guide and determine the development of the market and the following first steps should be taken.

This first body should include representatives of the financial market industry groupings / participants that are involved in the bond market. It is critical that the representatives on this body should look to the development of the market as a whole for the benefit of all and not be looking after their own constituency's interests.

Representatives should come from the following groupings of market participants:-

- Registrar of Financial Markets
- Bank of Namibia
- Investor management industry
- Issuers
- Commercial banks and / or Investment banks
- Intermediaries / brokers
- Custody Services / Transfer Secretary
- Auditing or legal firm (as a proxy for the individual investor)

The Registrar and Bank of Namibia representative should not have a vote.

The initial members of this body should ideally remain until granting of a financial license, on the assumption that an exchange is the desired outcome. Bond markets are not generally within licensed exchanges and it is not a necessary condition for the development of a successful and liquid market.

6. THE REGISTRAR

The Registrar of Financial Markets is responsible for the regulation of the markets. Its duties include, inter alia, developing the legal framework within which the market operates, and the licensing of financial markets and exchanges as well as the supervision of the exchanges and the financial market.

The Registrar has adopted the policy of self-regulation (e.g. Namibian Stock Exchange). The distinction needs to be drawn between self-regulation delegated to an Exchange by the Registrar; and self-regulation, where by agreement, a group of persons gather to implement certain requirements amongst themselves, in the interests of the market development.

The NBMA should apply to the Registrar for exemption from the current legislation to develop and operate the bond market.

The NBMA should hold meetings on a regular basis in order to set parameters, and determine the guidelines within which the NBMA should operate.

The principles to be covered should include:-

- Self Regulatory framework;
- Steps to ensure a competitive environment; covering
- Trading rules and processes
- Centralised price discovery mechanisms
- Client protection mechanisms
- Clearing and settlement processes
- Proper (appropriate) risk management principles and guidelines;

The NBMA could use the rulebook of and learn from the experiences of BESA an example of the way forward.

7. BANK OF NAMIBIA

The involvement of the Central Bank in the regulatory issues of the NBMA arises out of, inter alia:-

- It has an interest in and obligation to maintain the safety and soundness of the financial system, through inter alia, the integration of the payment system;

- The use of the banking system for the settlement and custody risk management indirectly involves the Registrar of Banks; (the settlement and custody services are the functions of a bank and are not generally those of an exchange)

- The Central Bank, through the regulatory process of the banking sector, has a major interest in cross-market risk. Larger exposures in one market may influence the stability of other markets;

- The Central Bank is the custodian of money and capital markets. The Central Bank is indirectly an agent of the National Treasury.

8. THE MEMBERSHIP OF THE NBMA

The needs of the membership / users will be addressed through the rules governing the NBMA.

The NBMA will monitor developments on other bond markets and could use BESA as a barometer and adapt accordingly when necessary.

9. THE FINANCIAL MARKET PARTICIPANTS

The market participants should all have a common objective being the development of an efficient market where all can a benefit from its success.

NBMA should aim to provide a more functional approach with a greater reliance on service and the creation of a more competitive environment.

Over time the NBMA and the participants could look to providing a system whereby trades are guaranteed within the market between members.

Guarantees of settlement performance and settlement itself can be arranged in various ways. The NBMA should learn from the experience of BESA and consider using the settlement system in use in South Africa.

10. OBJECTIVES OF THE NBMA

- To uphold the principles of the NBMA at all times;
- To provide an environment for the efficient and secure listing, trading and settlement of interest rate products;
- To ensure that all participants are of good character and high business integrity ;
- To introduce a system of examinations and determine the standard of training necessary to be a market participant;
- To ensure that the authorities, as well as other financial exchanges, are suitably advised of cross market financial risk exposure;
- To ensure protection of the NBMA's members through the application of internationally recognised capital adequacy requirements and appropriate risk management processes;
- To establish a reasonable and fair entry process for new members
- To provide a degree of protection to clients in their dealings with members;
- To endeavour to harmonise the interests of members or clients of members.

11. ECONOMIC RATIONALE FOR SECONDARY MARKET

A growth of a domestic bond market is a necessary step in the development of a more efficient capital market. It is an important way of attracting both domestic and international funds and should be high priority on the agenda of the Bank of Namibia, Registrar of Financial Markets and NBMA.

The bond market sits at the lower end of the risk profile of the capital market and provides government; provincial and local authorities; parastatals or state owned companies and major corporations with an important source of short, medium and long-term debt financing.

A functional secondary market will facilitate the creation of a range of new services and financial products.

The development of a yield curve across a wide range of activity traded securities will result in the creation of benchmark securities which market participants will use as reference points for their trading, investment / lending and borrowing policies. The yield curve can also be used to price repos, interest-rate futures and other derivative products such as interest rate swaps. As a consequence banks will begin to price debt differently and hopefully more efficiently.

The financial markets exist on and thrive on good, accurate and timely information. An efficient secondary market should have mechanisms that enhance price discovery and transparency, coupled with investor protection mechanisms and trade reporting, matching, and clearing and settlement processes. These should operate within the ambit of good appropriate legislation and regulation.

Factors impeding the development of secondary markets are, inter alia

- Absence of an appropriate legal and financial regulatory frameworks;
- Lack of an institutional investor structure with the required players;
- Strong pockets of narrow vested interests.
- Lack of a secure national payments mechanism.
- Inefficient and costly settlement processes.

12. ECONOMIC JUSTIFICATION FOR THE UNDERLYING MARKET

- Advantages of the bond market

The benefits flowing from a successful capital market are, inter alia:--

- Sound macro economic environments;
- Development of a dynamic financial sector;
- Promotion of local and foreign investment;
- Promotion of economic growth; and
- Mobilisation of savings and creation of a market for meeting long term finance needs.

- Importance of the bond market

The capital market provides opportunities for, inter alia:-

- Capital raising for economic development and growth;
- Promotion of an investment ownership culture;
- Reducing the cost of borrowings for issuers;
- Mobilisation of private savings can be channelled into productive sectors;
- Creation of a performance driven privatised pension fund industry;
- Transparency and increased liquidity;
- Introduction of products that meet the needs of long-term issuers and investors
- Transparent market related rates for the valuation of financial assets and investments

13. STRUCTURE OF A CAPITAL MARKET

The promotion and development of an efficient and transparent and competitive capital market will lead to economic growth. To this end the distinction is to be made between the various members and non-members within the financial markets.

- Membership

Membership of a financial exchange should not necessarily be limited or restricted to the traditional homogenous membership and should include financial institutions, banks and stock brokers. BESA's experience is that conflicts of interest do arise in an exchange if the investor community firms are equal members with the intermediaries and their inclusion as members need to be considered.

The wider the participation the better as this will increase the number of transactions, enhance transparency, make the market more liquid and give the market / exchange the critical and necessary market credibility that will that will in give rise to further investor confidence and support. All those that are interested in making a contribution towards the development of a capital market should be given an opportunity to do so.

The capital market must be seen and respected by all the professionals in the public and private sectors and seen to represent a reasonable balance of all the competing interests.

- Non-membership

These market participants that are not usually members of a financial exchange are, inter alia:-

- Clients of members, generally entities whose main business focus is not that of trading securities.

- Portfolio managers, i.e. entities that invest the funds of third parties, generally pension and provident funds, in listed securities on behalf of that third party.

- Services

In order for a financial market to operate in an efficient, transparent and secured manner, the services that are needed are:-

- Trading systems;

- Clearing and settlement and depository systems;

- Settlement agents (custodial banks) which are responsible for the electronic settlement whereby there is an exchange of "electronic scrip" for funds on behalf of the participants to a trade, in essence the completion of the delivery vs payment cycle (DVP).

• Market Information needs

In order for a financial market to operate in an efficient, transparent and secured manner, this in formation needs to be:-

- Accurate;

- Distributed timeously / available to all on an equitable basis;

- In a standardised format.

The price information disseminated must be reliable and every market participant should have equal access to price-sensitive information.

It must be:-

- Cost effective;

The market information must be affordable to all

- Have audit trail to the source;

The audit trail of market information, which may have affected the market price movement, can be tracked back to its originator.

It is critical that there be no opportunities for front running, fraud, market rigging through the selective distribution of or delay in or corruption of market prices.

The information should be distributed to the market on a real-time basis from a central official source (for example financial exchanges, clearing-houses) via the data vendors' networks.

- Centralised market rules

A centralised financial market brings together buyers and sellers, ensures trades take place at competitive prices and optimises liquidity.

A centralised financial market levels the "playing fields" through self regulation (exchange rules) where economic efficiencies will attract further business opportunities for market participants within the ambit of a market renowned for its integrity with mechanisms for investor protection in place.

- Settlement Infrastructure – Adoption of Internationally Accepted Settlement Practices

The growth and development of cross-boarder trading is dependent on many aspects, inter alia; whether the host country has implemented investor protection measurements; implemented efficient clearing and settlement mechanisms to ensure that secure delivery versus payment takes place, as recommended by the G30 (Group of Thirty).

These were drafted in the early 1990s and have been updated recently to take account of the changing market conditions and the ever growing integration of systems through the innovative use of technology. It should be the goal of the NBMA to implement these clearing and settlement recommendations.

14. TRADING

A bond market depends on suitable and appropriate issuers, willing investors and intermediaries within an environment where there are committed regulators / authorities.

An active primary and secondary market needs diversified issuers offering varied credit risks. Potential issuers include corporations, financial institutions, infrastructure projects and local authorities. These issuers will only be able to reap the benefits of a listed market if there is a thriving government bond market in place. Without the long term commitment of government to the development of this market as an issuer, little sustainable progress can be made.

A government bond market is the important foundation for the future development of the corporate bond market. It provides a benchmark yield curve and will help the broader distribution of bonds.

Primary dealers can be introduced at a later stage. This step should not be taken lightly and needs careful analysis and consideration of the cost/benefit relationship for all participants before being introduced.

The introduction of a Repurchase, Scrip Lending mechanism / “facility” is an important part of a liquid bond market. Although, equity stock exchanges have rigid rules or do not allow short selling (dealers must either own the bonds for sale or finance them, and/or must announce a bear sale to the market) bond markets are different. This aspect is an important part of the liquidity of a bond market and these restrictions should not be in place. The only proviso is that the participant must be able to settle their positions on due date.

Market speculators are an important part of the liquidity of markets and should be encouraged to participate. Appropriate risk management mechanisms will need to be considered to achieve that.

It is important to develop the skills and trading experience of traders. The NBMA should require that registered officers, compliance officers and traders meet the standards of training and experience to be specified by the NBMA. Members will also have to ensure that these officers:-

- Be of suitable of character, and integrity.

- Passed the necessary examinations (registered person exams of the Institute of South African Financial Markets adopted by SADC Stock Exchanges for example);

The rationale of examinations is to ensure that:-

- The officers & traders have a certain level of knowledge of the mechanisms of financial markets and of its regulations.

- The principles of risk management are understood.

- Trading in the financial markets is conducted within the rules and conventions.

- The public is advised on financial affairs by persons with acceptable degree of theoretical financial and practical knowledge, and be people of integrity.

15. LISTING

Whether the issuance is private or a public placement, the issuer should have to disclose sufficient information for investors to evaluate the issuer's credit quality and the risks associated with the particular bond on offer. The principle of full disclosure is the key to listings.

It is not the role of an exchange or a regulator to make value judgements on the investment merits of a listing; their role is to ensure that there is full disclosure so that investors can make that decision.

BESA's Listing requirements have been adopted by SADC's -Committee of South African Stock exchanges (COSSE) - as being suitable for the listing of bonds across that community.

We would recommend that NBMA should harmonise its listing requirements with that of BESA in that light.

16. RISK MANAGEMENT

The management of the various types of financial risks that could cause loss to a NBMA member or a client is an important aspect for a successful liquid market.

A few of those risks are discussed below.

Types of Financial Risk

- The various types of financial risks in securities trading which are considered relevant to the formulation of risk management policies are:-

- Performance risk;

- Settlement risk;

- Post settlement risk;

- Issuer's default risk

• Performance Risk (pre settlement risk)

The risk of loss to one party to a transaction as a result of the counterparty defaulting prior to settlement, and because of changes in the price at which a replacement transaction can be concluded.

The upper limit of the loss will be the difference between the original transaction value and the replacement transaction value.

• Settlement Risk

The risk of loss to one party to a transaction at the time of settlement taking place on the basis of a failure to complete the delivery vs payment process.

The upper limit of the loss will be equal to the full transaction value plus the difference between the original transaction and the replacement value if any.

• Post Settlement Risk

The risk arises after settlement has taken place, and is due to the scrip having no inherent value because of its tainted nature, or the scrip having been fraudulently introduced.

The upper limited of the loss will be equal to the full transaction value plus the difference between the original transaction and the replacement value if any.

• Issuer's Default Risk

In the context of this document, the risk of issuer default is the risk of loss to the holder of a position in a security as a result of the default of the issuer of security.

A number of risk management issues are prevalent in any market and some of the mitigation processes include:-

- Use of more efficient systems,

- Management of pre settlement risk through shorter settlement periods – implementation of the G30 recommendations of T+3.

- The netting of transactions further reduces risk through an efficient electronic settlement system;

- Counterparty risk processes, may need to be replaced with a system of margining at some time. The investigation needs to consider the advantages & disadvantages and impacts of a solution that many consider to be more appropriate for derivative instruments than bonds.

- The creation of a Guarantee Fund to cover market risk in the event of members default between trade and settlement would take time to build up;

- A cross market risk management system needs to be considered in the longer term - the South African markets are looking at this.

Approach to financial Risk Management

In the interests of promoting the development, credibility and orderliness of the markets, the NBMA should develop a mechanism that can offer some form of protection for all participants in the bond market against risk of loss as a result of the default of counterparty or an intermediary to a transaction.

This could be achieved by the implementation of a Guarantee Fund – see below.

17. GUARANTEE FUND

The NBMA should establish a Guarantee Fund for the discharge of a claim by either a member or a client of the member for the market price movement in the event that a member is in default between trade date and settlement commitment.

The extent of the permissible claim on the fund will need to be made in consultation with the members of the NBMA and the regulators.

The Guarantee Fund should cover the losses incurred in replacing (or re-transacting) bond trades which were originally executed with a defaulting member. The market price movement, being the difference between the price of the original trade and the price of the replacement trade, could be claimed from the fund – subject to any limitations. This is important as the fund size may be limited and /or the facilities or policies available from the market may further restrict the limit of the claim.

The existence of the Fund will not obviate the need for members to assess the counterparty risks of their clients or of other members prior to trading. The Fund should not cover members or clients against settlement risk, the risk of the capital amount of the transaction being impaired through settlement failure, fraud or tainted scrip. The latter capital risk will be covered as a consequence of having the security immobilised in the central Depository.

The Guarantee Fund should not be a fidelity fund, and should not cover fraud or misappropriation by officers or employees of a member firm. The latter risks should be addressed by each member individually through self-insurance or an appropriate fidelity policy.

The basis upon which members should contribute to the Guarantee Fund should be set in consultation with the regulator and the participants.

General – member default

A member will be declared a settlement defaulter on failure to deliver scrip or funds to the settlement agent (or as required by the settlement process at the time) or where the settlement agent is not prepared to accommodate the member in some way, such as lending the member scrip or funds, or where the member is unable to enter into same-day trades to facilitate the settlement.

In addition to the above events, the following circumstances will also constitute a member default:-

- Where a member commits an act of insolvency or an application is made for provisional liquidation of a member;

- Where a member is suspended or its membership terminated by the NBMA;

- Where a member fails to provide adequate assurance that the firm will be able to fulfil its obligations in respect of any trade reported to the NBMA.

General – client default

A client will be in default on failure to deliver scrip or funds to the settlement agent in time for settlement, or where the settlement agent in not prepared to accommodate the client in some way, for example, by lending the client scrip or funds. Members that traded with clients will be required to assume their client's positions. In practice, this might take place before the act of declaring the client in default. A member firm should not be able to claim on the Guarantee Fund for any losses incurred in doing so, based upon the premise that a member should "know his client".

18. SETTLEMENT

Electronic settlement is one of the key success factors for an efficient, liquid bond market and it should be the declared aim of the NBMA to achieve the recommendations of the G30 on clearing and settlement as soon as possible.

(See Appendix on G30 Global Clearance Settlement)

19. CONCLUSION

Efficient well designed bond markets can deliver a number of economic benefits:-

- Allows for the more efficient allocation of savings – it matches borrowers with savers directly;

- Provides retail and wholesale investors with a number of varied and liquid investment products across the risk and maturity spectrums.

- Allows for an efficient allocation of investments funds without restrictive legislation;

- Provides a market in which issuers and investors can more efficiently match their asset and liability requirements.

There is ample evidence that a well regulated, efficient bond market with centralised price discovery together efficient, secure settlement systems will improve liquidity in the listed bonds and thus attract more bonds and more liquidity and so on.

The proposed NBMA, in consultation with the authorities and participants, should work towards a clear framework to ensure equitable, smooth functioning and transparent markets, with suitable investor protection mechanisms, using a secure electronic settlement environment.

BESA is very committed to assisting the NBMA and all the other market participants in their endeavours to develop the bond market in Namibian bond market in whatever way it can.

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COMMENTS ON DEVLOPING AN EFFICIENT SECONDARY MARKET IN NAMIBIA

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INTRODUCTION

Tom has led us into the topic outlining the background and development of the bond market in SA. And we know that it is a very well developed market. To promote the development of our market we can definitely learn from these experiences, by taking what is relevant to Namibia.

But we will argue that we also need to have the courage to avoid what is not suitable, that local market participants and regulators need to first establish our specific needs in terms of market development and then decide what is relevant for Namibia versus what is not relevant.

Features that work in SA may not be appropriate to the current stage of market sophistication in Namibia and may actually be counter-productive by burdening players with expensive new infrastructure in the presence of suitable spare capacity on existing infrastructure.

We will focus our response on providing some details on Namibian market conditions that currently constrain growth and particularly secondary market liquidity and efficiency. Then we can debate which development route and infrastructure best serves the Namibian bond market.

For our analysis we have used the following definition of secondary market efficiency:

Market conditions that allow investors to exchange their fixed income exposure at fair value in the shortest time and with the least degree of settlement risk.

Namibian market conditions and needs

It is our experience that the factor that most curtails liquidity is the fragmentation of our market into narrow niches, with institutional investors, banks, and retail investors having diverging investment horizons. While these groups unfortunately have a pretty consistent view of interest rates, inflation expectations, and implicit issuer ratings and hence create few contrarian positions on the yield curve, they are different in their asset-liability positions and governing regulatory framework, resulting in different attitudes towards trading vs holding strategies.

It is enlightening to compare the different arguments investors use to justify their pricing and trading positions. On the one hand investors argue that a huge premium is justified on Namibian government bonds vis-à-vis the South African benchmarks, because the lack of liquidity forces them to maintain their position, i.e. they cannot liquidate their bond holdings at the right price and time. On the other hand we hear investors argue that they will not exit their current holdings because they would not be able to buy sufficient quantities of bonds in due course. So which one is it? Is there an excess supply of bonds or a shortage? Or is it both, but at different times or in different market segments? This would point toward a serious lack of information and transparency which undermines accurate price discovery.

It is for this reason that we place trading transparency, i.e. the availability of sufficient information on market activity to all players at reasonable speed and cost, at the top of our list of priorities. Players need sufficient market information to establish the fair value of their bond investments at any time; trading transparency in this context encompasses both price and volume transparency. The Namibian market is deep enough to protect the confidentiality of participants while informing the market of essential elements of all trades, i.e. volume and price of all trades. If we cannot achieve general access to this information on a voluntary basis across the market niches, our regulatory agency (-ies) should step in to enforce timely and accurate reporting via statutory requirements for all issuers, intermediaries and settlement agents. It is an easy step to take, yet the most crucial of all. And we don't need fancy trading systems or software to achieve this, a mere pooled database with dissemination approaching real-time will do the trick for now.

Over time regulators will not need to enforce this anymore, because pooled trading facilities for all bond investors and intermediaries will have such advantages for investors in terms of speed, cost, and lower risk, that unregulated off-market trades will become the exception instead of the norm; but in the interim we need that help from regulators to get there. The next step would be to bring the interests of the different market segments together on the basis of freely available pricing information. We completely agree with Tom that we should encourage a larger number of active competitors in a centralised liquidity pool. It is the only way to ensure sufficient market depth in terms of number of players and trading volume to allow investors to engage in a trade at relevant fair value at any time.

How do we achieve this? For one, we need intermediaries to bridge market segments and positions of different players. This role is largely being performed at the moment by stockbrokers, but until recently brokers had little incentive to actively pursue bond trading due to low fixed brokerage rates that only make sense for high volumes of trades, something we do not have yet. Recently introduced regulation allowing principal trading on spread was a step in the right direction, but for it to play its desired role we need to combine it with effective capital adequacy regulations to curb settlement risk.

We would welcome a larger pool of intermediaries, and we believe that the regulatory framework and infrastructure of the Namibia Stock Exchange can easily accommodate the licensing, supervision and settlement legs of a separate board for bond trading. We would need to address the exposure, trading and information disbursement side of things, and this is where something like a yet to be formed association of bond market participants can play a role. In this context we support Tom’s warning that costs should not become an impediment to trading, with costs consisting mainly of trading, settlement and listing fees. In our view this presents a strong argument for avoiding costly duplication of infrastructure and regulation.

Nevertheless we want to make it quite clear that a newly constituted NSX Bond Board, and more so a separate Bond Exchange, would not mean less regulation and less onerous statutory requirements for traders, but rather more stringent regulation, because the Board / Exchange would need to build a regulatory reputation to attract investors and issuers. Again, by piggy-backing on NSX infrastructure we could benefit from the reputation that the NSX has already built over the years, and in part probably also from an existing guarantee fund.

Tom did not seem too concerned about the need for formal market making. In our view the need for some form of market making arises from the typical local situation where all players think the same at the same point in time (some would say this means that nobody is thinking at all!). We regularly experience either a drought of paper or a drought of buyers. As per Mike Sandler's earlier input, one ingredient of a successful primary market is the issuer's agent or primary dealer; in the case of GRN, the primary dealer is BoN.

If we do not envisage market making by the private sector as an extension of intermediation, the BoN needs to extend its primary dealer function to the secondary market as well, if not for the sake of improved liquidity on the secondary market per se, then because issuers need an interface with the market beyond the time of issue! We have on numerous occasions seen the mismatching of GRN bond offers and market appetite, which could have been avoided with a closer ear to the ground through a primary dealer(s) that is (are) also active in the secondary market.

The exercise should not perpetuate BON's role, rather it should allow intermediaries to grow into the role of future primary dealers, and the Bank's experience would allow it to set a workable framework for local primary dealers. The CMA Agreement and its stipulations in terms of forex cover possibly present a limit to market making activities, but they do not per se prevent activity in the market.

Derivatives like repos, strips, and options would be an alternative way to create "artificial" liquidity. E.g., short selling and repo facilities could well serve as an interim measure to create "bridging" buyers or sellers in the market. Nevertheless we believe that an agency like BON would initially need to perform the role of counterparty within defined risk limits. We cannot improve secondary market efficiency without assistance from our regulators. We need the Bank of Namibia and NAMFISA to encourage the intermediation process as well as the creation of derivatives and to encourage and oversee the use of such instruments by the industry. As Tom indicated, putting in place an effective risk management system that spans the different statutory regimes of banks, institutional investors, and stockbrokers will allow equal access to the central pool of liquidity for a wider range of participants.

To highlight the importance of regulatory assistance, let me mention some settlement issues: Counterparty risk could be addressed by immobilising bonds in a central register with possible dematerialisation at a later stage; this is being pursued by BON at the moment. As volumes will hopefully continue to increase, we need a coherent clearing and transfer process to achieve delivery-vs-payment and control settlement risk. This settlement system needs to span BON in their role as payment system supervisor and GRN's current transfer agent on the one side, and custodians like Standard Bank on the other. This will allow us to maintain our time to settlement at T+2, which is very favourable in terms of world standards.

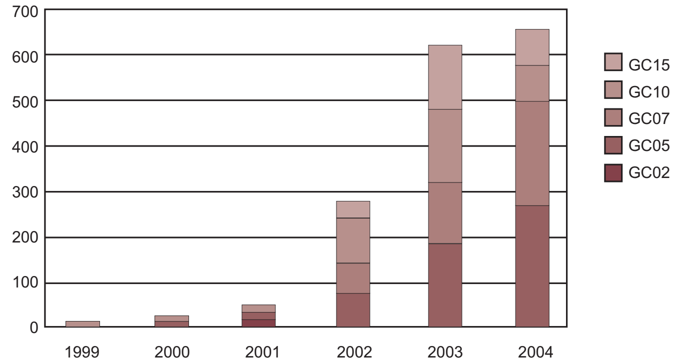
We have mentioned capital adequacy for principal trading intermediaries to mitigate settlement risk. Regulators should couple this with statutory requirements in terms of integrity, insurances and qualifications to ensure highest standard. Regulators should introduce simple and enforceable statutory reporting requirements for the issuers of any fungible debt instrument issued to a non-strategic investor. We have stressed the priority of information for market participants, and knowing the product range and its yield curve implications is part of this. The reporting requirement should apply even to unlisted private placements. Furthermore, regulators like the BON / NSX should clarify the line between deposit taking for licensing purposes and the issue of debt instruments (authorised sponsors and for the issue of debt instruments).

In contrast, tax exemption for private investors does not need to be upheld. It should have resulted in keener competition for scrip and a noticeable pressure on yields. However, the relatively low weight of individual investors participating directly at the auctions has had negligible impact or benefit to GRN as issuer. It also does nothing to encourage the trading of bonds. Since bond (and TB) yields exceed returns available on other interest-bearing investment products in Namibia, we do not foresee a negative impact on investor appetite if the tax exempt status is withdrawn with advance warning.

So much for the regulators, but what can we as intermediaries contribute to market development?

It is interesting to visualise the impact that dedicated bond trading teams at various stockbrokers have had. Supported by the chart below showing volumes traded over the past five and a half years in absolute terms, we argue that the trading desks have had a visible impact, possibly even on the significant premium correction before the latest credit-risk related increase in premiums. Unfortunately the impact has not been sufficient to maintain volumes as a percentage of market capitalisation this year.

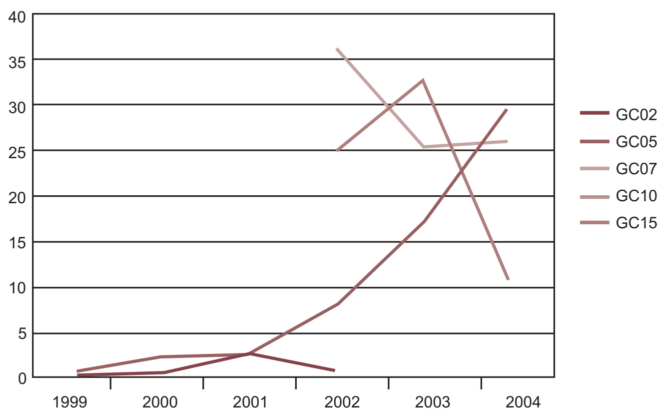
Chart 1: NSX bond trading volumes



Source: IJG

Source: IJG

Chart 2: Trading as percentage of market capital



Source: IJG

Source: IJG

Obviously the pickup in trading was facilitated by the bond consolidation in 1998 and its benefits in terms of less fragmented issue volumes. Nevertheless, the consolidation effort still fell short of expectations regarding secondary market trading, not least because the planned element of market making was never introduced. What we want to stress here is the validity of Tom's assertion that more players result in more liquidity, and we note that this is possible even in the absence of fancy trading and settlement systems. More players are likely to be foreign players and will be more inclined to come with the sovereign rating and more transparent market.

Tom also mentioned the daily marking to market of bonds as well as index development. We certainly found that the introduction of the IJG Bond Index, IJG Money Market Index and IJG Money market Valuations model has encouraged a more direct involvement in the local bond market instead of the traditional focus on the SA market. Likewise, the recent introduction of the AC133 standard has highlighted the need and benefits for banks, the regulator, and bond intermediaries to consolidate available pricing information on Namibian bonds. But despite these efforts we are a long way from sufficient price and volume transparency.

How can the issuers assist? The issue process and bond design on the primary market serve as the foundation of the secondary market, both in terms of issue volumes and in terms of characteristics that enable adequate pricing, either off other benchmark bonds or previously issued tranches as a first step.

Following the earlier consolidation exercise, we now need to encourage two developments on the side of issuers. Firstly we support Tom's suggestion that GRN as the currently dominant issuer should seriously think through the benefits of an independent rating. And please do not confine your analysis to short-term interest cost benefits to Treasury, but have a look at the more far reaching consequences for market development.

A rating would facilitate international interest in our market because of the additional information availability and transparency, as well as the implied improvement in the debt management process. The same can be said about the impact on local investors, who would not have to fall back on hypothetical risk premiums for comfort. After all, adequate communication with investors is key to attracting favourably priced capital.

Currently GRN has a captive market to some extent through local asset requirements, but new asset classes may develop that may reduce the direct benefit to Treasury as issuer. GRN should ensure that its investor base is diversified by attracting new interest outside the country. Hopefully more secondary trading would be another spin-off because foreign investors have a more complex interest rate outlook than their local counterparts. Furthermore, a rating would enable other issuers to come to the market with properly priced debt. The Namibian market needs to go beyond explicitly or implicitly guaranteed debt, but we can only achieve that if we have all the information needed to adequately price risk. Risk pricing starts with a benchmark – Government. Accordingly a sovereign rating is one of the first steps on the way to risk-adjusted price benchmarking and a more complete yield curve that includes corporate issuers.

Only then do we come full circle by being able to satisfy diverse investor appetites with different maturities and risk features, and the market would in turn attract a wider range of fixed income listings as more diverse issuers across the yield curve find investors in one unified market place. Products from short-term promissory notes to long-term zero bonds as well as related derivatives could be listed and traded to complement the current spectrum of bonds.

CONCLUSION

In our view there are a whole host of improvements that we can achieve without introducing new trading systems or a fully-fledged stand-alone Bond Exchange, with trade capture and the centralised distribution of market information being the most pressing concerns. However, this does not mean that we should not assess the merits of electronic trade capture and matching facilities as one way to achieve a unified market across current niches. We suggest that an industry forum with representatives of regulators and market players, particularly of banks, institutional investors, the NSX with its brokers, and other intermediaries, sort out a cost-effective way to achieve market transparency of product availability and secondary trading. Market needs do not currently dictate an electronic system, but the time may well come when trading volumes put too much strain on current infrastructure.

GENERAL POLICY ENIVIRONMENT FOR THE DEVELOPMENT OF A BOND MARKET: LESSONS FROM OTHER DEVELOPING COUNTRIES

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1. INTRODUCTION

Central banks have multiple interests in the development of bond markets. At a fundamental level, the government bond markets help to fund budget deficits in a non-inflationary way and so enhance the effectiveness of monetary policy. In addition, many central banks use government bond markets for the conduct of monetary policy. They often act as agents for the government in various aspects of the management of government debt. They oversee clearance and settlement systems, and they are responsible for the stability of the financial system, often directly supervising banks. This multiplicity of interests means that the policy issues that arise are very diverse.

When a company needs to raise funds for some type of investment or expenditure, they often turn to the public markets for funding. One way to do this is to issue additional stock in the company, but this has implications on the value of the shares and dilutes ownership. The other major option is to sell bonds to the public and take on debt. Selling bonds is often more attractive to companies than getting a loan from a bank. When you, for instance, leave money in an instant-access bank account, your bank invests it. With corporate bonds, you invest your own money on your own behalf. When you buy a bond, you are like a bank: you are lending your money to a company or the government.

Domestic bond markets in developing countries have seen a significant growth in recent years. Nevertheless, as the experiences in many countries have indicated, lack of liquidity remains a major obstacle to their development. The benefits of developing a liquid bond market go beyond financing government or corporate deficits at lower costs. First, a liquid bond market will facilitate pricing of other financial assets. Second, it has a direct impact on the degree to which other segments of financial markets (forward and futures markets, including foreign exchange hedging) can be developed to support risk management functions. Third, the depth of money and bond markets has a decisive influence on the effectiveness of central banks. monetary policy. Finally, the yield curve in a liquid bond market carries important information for the conduct of monetary policy.

2. SOME BASIC DEFINITIONS

What actually is a bond?

A bond is, by definition, a debt obligation issued by a government or corporation or, put simply, it is like a share but with some remarkable differences. For instance, bonds bear a pre-specified dividend payment (their coupon) and generally have a pre-determined maturity date at which they will be paid back, at par. The question of interest is- why would investor prefer bonds to shares?

Government versus corporate bonds?

A corporate bond is really like a government bond only, as one would expect given the increased risk of a company versus the sovereign risk of a government, it is cheaper. Corporate bonds pay higher dividends and have higher yields than government bonds such as UK 'gilts'. However, a good mix of the two could provide an optimum between low risk and enhanced yield, which will suit most conservative investors who require a mix of cash preservation with a boost to the overall return on their money invested.

3. WHY THE NEED FOR A BOND MARKET?

Bonds are a great way to protect ones principal and set up a steady stream of income. They are usually much less volatile than stocks in the short-term, which is why conventional wisdom says you should gradually increase your bond holdings as you approach retirement. A growing number of African countries are looking into the prospects of establishing local bond markets to reduce, for instance, the currency and interest rate risks, and funding exposures that precipitated the Asian crisis. First, the basic philosophy of developing a diversified financial system with banks and non-banks operating in equity markets and bond markets is that it enhances risk pooling and risk sharing opportunities for investors and borrowers. More specifically, the case for ensuring the presence and development of bond markets is made on several grounds. First, in the absence of a bond market, the banking system would be larger than it otherwise would be.

Prevalence of a domestic bond market can move a crisis outside the banking system making it easier for Government to stand back. Alan Greenspan once argued that coexistence of domestic bond market and banking system helps each to act as a backstop for the other. In the past, countries like Japan have developed with almost total reliance on bank intermediation but the risks of such excessive reliance are more in a relatively open economy since non-bank intermediation may get located outside the country. It is also argued that domestic bond market helps in avoiding the double mismatches of currency and maturity. Second, it is argued that debt markets facilitate efficient financial intermediation as they use market mechanism for allocating and pricing of credit. In particular, debt markets are expected to facilitate availability of long-term funds for specific uses such as for infrastructure. They also infuse greater transparency in the process of credit allocation in view of the information that is contained in market determined rates. In fact, e-commerce makes information sharing less costly, and hence it is easier to develop bond market infrastructure in the current environment for facilitating transparent market-based allocation of credit.

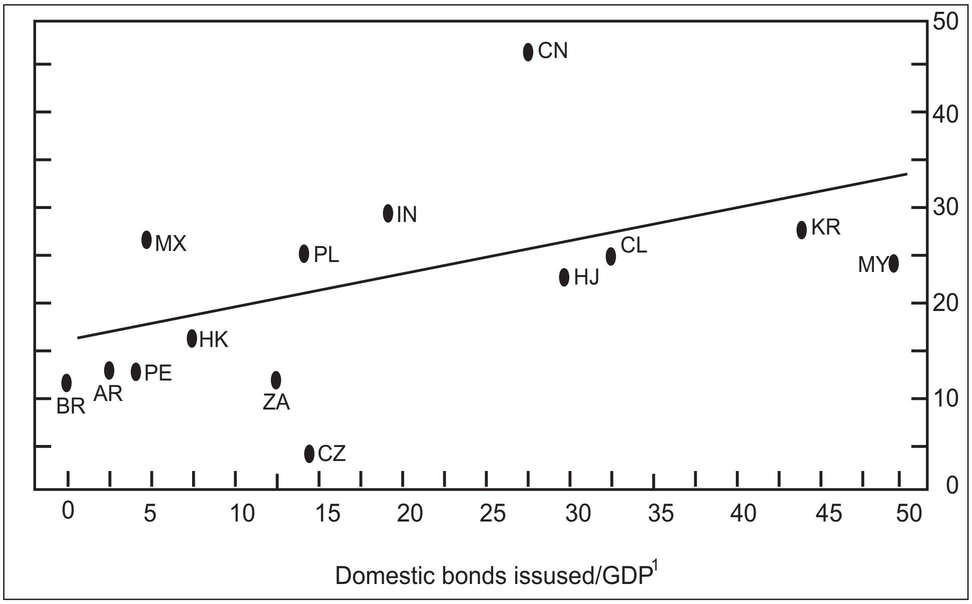
It may be difficult for Government to intervene through debt market for directed subsidised lending as compared with the banking system. Hence, it is always argued that bond markets facilitate the reduction of bad loans. Furthermore, since debt instruments are mostly rated, investor awareness and monitoring is greater, which mitigates the moral hazard arising out of deposit insurance as in the case of banks. Third, bond market can help develop the derivatives market thereby facilitating hedging mechanisms and enabling greater diversification of risks by participants. Also, the variety of instruments possible in the domestic bond market may result in gains to savers and borrowers (Wellons, P.A. (2000) and Biekpe (2003).

It is, however, essential to recognise that domestic bond markets may not be able to deliver, in reality all that is sought from them. The efficiency of bond markets would depend on the efficiency of credit rating agencies (CRAs), standards of accounting, auditing and disclosures, institutional infrastructure, prevalence of an environment for enforcement of contracts, etc. Bond markets may not necessarily reduce systemic risk since banks themselves could be major players in bonds as issuers, investors and underwriters. Development of a bond market for long-term instruments would also require disciplined policies such as flexibility in interest rates, inflationary pressures, enabling legal environment, etc. Though higher degree of transparency is to be expected, it has been argued that where sophisticated instruments like options exist, transparency in bond markets may not be automatically ensured. Furthermore, a domestic bond market by itself need not necessarily address the fundamental issues of risk management and pricing of risk.

On balance, the current realities would lead one to believe that the banking system in most developing countries will continue to be at the centre of the financial system. In fact, banks are likely to have significant direct or indirect presence in the bond market as issuers, investors or underwriters. If the overall environment in the financial sector contains problems in pricing of risks by banks, bond markets too can suffer infirmities in pricing. As the financial system is evolving, bank loans and bond contracts must be treated as complementary and to some extent as substitutes. In view of the undeniable benefits of a multi-institutional financial structure, a number of countries are, rightly, devoting considerable resources and attention to the development of domestic bond markets, though each country may have different motivations for doing so.

Policymakers have become increasingly concerned about the absence of broad, deep, resilient bond markets in developing economies. In addition to the motives noted above, bond markets have historically developed in response to corporate sector demand for investment finance. As they grow, many firms sooner or later approach the bond markets for additional capital with which to finance their assets. This should imply a positive cross-country relationship between real economic growth and the size of bond markets. Table 1 below shows the GDP growth and size of domestic debt of 14 emerging economies from 1995-2000. The countries are Brazil (BR); Argentina (AR); Hong Kong (HK); Mexico (MX); South Africa (ZA); Czechoslovakia (CZ); Poland (PL); India (IN); Hungary (HU); Korea (KR); Malaysia (MY); China (CN); Colombia (CL) and Peru (PE).

Table 1: GDP growth and size of domestic debt market



Source: IMF; SIS

1. Cumulative: calculated over the period 1995 - 2000.

As can be seen, South Africa, which has the largest bond market in Africa is not even among the top emerging markets bond issuers per GDP. Malaysia and Korea, on the other hand, are ahead of the class.

4. COMPETITION BETWEEN BANKS AND BOND MARKETS- NEED TO WORRY?

The historical development of banking and bond markets

The issue of conflict of interest between bond markets and banks is a real one and it is important that this paper touches on the potential relationship between the two institutions. The question of interest is whether the banking sector in Namibia will see the bond market as a threat or partner in business. It is often argued by some analysts that a bond market will take away much needed business from traditional banking sector. In some economies, banks are major holders of corporate bonds. For example, in Indonesia, banks hold the majority of corporate bonds and until recently, this used to be the case in Argentina, Brazil, Chile and Malaysia as well. Banks may hold a smaller proportion over time as institutional investors such as pension funds develop. However, at early stages of development, bond markets are not generally an alternative to the banking system. The general pattern observed in advanced economies has been for banking to emerge at a much earlier stage of development than bond markets.

In the United States, where the bond market is most developed, bond market financing overtook borrowing from domestic banks long ago. In Western Europe it has been much slower to develop. Among emerging economies, the bond market is largest in Korea (in terms of amounts outstanding, although much of this is little traded). Notwithstanding a major setback following the 1997 crisis, this has been the major source of funding for corporations in Korea since the early 1990s. Bonds have been increasingly supplementing bank lending as a source of finance for the private sector in other emerging economies. As economies mature, banking sector tend to become developed before bond markets. Yoshitomi and Shirai (2001) suggest several reasons for this. They suggested that in poor countries, individuals have a greater preference for liquid short-term bank deposits; institutional investors are underdeveloped or non-existent; few companies are sufficiently large and reputable to issue bonds; and the required informational, legal and judicial infrastructure is not in place.

This raises the key question whether Namibia has sufficient key players in the market to support and develop an active and, reasonably, liquid bond market. Table 2 shows the distribution of issuing of bonds between financial institutions, central banks, public sectors and corporate sectors of major emerging markets.

Table 2: Issuers of domestic debt securies, end - 2000[1]

	Financial Institutions	Central Bank	Public Sector	Corporate Sector
Hong Kong	64	23	5	8
Singapore	4	0	3	93
Korea	13	16	31	40
Malaysia	0	2	39	59
Thailand	1	0	83	15
Asia	16	8	32	43
Chile	27	55	4	14
Mexico	20	2	63	14
Peru	30	10	28	32
Latin America	26	22	32	20
Poland	1	14	73	12
Israel	0	16	79	5
Total sample	14	15	47	24

Source: National Statistics & Bank of International Settlements (BIS)

1. As a percentage of total domestic debt issued in a country.

Do bond markets substitute for bank lending?

A much cited metaphor coined by Alan Greenspan is that bond markets can act like a “spare tyre”, substituting for bank lending as a source of corporate funding at times when banks’ balance sheets are weak and banks are rationing credit. This was the case in the early 1990s in the United States, and there were some signs of it in Hong Kong in the late 1990s, when domestic banks adopted a conservative lending stance as property prices collapsed. Conversely, banks may substitute as a source of funds when bond markets dry up, as occurred following the Russian default in 1998. An alternative view is that bond markets rarely fulfil this “spare tyre” role. When banks are reluctant to lend, it is usually a reflection of a general loss of confidence in the economy. At such times, it is also hard to place corporate paper; indeed, as bondholders generally know the lending parties less well than do bankers, this form of finance may be even more likely to dry up in adverse times.

Do bond markets take good lending business away from banks?

Views differ about the extent to which bond markets will reduce banks’ business. Large companies are likely to retain a relationship with banks but the nature of that relationship will change. Good companies will deal with banks because of banks’ role at the centre of the payment system. Firms may also want to keep credit lines with banks and maintain relationships with them to ensure support in troubled times when securities may be hard to issue, or hard to issue cheaply or quickly. A bank loan is easier to restructure than a bond issue. Some companies may prefer to deal with a bank confidentially rather than face the disclosure requirements of bond financing. Issuance of bonds by companies, giving them more stable longer-term funding, may improve the quality of remaining loans to them by banks. On the other hand, if companies use bond issuance to raise their overall debt-equity ratios above prudent levels, it may worsen the quality of bank loans.

Do bonds take deposits away from banks?

As bond markets develop, banks may lose the deposits of wealthy customers who seek to earn higher returns on at least a portion of their portfolio. The main type of bank deposit with which corporate bonds may compete is the negotiable certificate of deposit. The issue of certificates of deposit gives the bank secure funding for their typically 3 to 12-month maturity, and should give the holder a liquid instrument (although in many emerging economies they may not be very liquid in practice). However, some of the funds put into domestic bonds may have previously been invested in foreign bonds rather than in domestic banks. It can be argued that banks are favoured over bond markets by the authorities, due to the provision of explicit or implicit deposit insurance. Indirectly, the development of the bond market may reduce demand for bank deposits by stimulating the growth of the funds management industry. This may particularly be the case when banks pay no or very low interest on many accounts.

5. HOW ABOUT A REGIONAL BOND MARKET?

This question is particularly relevant to Namibia which already works very closely with South Africa- in particular JSE Securities Exchange and BESA. The question of whether Namibia needs a separate Bond Market is an important one. Building the infrastructure required for a well developed bond market is subject to significant time and resource costs. Consequently, many, particularly small emerging markets economies are caught in a vicious circle of low liquidity and underdeveloped markets. This situation provides a rationale for coordinated attempts to pull issuers and investors together and develop bond markets on a region-wide or multi-country basis.

Additional arguments in favour of such attempts are that name familiarity reduces information asymmetries and the same time zone eliminates settlement risks. On the other hand, a major disadvantage of regional or multi-country bond markets is that they do not provide instruments that would strengthen monetary policy operations in individual countries. Cooperation in developing a regional or multi-country bond market might take several forms. One arrangement could be to encourage countries to use regional financial centres to issue bonds in regional or international currencies along the lines of the euro-dollar and euro-yen markets. For the host country, development of offshore markets could mean further deepening of local bond and foreign exchange markets and more diversification opportunities for domestic investors.

In Asia, the Japanese government has offered to provide funds and guarantees for the acquisition of sovereign or semi-sovereign bonds issued by other Asian countries. The proposal was meant to pool the large amounts of excess savings in the region and reinvest the funds in local debt instruments. This would eliminate currency and maturity mismatches, both of which were primary causes of the Asian crisis. For several reasons, progress to date has been disappointing. There are no credit rating agencies or clearing and settlement systems at the regional level. Cross-border transactions in securities as well as trading mechanisms are absent and listing rules and tax treatments have not been harmonised. Finally, regional credit enhancement and guarantee agencies are missing and there is no common currency for the denomination of sovereign bonds. Regional cooperation could also be strengthened by encouraging domestic financial institutions to invest in bonds issued by other countries within the same region. Although no formal cooperation schemes exist in practice, banks and institutional investors in emerging market economies have increasingly sought to diversify into bonds of neighbouring countries.

In Latin America, this has meant that institutional investors look towards developed markets for asset diversification and stay away from bonds issued by neighbouring countries (Mihaljek, D (1998)). Other ways of promoting regional bond markets and attracting local and international investors include the creation of a regional bond index or even a synthetic regional bond based on a basket of major regional currencies. However, these forms of cooperation are difficult to realise, as they may ultimately require a regional currency unit- this is not a problem for South Africa and Namibia.

6. BOND MARKET IN AFRICA

The need for domestic debt issuance

The need to issue domestic debt can arise both from government deficits that are not fully foreign financed and implementation of monetary policy. Generally, the deficit leads to a change in government net assets. Hence, a budget deficit can be financed either by drawing down assets or incurring new liabilities of both domestic and foreign nature. The use of assets entails selling property or reducing deposits. The choice between foreign and domestic borrowing depends on the cost (interest rates), maturity structure, and risks. Most of the Sub-Sahara African (SSA) countries have access to foreign financing at very low interest rates (well below market interest rates) and at very long maturity from international aid agencies or on grant terms.

These terms are often more favourable than for domestic borrowing, as domestic debt instruments carry much higher interest rates and have shorter maturities. Another advantage of foreign borrowing is that it increases the supply of foreign exchange, which is critical to meet import requirements. One drawback concerning foreign borrowing is the currency risk, which may increase along with the foreign indebtedness, given that a growing foreign debt service increases the demand for foreign exchange. Despite the attractiveness of foreign borrowing, governments may still look toward domestic borrowing for a number of reasons. First, the supply of foreign financing may be determined by the aid agencies' budget and their assessment of the economic performance in the recipient country. Second, international aid is very often linked to project financing and can therefore not finance government's recurrent expenditures or capital projects not supported by donors.

Hence, governments with large recurrent budget deficits may be forced to tap into domestic savings, including through issuance of domestic debt, to close their budget gaps. The market for bonds is still very young in most sub-Saharan countries due to their reliance on donor support. Countries such as Ghana, Botswana, Kenya, Zimbabwe and Zambia have very small bond trading platform in the form of mostly government bonds. Table 3 shows a small mix of issues at the Botswana Bond Market.

Table 3: Botswana Bond Market, 2003

Issuer	Par Value P million	Coupon Rate	Maturity
Botswana Building Society	100	14.25	2005
Botswana Development Corporation	50	14.00	2004
Botswana Telecommunications Corporation	50	13.75	2008
Stanbic Bank Botswana	30	Floating at the prevailing 91 day BOBC rate of interest plus 1.5% before 2009 and plus 2% afterwards	2013
Barclays Bank Botswana	100	Floating at the prevailing 91 day BOBC rate of interest plus 0.85% before 2009 and plus 1.5% afterwards	2014
Standard Chartered Bank Botswana	75	Floating at the prevailing 91 day BOBC rate of interest plus 0.70%	2012
Government of Botswana, BW002	750	10.75	2005
Government of Botswana, BW002	500	10.25	2008
Government of Botswana, BW003	500	10.25	2015

Source: BIDPA.

Domestic debt can also be used to achieve monetary policy targets. This is particularly the case in countries with large balance of payments surpluses (very few in Africa- some exceptions are Botswana, South Africa and Mauritius). In those situations, the inflows of foreign exchange increases liquidity which could undermine macroeconomic stability and the central banks often decide to intervene by selling government or central bank bills to stem inflationary pressures from excess liquidity.

Development of Domestic debt of selected African countries: 1980-2000

Table 4 below shows the developments in domestic and external debt for 27 non-CFA SSA countries for the period 1980–2000. From the Table, it is apparent that domestic debt is not a recent phenomenon in African countries as most of the countries have relied on domestic borrowing since the beginning of the observation period. However, the average ratio of domestic debt has increased from 11 percent of GDP in the 1980s to 15 percent in the late 1990s, with the median increasing from 4 percent to 10 percent over the same period. An increasing number of countries became heavily, domestically indebted, and the number of countries with debt-to-GDP ratios exceeding 20 percent rose from three at the beginning of 1980 to nine by 2000. There are wide differences across the countries with respect to the size of government securities markets. One group of countries has relied extensively on domestic debt since the beginning of period. This group includes Ethiopia, Kenya, Mauritius, Nigeria, South Africa, Tanzania, Zambia, and Zimbabwe. In contrast, countries such as Angola, Botswana, the Democratic Republic of the Congo, Mozambique, and São Tomé and Príncipe, have not used or have only recently developed government securities markets. Between these extremes, there is a vast group of countries that have either fairly small debt markets, or have recently experienced a considerable increase in their domestic debt burden, including The Gambia, Ghana, Seychelles, and Namibia. (Christensen, 2004) and Mehran, Hassanali et al. (1998).

Table 4: Domestic and External Debt (1983 – 2000)

Country	Type of Domestic Debt	Domestic Debt 1980-1989	Domestic Debt 1990-1994	Domestic Debt 1995-2000	External Debt 1980-1989	External Debt 1990-1994	External Debt 1995-2000	Total Debt 1980-1989	Total Debt 1990-1994	Total Debt 1995-2000	Domestic/Total Debt % 1980-1989	Domestic/Total Debt % 1990-1994	Domestic/Total Debt % 1995-2000
Angola	...	0	0	0	158	113	81	158	113	81	0	0	0
Botswana	...	0	0	0	5	4	10	5	4	10	0	0	0
Burundi	TB,TC	3	2	6	40	96	138	44	98	144	8	2	4
Cape Verde	TB	0	11	34	42	42	40	42	53	74	0	20	46
Congo. Dom. Rep of the	...	0	0	0	30	125	254	30	126	254	0	0	0
Ethiopia	TB,B	16	19	10	31	115	109	47	134	120	34	14	9
Gambia, The	TB, DN,S	3	13	23	80	84	104	83	96	127	3	13	18
Ghana	TB	12	7	24	19	55	83	32	64	106	38	13	22
Guinea	TB	-	-	-	0	0	91	-	-	-	-	-	-
Kenya	TB,B,S	21	23	22	61	77	52	81	100	74	25	23	29
Lesotho	TB,B	8	8	5	40	49	58	48	38	62	17	15	8
Madagascar	TB	3	3	3	71	120	110	74	123	113	4	2	2
Malawi	TB.S	13	8	9	65	100	126	78	109	135	16	7	7
Mauritius	TB,S	27	29	33	39	21	15	66	30	48	41	57	69
Mozambique	...	0	0	0	75	207	121	75	207	122	0	0	0
Namibia	TB	0	8	19	0	4	2	0	12	21	-	69	89
Nigeria	TB, B,TC, S	25	29	16	49	93	80	77	122	97	37	24	17
Rwanda	TB, B	8	9	5	17	55	70	25	68	75	31	14	7
Sao Tome and Principe	...	0	0	0	155	422	643	155	422	643	0	0	0
Seychelles	TB, B,S	14	45	68	29	24	20	43	69	88	33	65	77
Sierra Leone	TB, B,S	13	5	7	34	94	143	47	99	150	28	5	5
South Africa	TB, B	30	37	45	0	0	0	30	37	45	100	100	100
Swaziland	TB, B, S	4	1	1	20	21	16	24	22	17	16	5	7
Tanzania	TB, S	26	6	12	71	131	100	96	137	112	27	5	11
Uganda	TB, S	2	1	2	0	73	57	2	74	59	100	1	4
Zambia	TB, B	25	9	6	134	178	196	159	176	202	16	5	3
Zimbabwe	TB, B, S	35	29	37	27	34	48	62	63	86	56	45	44
Average		11	12	15	49	87	100	62	102	118	25	19	22
HIPC		9	6	8	56	124	156	69	138	169	22	6	6
Decision point reached 2/		10	7	8	58	136	150	73	143	164	25	7	7
Eligible3/		2	1	3	45	111	196	47	112	199	4	1	2
Non-HIPC 4/		14	18	23	39	40	35	53	59	59	30	35	40

1/ TB = Treasury bills; TC = Treasury certificates; B= bonds; S=Government stocks; DN=Discount note series
2/ Includes Etiopia; The Gambia, Ghana, Guinea, Madagascar, Malawi, Mozambique, Rwanda, Sao Tome and Principe, Sierra Leone, Tanzania and Uganda
3/ Includes Burundi and the Democratic Republic of the Congo
4/ Includes Angola, Botswana, Cape Verde, Kenya, Lesotho, Mauritius, Namibia, Nigeria, Seychelles, South Africa, Swaziland and Zimbabwe

Source: IMF staff reports and selected central bank statistics

7. DOES NAMIBIA NEED A BOND MARKET?

As mentioned above, most African countries have very limited and unstructured bond markets of some form. In Africa, government securities are a major means of financing government deficits. The Namibian Government, like any other African government, finances its operations largely through taxation and levies. When revenue received from taxation and levies is less than expenditure, the government finances the difference mainly through borrowing by issuing government securities (Bank of Namibia, 2002).

Some Essentials for a Bond Market in Namibia

To develop a sustainable and "independent" bond market, will require among other things, an adequate institutional investor base; the availability of a variety of instruments of differing maturities and a supporting infrastructure. Most importantly, the advantages for a case for a bond market must far outweigh the disadvantages. Support of government and regulatory bodies, in the form of establishing efficient legal systems is important for deep and liquid bond markets. Regarding legal reforms, bankruptcy laws or capacity to seize collaterals are particularly important. The legal and regulatory requirements, accounting and auditing standards for issuers and the infrastructure for trading, clearing and settlement need to be developed much more in case the market has to become deep and liquid.

Experience also indicates that in many developing countries, since the risk is transferred to the creditor in bond markets as compared to banks, there is a preponderant bias towards bank deposits among household savers in many countries. In other words, development of domestic bond market is bound to be a long drawn process and banks will be expected to "be special and dominant" in the financial systems of most developing economies.

In Mexico, while the experience is that larger companies issue bonds abroad, the smaller companies prefer to borrow from banks. The question is- will Namibian companies (which are mostly very small) get market for their bonds when they can probably borrow from the banks? In Chile, there is some substitutability between bank and bond financing as a few companies raise bonds to prepay bank debt. Pre-crisis, Korea had a large corporate bond market and the biggest lesson from the episode was that too much Government intervention (either in exchange rate or implicit or explicit guarantees) resulted in serious distortion of markets.

Bond markets in many emerging markets have not performed very well. Poland for example has a fragmented and illiquid corporate bond market characterised by private placement and cross holdings. Peru is experiencing a situation where good credit is going to banks while bad credit is going to bond markets; hence there is a justified reluctance to invest in bonds. On the other hand, this raises the contrary view-point that if bond markets are developed, bad credit could go to banks.

There is recognition of the need to develop securitisation market as a related issue. Securitisation, which hasn't taken roots in African countries- except South Africa, as an instrument acts as a risk transfer mechanism that could work to the advantage of both banks and investors. In Korea, non-performing loans spurred this market; Hong Kong has established a Mortgage Corporation. In many countries, this market is in nascent stage, either because it needs complicated legal changes or the credit environment does not enable securitisation. For instance, Hungary has neither non-performing loans nor mortgage in household; hence no mortgage exists to warrant securitisation to be involved in the development of this market. A Reserve Bank's role in development of corporate bond market is indirect and governed by its interest in monetary policy transmission, government securities, and stability as well as efficiency in financial sector as a whole (Herring, R and N Chatusripitak (2001)).

Some Institutional Issues for a possible Namibian Bond Market

There are several institutional issues relating to bond markets and each of them is critical but they are not necessarily interrelated. These are many, but this section focuses on some of them, namely, institutional investors in debt markets, self-regulatory organisations, banks, credit rating agencies and the tax regime.

a. Role of Institutional Investors

There is wide consensus regarding the need for institutional building for development of bond markets, though countries have approached it differently. The notion of pension reforms as an important instrument in the process is generally upheld although there is a case for regulatory limits on their investments in riskier assets in the interest of financial stability.

There are several approaches to improving institutional investors' interest in domestic debt markets. For example, Indonesia recently embarked on substantial regulatory reforms to encourage institutional investors. Hungary is emphasising on development of mutual funds. In South Africa, plans are underway to reform and "privatise" the Public Investment Commissioners. Unfortunately a Bill to kick-start the process ran into opposition from Trade Unions and other stakeholders. Some countries like Philippines are concentrating on market for securitisation. Hong Kong prefers a portfolio approach, a greater role for credit rating agencies, to build Collective Investment Vehicles and to explore other options like credit enhancements, rather than increase the supply of Government or quasi-Government paper to whet the appetite of pension funds (PFs). In general, PFs are encouraged to invest in Government Securities as in the case of Chile, Indonesia and Singapore although some countries like Hungary and Philippines are permitting some portfolio diversification by allowing investment within limits, in non-Government paper. It is also observed that many pension or provident funds voluntarily invest in government securities above the minimum requirements (Merrill Lynch (2002)). The question is- what is the appetite level for a bond market by Namibian institutional investors?

b. Role of Self-Regulatory Organisations

Self-regulation is fast emerging as a viable co-operative framework for both the regulator and market participants to come together towards the fulfilment of common goals and objectives. By creating a unique combination of private interests and official oversight, SROs have emerged as an effective and efficient form of regulation for the complex and dynamic financial services industry. International experience with self-regulation suggests that the power of self-regulatory organisations vary significantly. In its most complete form, self-regulation encompasses the authority to create, amend, implement and enforce rules of conduct with respect to the entities subject to the SRO's jurisdiction and to resolve disputes through arbitration or other means.

Typically, this authority is derived from a statutory delegation of power to a nongovernmental entity. In some countries, SROs do not have formal regulatory status but nevertheless provide codes of good conduct and master agreements and perform important roles in the standardisation of common practices without any formal regulatory status. It is necessary to recognise that exercise of authority in any form by SRO does raise some fundamental issues such as their accountability and monopoly status. There is merit in constantly reviewing both the representative nature of SROs and responsiveness to overall public interest considerations (Biekpe, 2003). Are the regulatory bodies strong or independent enough to “police” a bond market in Namibia?

c. Banks and Bond Markets

As explained above, the relationship between banks and bond markets is complex especially in emerging countries where the dominance of banks in financial intermediation is set to gradually decline but banks do have a critical role in development of debt markets. Banks operate as issuers, investors, underwriters and guarantors. Banks may also securitise loans and thus participate in long-term bond markets. In the process, the regulator of banks has a responsibility to ensure that banks’ participation in bond markets, both as issuers and investors is consistent with their risk management. The intricacies of bond markets do impact the balance sheets of banks, while banks’ confidence and participation in bond markets influence the growth and liquidity in the markets (Wellons, P.A. (2000)). In some countries, banks have been active participants in equity markets but their small presence in bond markets may be partly explained by the less developed nature of bond markets, particularly in Asia. Do banks operating in Namibia see the bond market as a treat or a collaborator?

d. Role of Credit Rating Agencies

Banks do possess intimate and specialised knowledge of the borrowers and are thus in a unique position to assess the risks in advances, while in the case of large number of investors in bond markets, such knowledge and skill are usually lacking. Sometime (not always judging by their performance in US and Europe lately!) Credit Rating Agencies (CRAs) help mitigate this problem of asymmetric information. The dissemination of information by the CRA, incidentally, makes the regulator’s task less tedious. The question is- how serious does Namibia take recommendations from CRAs?

e. Tax Regime and Debt Markets

An efficient tax regime should ensure that it does not create an impediment to the development of secondary bond market. Distortions may be created if, without clear justification, some participants are exempted from tax as compared to another, certain instruments are taxed while others are exempted and procedures for calculating tax or deducting tax at source distorts prices. Similarly, lack of clarity in provisions could also hamper trading in certain segments of the debt market. While the process of reform would have to be initiated in a given tax regime, with the evolution of reform, and as the market, institutions and instruments develop, the tax regime would need to be modified to suit the changing circumstances (OECD , 1988).

8. CONCLUSION AND SOME RECOMMENDATIONS

Developing viable bond markets needs continued and consistent policy efforts over a sustained time period. The policy efforts should deal with both demand and supply side impediments as well as infrastructure problems. Governments, fund managers, banks and other stakeholders will need to simultaneously support and assists in the development process of a bond market if it is to be sustainable.

The following are some lessons for developing countries:

- To develop a meaningful bond market, there should be a clear and balanced long-term debt strategy and a sound operational capacity.

- Three courses of actions are advisable to minimize the cost of debt securities. They are: first, tap the pool of global capital, in other words, open the bond market to foreign investors; second, there should be clear division of responsibility between debt management and monetary policy; and third, primary and secondary market infrastructures should be satisfactory.

- Regular and substantive communication and dialogue with markets on debt management objectives and operational strategies is essential. The rationale for debt management operations should be transparent and the operations are reasonably predictable.

- Too many different types of sovereign bonds are not desirable, but simplicity is better.

- There seems to be a broad consensus that a benchmark yield curve of at least ten years is meaningful.

- Selection of primary issue arrangements should consider the development stage of the bond market. Generally the open auction system is preferable, while smaller and less liquid markets may benefit from a dealer panel arrangement. In any case, a primary dealer system is essential to ensure market competition among participating dealers, efficiently distribute government securities and increase the liquidity of the securities.

- A captive or obligatory investor arrangement, such as required holding of specified proportions of financial institutions' assets in the form of government securities, is not desirable. In Australia, one consequence of the captive arrangement was only a very limited secondary market in government securities.

- Markets require a steady supply of new securities to sustain liquidity. Secondary market liquidity should be ensured by deliberate policy measures of the authorities.

- The uniform price, sealed bid auction is advocated in general.

- A coupon stripping, which splits bond income streams into coupon interest and principal repayment is desirable.

- Reliable and real-time clearing and settlement arrangements are equally critical to efficient operations.

- It is important to ensure a regulatory regime that provides both legal certainty and a level playing field, and remains responsive to the changing requirements of the market.

- Government bonds must be attractive to investors.

- There is the need to create a single central securities depository (CSD) to perform safekeeping, clearance, and settlement functions for all securities.

9. Initial steps ahead for a possible Namibian Bond Market

The following is further recommended:

9.1 After this symposium, a feasibility study be conducted involving all stakeholder- e.g. Banks, Fund Mangers, Major Corporations, government and other stakeholders to establish whether there is a financial/economic need for an established bond market. The study should involve interviews, questionnaires, qualitative and quantitative analysis aimed at establishing the need for such a market;

9.2 Assuming that (9.1) is positive, further workshops should be organised to discussed the possible structures to be in place- e.g. type of securities, necessary bill/laws, regulatory and other requirements and stakeholders' responsibilities;

9.3 A final document detailing the possible format and structures of the bond market should be written and made available to all stakeholders for final "debates" and revisions.

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Comments on "General Policy Environment for the Development of the Bond Market – Lessons From Other Developing Countries"

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Previous papers today have outlined the advantages of a well-developed bond market for Namibia and also how far we have come in the development of this market.

There are many roles a well-developed capital market can play in the development of an emerging economy, even one as small as Namibia. In the simplest terms the key challenge is to bring together two key participants in the economy:

- Savers (originally households) who have foregone some consumption spending in favour of future growth, and
- Entrepreneurs who wish to use this money for productive investment in assets that will produce growth.

Everything in the development of a capital market, whether it is for equities or for debt, should be subordinated to achieving this efficiency. In the process, a capital market will bring many other benefits, including:

- Increased efficiency of allocation of credit as investors use their freedom to channel investments to the sectors producing the best returns,
- Risk sharing and risk pooling,
- Matching risk, currency and duration in the funding instruments and the funding opportunities,

- Better monitoring and governance, particularly if investors are skilled and active, possibly leading to more efficient management of growth investments,

- Reducing risks by facilitating better flow of information including, in the case of a bond market, creation of a yield curve, price disclosure, as well as encouraging the gathering of accurate information on future Government and private corporate debt and capital management. The research output of some of the local stockbrokers, (notably IJG) bears witness to their efforts to promote this process,

- Reducing the cost of capital, and

- Facilitating inflows of foreign capital while reducing foreign exchange risk imposed by borrowing in foreign currency, and encouraging better utilization of domestic capital.

Professor Biekpe has given us a compelling and detailed paper on the benefits of developing a bond market. He has shown that there is a correlation between economic growth in several economies and the size of the debt market. It is not clear from debt and equity capital markets literature, whether the growth precedes the market or vice versa. That is, whether there is economic growth because there is a developed market infrastructure or whether the market develops in order to provide the capital demanded by excellent growth prospects. Intuitively, the second seems more likely and it has often been a mistake of emerging countries' capital market development to put a lot of structures into place. Instead a capital market should be pulled into existence by an enabling environment and the resultant activities of profit-seeking intermediaries and the demand for capital. Biekpe has pointed out that the market should be driven by the corporate demand for investment finance. Some of the recent capital market activity, especially in Africa, has been driven by the need to support new economic orthodoxies including privatization and after this, some markets have generally been slow to develop further.

The paper makes clear that banks should not see bond markets as competition. In fact it is clear that bond and equity markets supplement the role of banks. By creating new instruments and efficiencies a bond market facilitates more growth and more lending for banks. In the case of Namibia, banks are heavily constrained by single party lending limits in terms of their exposure to the few big clients available in our economy. In addition, bonds have proved good ways for two of the major banks – Standard Bank

Namibia and Bank Windhoek – to raise capital and would be a good idea for their competitors, especially those interested in growth.

Efficient and well-run capital markets provide many opportunities in an economy, including increasing investor confidence. Professor Biekpe has taken indicated clearly how the bond market can be a useful tool to Government and to the central bank, both as a mechanism for monetary policy and for funding Government deficits in a less inflationary way. He has also cautioned that it is necessary to handle the two functions separately. Bond markets can similarly mop up liquidity in the case of balance of payments surpluses, such as in South Africa and Botswana. Bond investments provide investors with a steady stream of income, usually at better rates than banks can provide and for longer durations, due to reducing the role of intermediaries. An effective bond market acts as a good way for Government and larger corporates to raise long-term and low cost capital.

In the case of an economy such as Namibia, debt finance including corporate bonds can often be more appropriate than equity finance. Larger Namibian corporates tend to be mature and not to offer the growth prospects which many equity investors are seeking. With the Namibian market hamstrung by illiquidity, the cost of equity capital is high –First National Bank of Namibia trades on a price earnings ratio of 3.6 times and a dividend yield of some 10%. Bonds can be a much cheaper and more appropriate way to finance such large corporates.

Biekpe has also summarized the conditions necessary for the development of a bond market. These include:

- The institutional base, including the existence of reformed pension funds and mutual funds,
- Supporting infrastructure including effective self-regulatory organizations and regulators, and a working clearing and settlement system,
- A clear long-term debt strategy from Government, including confidence in Government's predictable and stable macro-economic management,
- Legal infrastructure, including bankruptcy laws,

- Availability of different instruments and the possibility of securitizing other financing, and most importantly
- Liquidity

He has also discussed the possibilities of creating a regional bond market, the regional clearing and settlement, and the advantages and disadvantages of this. The main advantage would be increased visibility, accessibility and hopefully liquidity. The disadvantage could be that such a market may reduce the role of a debt market in servicing domestic monetary policy and in supporting the creation of further risk intermediation instruments such as forwards, hedges, futures and foreign exchange instruments.

The next stage in the discussion would be to see how far developments in Namibia have lived up to the lessons from other developing economies and how the bond market in Namibia is to continue its development in the interest of the growth of our economy and the improvement of living standards of our people.

Namibia has a relatively advanced bond market compared to many of its neighbours and other larger African economies. In terms of the criteria outlined by Professor Biekpe we score highly on:

Government: Since independence, the Government has taken a leading role in economic development and has already taken a lot of the steps outlined by Professor Biekpe. It has created a miraculously stable political and economic environment, including its own predictable management of deficits and a long-term bond and treasury bill timetable. On the macro-economic level it has sought to achieve growth and equity targets within the framework of linking our inflation and interest rates to the successful management of the South African economy, ensuring we can also benefit from the liquidity of our larger neighbour. A major advantage of Namibia's position is that the bonds can be priced according to benchmark South African bonds, and this has developed in response to market acceptance. This means that we overcome some of the problems of illiquidity. The market can use regional trading as a measure for future inflation, interest and currency prospects, while expressing their views on domestic management in terms of the risk premium or discount attached to local securities. Overall, the Namibian Government has supported a good enabling legal and regulatory environment.

Legal framework: Namibia has a well-developed legal structure including adequate laws, and courts that have been used successfully for many corporate actions. This is a major advantage that should be encouraged by the creation of continuously updating legislation.

Institutional development: Namibia has a well-developed institutional investor market including at least N$20 billion under the management of pension and long-term insurance investors. Critical steps have included the successful creation of well-constructed local funds, including the Government Institutions Pension Fund, and the resultant encouragement of local fund management skills. There has been a focus on delivering good investment returns to the many Namibian savers who are the owners of the pension and insurance funds.

Market mechanism and intermediaries: There is already a well-established Namibian Stock Exchange with efficient computerized trading and good supervision of market participants. Its roles include as a self-regulatory organization, and to disseminate information and education supporting market development. There are also successful and competitive stockbrokers, some with top-quality research facilities and most with excellent reputations of integrity and efficiency, reputations which they strive zealously to protect. Our banks are well-run and efficient and could support bond dealing operations. The introduction of Namclear as a clearing and settlement system between the banks and the development of one or more central depositories in the Namibian context should further enhance the process, supported by the existence of efficient and experienced Transfer Secretaries. Decisions have further been taken on the establishment of a Namibian Bond Association to bring together all possible market participants for the development of the Bond Market.

Regulators: The Namibian Financial Institutions Supervisory Authority and the Bank of Namibia both have skilled regulators. The aim behind the creation of Namfisa was to increase the availability of local skills in order to ensure that legislation can keep up with the needs of developing the capital market. Both bodies should be able to combine to provide information and advice, closely linked the market practitioners’ views, of how to develop the markets.

Instruments: There is already a good range of bonds listed and this development continues, with several more bond issues planned for the rest of this year. The bond market has helped Government has a total of N$9.2 billion in the domestic debt market, with some 46% of this in the long-term market. Bonds issued range from the GC05 to the latest addition, the GC24, expiring 15 October 2024. Government uses this partly for capital development. Other listed bonds that contribute to economic growth include an Agribank bond, funding agricultural development, and N$400 million of Road Fund Authority stock to finance road infrastructure development and improvements. National Housing Enterprise also has a bond issued. Dynamic and innovative banks have not stayed away from the exchange - Standard Bank and Bank Windhoek have both used the opportunity to improve their balance sheet and capital base, while also obtaining longer-term finance through the issue of N$150 million and N$75 million bonds respectively.

Given this stage of development, why is the Namibian bond market not developing further? The participants at this symposium are well placed to share collective and individual wisdom and the opinions voiced here are a few controversial ideas to get the ball rolling. Lack of liquidity is currently the key constraint on Namibia's market development and this needs to be tackled through:

Institutional and individual development and skills advancement

There is not a trading mentality among the managers of Namibia's institutional savers. Very few have bond market skills and believe their mandate requires a "buy and hold" mentality when it comes to bonds. Few, if any, of the banks' treasuries have any mandate to actively profit on the local bond market or any capacity to look for trading profits by using their own capital base as a trading platform. This will only be introduced when one takes the plunge and the others see the profits that result - currently there is little competition in this field between banks. Human resource development is critical in this, as in all forms of economic development. The role of skilled and profit-seeking individuals is generally overlooked in understanding the development of successful capital markets and thus is not sufficiently emphasized in recent emerging capital market development efforts. Markets such as the US and UK have been driven by the individuals who find and create opportunities and the market has grown around supporting, regulating and guiding these drives. The importance of developing and rewarding Namibians' skills in the local capital market cannot be overemphasized.

Lack of demand for growth capital

This is a critical constraint in the Namibian economy and Government has an important role to play to freeing up and encouraging growth capital opportunities. Recent policy announcements that more of Namibia's institutional savings are to be pushed into the local market, even if it means lower returns to the Namibian savers, could have a adverse effect if not handled well and selectively, including through professional intermediaries. It is demonstrated in some of our neighbouring markets that capital controls often encourage the "buy and hold" mentality and discourage liquidity. It also discourages investor and saver confidence if investments fail to deliver competitive returns. The difference between primary capital-raising and secondary security trading is also important in developing such policies.

An alternative strategy would be for Government to concentrate on encouraging demand for capital, including through investment facilitation and tax incentives for profitable investments. Further, most major corporates are 100 percent owned by Government, which is not allowing opportunities to Namibian savers (individually and through their institutions) to participate in the benefits of Telecom Namibia, Nampower and other well-run organizations. Government further crowds out the private sector through over-generous use of Government guarantees and other support, further reducing the efficient role of the market in allocating capital to the most successful growth prospects and other benefits of efficient bond and equity capital markets, outlined earlier in this discussion.

Market mechanisms

There is already a computerized trading system, which could be adapted for bond trading. However, the trading mechanism is not the key factor. Many developing and even advanced bond markets work well without computerized trading and instead using some other form of open auction. Most important is to make the market accessible by creating mechanisms through which all interested parties who have sufficient resources to settle their trades can be allowed to participate in the market. It is counterproductive to create several different market mechanisms and self-regulatory organizations and encouragement should be given to using and, if necessary, transforming and adapting existing structures, rather than creating new.

Market making and primary dealers have already been referred to. I believe it is important not to take too rigid a view, as a previous discussant already outlined. Limited-exposure market making, say up to a particular amount a day or at the discretion of the bank or issuer concerned, could be encouraged as an intermediate step to increase trading.

Regional market links

For the efficient trading of stocks and equities, it is not important where the marketplace is. For instance, local equities are traded on a platform based in Johannesburg. What is important is that there is sufficient focus on the local stocks and information about the local economy that the capital market meets the needs of the local economy. A key strategic direction should not be the dual-listing of bonds on different securities exchanges, as this could have the effect of splitting liquidity. Instead it should be to build common and accessible trading platforms and markets and to allow access to the widest possible range of participants including players in neighbouring countries. However this access should be consistent with good regulation, market confidence, and efficient settlement and clearing.

I realize that the above has probably raised more questions than answers. Namibia is blessed with a range of well-intentioned and skilled market participants on all sides, including at policy, regulatory and other levels. The way forward is for these participants to study both the economic theory, as outlined by Professor Biekpe, and market realities. Out of this we can formulate working policies for encouraging our capital market to help achieve the economic growth goals of our National Development Plans and Vision 2030.

CONCLUSIONS AND ISSUES EMANATING FROM THE SYMPOSIUM

The importance of a well functional bond market in Namibia cannot be overemphasised. The bond market can serve the following: offer an alternative source of funding debt, reduces the cost of capital, expands the choice of assets for investors and improve the pricing for risk. It will also help with mobilisation of private savings and channel them into productive sectors, transparency and increase liquidity as well as introduction of products that meet the needs of long term issuers and investors. The Government of Namibia, parastatals and banks are the main issuers of bonds in the Namibian bond market. The instruments used include the Government of Namibia's Internal Registered Stocks (IRS), debentures issued by parastatals and private sector bonds. The Government papers account for a large proportion of papers issued in the long term securities market in Namibia. However, the bond market in Namibia is faced with a number of challenges such as liquidity[7], transparency[8], efficient trading and the small number of and size of the local market.

The following were the main issues that emanated from the symposium.

Sovereign Credit Rating

There was a consensus that credit rating is critical for the establishment of a well functioning bond market. Further it provides the investor with unbiased and objective opinion of the relative risk of the bond issue. In order to attract foreign players ratings are therefore essential. From this background Namibia is encouraged to seek credit rating.

Appointment of Market Maker or Primary Dealers

The primary dealer acts as the issuers interface into the market. All bids for bonds are channelled via the primary dealer. They sell bonds to investors and buy again from them when investors want to dispose off these bonds. The Government which is the biggest issuer of bonds could consider appointing 2 or 3 primary dealers. Given the small and illiquid nature of the market the Bank of Namibia could consider to act as a market marker temporarily. However, the other opinion was to leave this role to the private sector.

7 The ease with which bonds can be traded in the secondary market.
8 There are neither fully transparent price indications in the entire market.

Guarantee Fund

Trading in bond involve a number of risks such as performance risks, settlement risks, post settlement risks, and the issuer' default risk. Therefore, once established the Namibia Bond Market Association should consider setting up a Guarantee Fund. This fund will be a mechanism that can offer some form of protection to all participants in the bonds market. The fund could be used for the discharge of a claim by either a member or a client of the member for the market price movement in the event that a member is in default between trade date and settlement commitment. The participants and regulators could set the basis upon which they contribute to this fund.

Retail bonds

The denominations of bonds may actually be too big to such an extent that it excludes small and individual investors. In this regard, it was recommended that practitioners in the bond market may consider introducing retail bonds denominated in hundreds and thousands, so as to cater for the needs of small investors. Such bonds could be sold by the Post Office as in the case of South Africa.

Feasibility Study

Further the symposium suggested the need for a feasibility study involving all stakeholders, on the need for establishment of a bond market in Namibia. Such study could involve questionnaires, qualitative and quantitative analysis. If these consultations are positive there is a further need to organise a workshop to discuss other issues such as the structure of the market, types of securities, necessary laws, regulatory and other requirements.