THE FIXED INCOME SECURITIES MARKET RECENT DEVELOPMENTS AND FUTURE PROSPECTS

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INTRODUCTION

The Fixed Income Securities Market in Sri Lanka has no doubt achieved considerable development in the recent past. Are we happy and contended? Or are we striving towards more and more success?

To answer these questions, it is worthwhile understanding what this market is; what are the ideal conditions and objectives that we strive to achieve? Where do we stand today? What have been the developments in the recent past? And where do we want to go? etc., etc.

FIXED INCOME SECURITIES MARKET

A Fixed Income Securities Market is a market place where transactions involving Fixed Income Securities (FISs) are carried out. They can be:

1. Outright buy or sell transactions

2. Repurchase or reverse repurchase transactions involving fixed income securities (REPOs and Reverse REPOs)

3. Transactions of derivatives such as Forward Rate Agreements, Interest Rate Swaps, Futures and Options connected with FISs that provide better price discovery, hedging and liquidity support for the outright and REPO markets.

FIXED INCOME SECURITIES (FISs)

What is a Fixed Income Security? To understand a FIS it is first important to differentiate between three segments of the financial market.

1. Loan market

2. Contractual Savings Market

3. Securities Market

The loan market represents the Banks of various types, Finance and Leasing Companies that carry out the intermediary functions of accepting deposits or funds under various forms and lending such money thereby creating non-transferable assets.

The contractual savings market is the segment where there are long term savings contracts such as Provident Funds and Insurance Schemes and the funds and institutions concerned engage in an intermediary process.

The securities market is where the market participants are engaged in transactions concerning tradable securities. These securities can be broadly categorised into two types viz. debt securities and equity securities. Accordingly there are two market sub segments i.e.

1. Debt Market

2. Equity Market

Of course, there are hybrid instruments such as preference shares and convertible debentures which will go into an appropriate segment, may be equity market or debt market respectively.

The debt market is the market place where the debt securities are traded. The debt securities, as we know, tend to have some specific features :

1. They represent borrowings by the issuers and hence the buyers or investors are creditors.

2. The investors are entitled to receive of interest on these instruments.

3. These interest payments are made at fixed rates or floating rates where, in both cases, the basis of interest payment is predetermined by the issuer at the time of issue.

4. Hence, the term fixed income securities; of course, the income can be quite volatile depending on the prevailing interest rate scenario. The debt market is also referred to as the Fixed Income Securities Market.

5. The securities can be issued on a secured or on an unsecured basis.

6. They may be issued in tranches where some are subordinated to the rights of the others.

7. The securities may be rated or un-rated. Ratings indicate the credit quality.

8. The securities can be embedded with call, put or prepayment options that create somewhat complex cash flow patterns for the so called “Fixed Income” securities.

9. A variety of coupon structures, embedded options and different credit ratings make it possible to have a large array of FISs that cater to various requirements of issuers and investors.

THE ISSUERS OF FISs

Who issues Fixed Income Securities? Anyone who wants to borrow may issue FISs. Governments, authorities, companies, associations and special purpose vehicles etc issue FISs.

In Sri Lanka, in particular, the biggest issuer of FISs is the Government of Sri Lanka. There are Government securities issued in two forms viz. Treasury Bills and Treasury Bonds. There are two statutes that govern the issues, viz.

1. The Local Treasury Bills Ordinance.

2. The Registered Stocks and Securities Ordinance.

The Government issues the securities to bridge the fiscal deficit. The issued and outstanding Treasury Bills and Treasury Bonds of the Government of Sri Lanka as at 31st December 2003 were Rs. 219.3 Bio and Rs. 483.1Bio respectively. The Government in addition to these had Rs. 248.4 Bio worth of Rupee Loans, a non-tradable security issued and outstanding and Rs. 8.8 Bio worth of US Dollar denominated Sri Lanka Development Bonds. With other domestic borrowings the total domestic debt was Rs. 1019.9 Bio. The foreign borrowings were Rs. 843.9 Bio making a total public debt of Rs. 1,863.8 Bio.

An interesting addition to the Government Securities Market was the issue of US Dollar denominated Sri Lanka Development Bonds commencing from 2001. These Bonds are issued with floating rate of interest linked to the six months' LIBOR rate. Issues are made through competitive bidding amongst selected authorized dealers and Primary Dealers. Up to August 2004, during this year, the government issued Development Bonds of USD 194 Mio in two stages of USD 144 Mio and USD 50 Mio. The government plans to issue as much as USD.400 Mio during the year. The Development Bonds appear to reduce the burden on Rupee interest rates to some extent and also can be considered a matching source of funds where the utilization is for foreign currency denominated expenditure or debt servicing.

The public debt being more than the GDP of the country (Rs 1,760 Bio for year 2003 at current prices) there is no doubt the Government is the biggest issuer of FISs. Accordingly, the Government Securities Market has seen substantial developments over the years.

The other significant debt issuers at present are the special purpose vehicles in the form of trusts to issue securitised paper against lease receivables and similar cash flows. The size of this market is approximately estimated to be around Rs.15 Billion.

The corporate debt is issued mainly by Banks for their capital requirements and other large corporates to meet their long term funding. The listed market capitalization of corporate debt outstanding as at 31st December 2003 was Rs.10 Billion.

MULTIPLE SOURCES OF BOND ISSUES; A NEED RECOGNIZED

As stated above, more than 95% of all the tradable FI securities are those issued by the Government. Do the "others" not need money? Why do corporate bodies not issue debt securities to meet their funding requirements? How about local authorities, corporations, housing Banks? There seems to be some severe dislike to go to the FIS market to raise funds. Or is it lack of awareness? Lack of confidence that the market can, in fact, raise the funds required through FISs? Or is it having too many restrictions and regulations that make issuers shy away from this market? Where do they in fact get the funds?

The sources of debt funding that keep the potential issuers happy for the moment can be identified as follows:

1. Companies seem to rely on the Banking system i.e. the loan market instead of the debt securities market. This is probably a matter of habit. Banks are there to lend so why issue bonds? After all, it is a lot of a hassle.

2. Companies, apart from Bank finance, do also raise a part of their funding from share issues and retained profits thereby relying on equity finance.

3. Government corporations and semi Governmental institutions too seem to be relying on Banks. Or they may have restricted borrowings.

4. Government corporations and semi Governmental institutions rely also on foreign project loans that are directly identified and earmarked for projects.

5. Similarly, Government departments and authorities such as Mahaweli rely on directly identified foreign borrowings of the Government apart from the budgetary allocations.

6. Housing and development Banks too tend to enjoy various credit lines that enable availability of debt finance, in addition to certain amount of debt instruments issued.

7. Apart from direct project type foreign borrowings, the Government and semi Government entities tend to have budgetary allocations for their capital expenditure.

8. The local authorities apart from their revenue from taxes, rates, duties etc. rely on the Central Government budgetary allocations. Very little or no borrowings are observed. The current legal framework may not permit direct borrowings.

In analyzing the different potential issuers, the competitors to raising debt by Government sponsored projects and entities can be identified as:

1. Direct Budgetary allocations by the Government. Of course the Government may borrow for these purposes.

2. Foreign borrowings and

3. Bank borrowings

The competitors to companies in raising debt finance appear to be the Commercial Banks, Development & Specialized Banks, Finance Companies and Leasing Companies.

The important issue in hand is that the traditional means of finance of most of the potential issuers of debt have created a status of complacency that they do not seem to think of going to debt securities market to raise funds.

SOME OF THE BOND SECTORS AND ISSUERS IN THE UNITED STATES (US)

We know that US is the largest bond market in the world. The US bond market comprises of four types of securities:

1. Government Securities

2. Federal Agency Securities
    - Federally Related Institutions (Government Owned Agencies)
    - Government Sponsored Enterprises (GSEs)

3. Municipality Securities
    - State and Local Governments

4. Corporate Debt

1. The US Government Securities

We do not wish to go into a deep analysis of the US Government Securities Market. There are three types of securities viz. :

1. Treasury Bills
    - with maturities up to one year
    - issued on a discounted basis

2. Treasury Notes
    - with maturities ranging from 2 years to 10 years
    - issued with interest coupons

3. Treasury Bonds
    - with maturities ranging from 10 years to 30 years
    - issued with interest coupons

An interesting variety of Treasury Securities is the TIPS (Treasury Inflation Protected Securities), which are also called the TIIS (Treasury Inflation Indexed Securities). These securities ensure a fixed real return adjusted for changes in the rate of inflation. Higher the inflation, higher the nominal return and vice versa.

Another interesting development is the coupon stripping of Treasury Securities. By stripping the coupons, one can make a separate series of zero coupon bonds which can trade separately. This process will identify and eliminate arbitrage opportunities where one can buy a bond, strip it and sell the strips at a higher price than the bond. This opportunity particularly arises when the yield curve is steep upward sloping.

A special arrangement for stripping of coupons is in place in the US FIS market. This is called Separate Trading of Registered Interest and Principal Securities (STRIPS).

2. The Federal Agency Securities

As stated above, either Government Owned Agencies or Government Sponsored Agencies issue these securities. Some of the issuers are:

1. Government National Mortgage Association (Ginnie Mae)

2. Export Funding Corporation

3. Federal Farm Credit System

4. Federal National Mortgage Association (Fannie Mae)

5. Federal Home Loan Bank Corporation (Freddie Mac)

6. Student Loan Marketing Association (Sallie Mae)

7. Federal Farm Credit Assistance Corporation

The extent to which the above issuers have the credit risk vary. Some like the Federal Farm Credit Assistance Corporation are backed by full faith and credit of the Government.

These agencies issue securities in two forms:

1. **Debentures which are not backed by specific cash flows**

2. **Mortgage backed/Asset backed securities. These are of two types**
    - **Mortgage pass through securities**
    - **Collateralized Mortgage Obligations (CMOs)**

Essentially these are securitisations of the cash flows of the mortgage loans.

3. Municipality Securities

The name here is misleading. These are not securities essentially issued by municipalities. They are issued by state and local Governments. There are a variety of securities issued:

- **General Obligation Debt**
    - **Unlimited Tax backed**
    - **Limited Tax backed**
- **Appropriation backed obligations**
- **Revenue bonds where the source of repayment is the revenue generated by the projects**

Some examples of revenue bonds are:

1) Utility Revenue Bonds

2) Transportation Revenue Bonds

3) Housing Revenue Bonds

4) Higher Education Revenue Bonds

5) Healthcare Revenue Bonds

6) Sports Complex and Convention Centre Revenue Bonds

7) Seaport Revenue Bonds

8) Industrial Revenue Bonds

4. Corporate Bonds

As stated earlier, these are issued by companies to meet their capital requirements and these instruments rank ahead of the equity, in the event of winding up of the business.

SOME REPLICATIONS TO SRI LANKAN MARKET; CAN WE HAVE MORE ISSUERS?

Observing the variety of instruments in the US Bond market, it is worthwhile looking at the feasibility of issue of other forms of Fixed Income Securities apart from the Government Securities that are widely spread and corporate debt that already exist to some extent.

May I suggest some crazy ideas for consideration one day or the other? Can we issue bonds such as:

1. Hospital Bonds backed by part of the excise duty on tobacco and liquor to develop the hospitals.

2. Student Loan Bonds backed by Student Loans on the basis that our University students will repay the loans after University Education.

3. Highway bonds backed by the tariff/toll to be collected to develop highways

4. Energy Bonds to fund the generation of energy.

5. Mortgage Backed Securities (MBSs) issued by separate entities that will be in the business of pooling mortgages and raising funds against the same.

6. Lease Backed Securities; Our market already has a kind of lease receivables securitisation which is not tested in accounting, taxation and legal aspects.

7. Airport Bonds that can raise funds to develop the airports, backed by the future airport taxes.

8. Provincial Bonds that can help development of the provinces, subject to strict fiscal discipline, backed by the future revenues of such Provincial Councils.

9. Foreign Employment Bonds backed by levies on those engaged in Foreign Employment to uplift the infrastructure facilities for the benefit of those employed abroad.

What is the feasibility of issuing such bonds? How will it help the market? How will it assist in the fiscal policy and monetary policy?

ISSUE OF SEMI GOVERNMENT/ PROJECT AND SECURITISED BONDS; THE IMPACT ON THE FISCAL POLICY

It is possible to complement some of the funding directly done by the Government under different types of Bonds. For example, a Highway Bond will replace the Government's need to raise borrowings under the central budget but give the responsibility to a separate entity which is not part of the Central Government Funding. In instances such as Hospital Bonds or Healthcare Bonds backed by future excise duties, the Government may enjoy the benefit of not having to set aside immediate funds while sacrificing part of the future revenues.

To develop this process into a workable solution, let us identify and propose few models that may evolve through a process.

Model 1 – Direct Government Borrowing

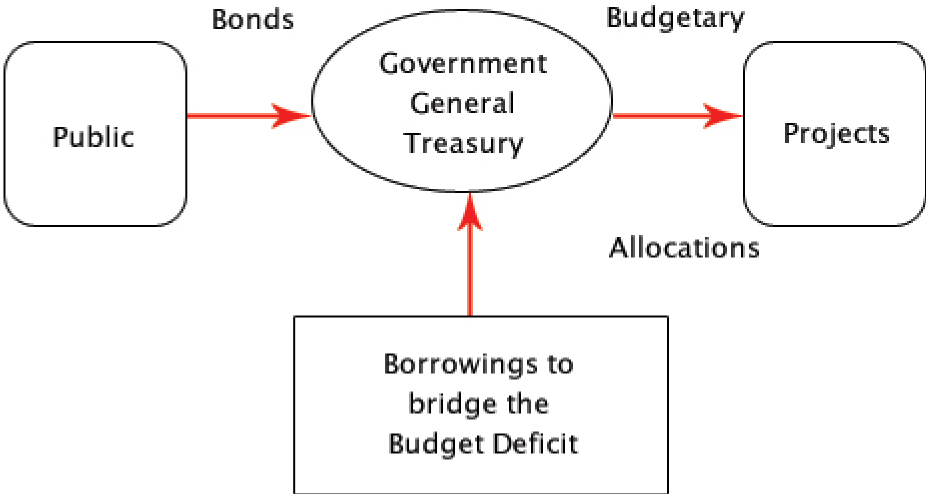

Diagram 1 - Direct Government Borrowings

This is the model that is followed at present. It is a very basic stage of pooling all the revenues centrally and then distribution by the General Treasury.

Model 2 – Indirect Government Borrowing

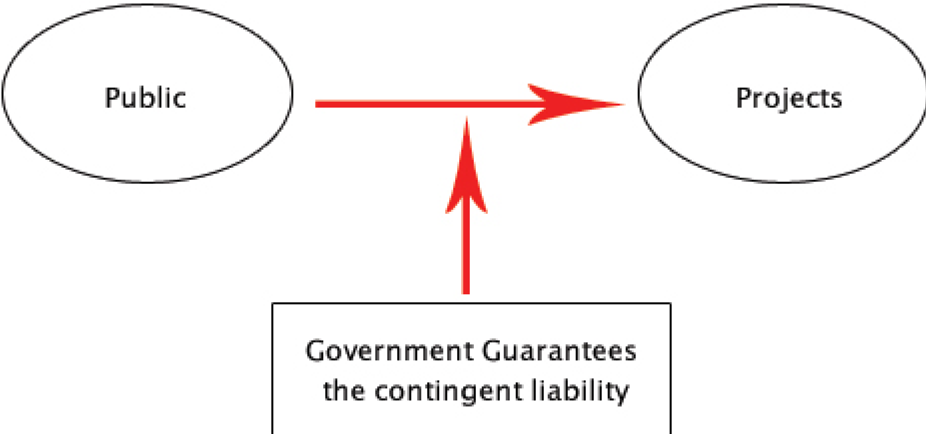

Diagram 2 - Indirect Government Borrowings

In this model the Government yet increases its commitment by way of contingent liabilities instead of direct borrowings. However an advantage is that the interest cost of borrowing and loan repayment will not be a direct burden on the budget except in an instance of default.

Model 3 – Borrowings under Future Revenue Commitments

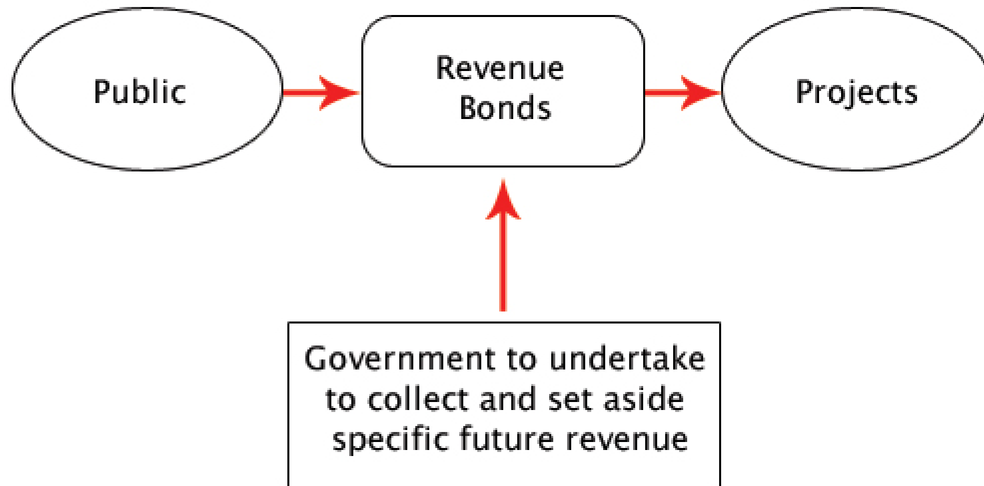

Diagram 3 - Securitised Revenue Bonds

In this model the Government does not create any direct or contingent liability. Hence the Government can reduce the fiscal deficit in a systematic manner over a period of time.

Model 4 – Independent Government Agency Borrowings

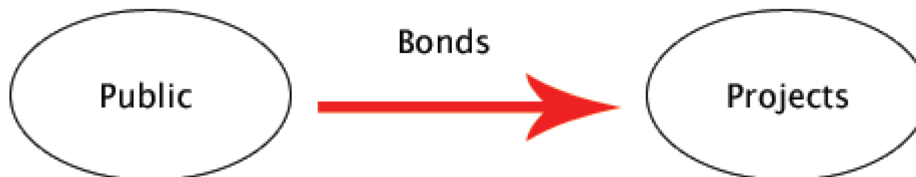

Diagram 4 - Independent Government Agency Borrowings

In this model, the Government does not have any involvement in raising funds except that the project may be initiated by the Government. Raising of funds will be done by the projects on their own merits.

The models can evolve in stages from Model 1 to Model 4. Initially the benefit on the Government's fiscal policy may not be visible or significant. But as time goes on there will be enormous advantages leaving some of the non-core activities outside the Government.

How do we bring Foreign Borrowings under the Bond Market?

This is a serious limitation that will arise. Most of the external borrowings are specific loans for identified purposes. Converting such loan obligations into debt securities may be a tedious or impossible task. Skills & wide spread use of securitisation will definitely help. This matter needs further study but a tentative model can be given below:

Model 5 – Securitising Foreign Debt

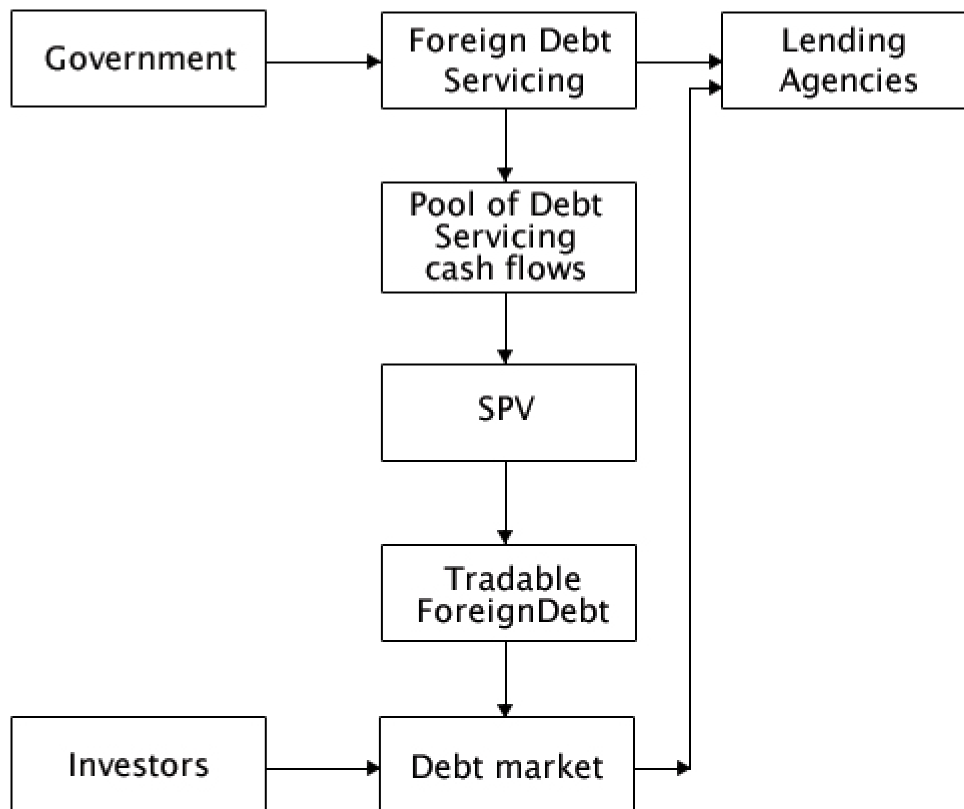

Diagram 5 - Securitising Foreign Debt

The non-tradable foreign debt can theoretically be converted into tradable foreign debt. Questions of the borrowing costs will arise as most of the foreign debt has been raised at concessionary rates. Further, the conditionalties of the lending agencies would not permit such early repayment and fresh issues. In any case such resources of creating tradable securities may better be spent in creating such securities for the future projects rather than for the projects already undertaken and/or completed. Further, the relevance will be seen only at a time when borrowings at concessionary rates would no longer be available.

Having talked about creating Semi-Government or Non-Government Agency and Project securities, there are yet many barriers that need to be defeated.

In particular, it is necessary to seriously study all the legal implications, regulations, tax implications and accounting issues that affect the securitisation process. The market is not mature enough and the legal outcomes not tested. Particularly, removal of assets through securitisation is not yet properly established in our system.

A task force to study securitisation and to come out with a draft Bill to make the necessary changes to the Statutes concerned is a matter of priority.

THE FUTURE PROSPECTS OF THE FIS MARKET; WHAT WE WANT

For the development of the FIS market, there are a numbers of factors that need to be addressed. The essential pre-requisites for the development of the market can be summarized in an acronym BIIPGRILL ©. This stands for:

a. A good variety of *Buyers*

b. A good variety of *Issuers*

c. A range of *Instruments* including Derivatives

d. Active and Sufficient number of *Players*

e. A good *Play Ground*

f. *Rules* of the Game

g. *Information* at no cost

h. *Liquidity* of the instruments through large volumes

i. *Low* Transaction Cost

Let us analyse each of the pre-requisites in detail.

a) A good variety of Buyers

The development of any Fixed Income Securities market requires that there should be a variety of buyers with diverse requirements with regard to the risk appetite, investments horizon, liquidity requirements, investment volumes, the level of sophistication etc.

The Sri Lankan FIS market however is concentrated in the hands of few institutional investors. Having observed that more than 95% of the FIS market is represented by the Government securities, it is adequate to analyze the holdings of Government securities to understand if we have a variety of buyers.

As at December 2003 total Domestic Debt outstanding was Rs 1,019 Bio. The Employees Provident Fund, (EPF) being the largest single investor in Government securities held Rs 323 Bio worth of Government securities. This was 31.7% of the total. Similarly the National Savings Bank (NSB) held Rs 138.9 Bio (13.6%). Commercial Banks in total held Rs 183.8 Bio (18%) and the Central Bank held Rs 44.5 Bio (4.4%). Others including Primary Dealers held Rs 329 Bio (32.3%).

Primary Dealers are those licensed by the Central Bank to bid at the primary auctions of Government securities. There are twelve Primary Dealers appointed at present. Primary Dealers buy Government securities in the primary auctions and sell/ hold and sell them in the secondary market. There is a minimum bid requirement (10% of each auction) to each of the Primary Dealers. Primary Dealers are also subjected to capital adequacy requirements, a comprehensive code of conduct, requirements to publish financial statements on a semi annual

basis, and a range of such regulations. They are also supervised by the Public Debt Department of the Central Bank of Sri Lanka.

Primary Dealers are exclusively engaged in the trading of Government securities. They are either fully owned subsidiaries of Commercial Banks, companies sponsored by other financial market promoters or units of Commercial Banks.

Primary Dealers also maintain accounts for the end investors in the Central Depository of the Central Bank of Sri Lanka. This function is performed by Commercial Banks too.

Apart from the existing institutional structure, there need to be a wider framework of institutions that generate the demand for Fixed Income Securities. The current limited institutions do not necessarily form an active market.

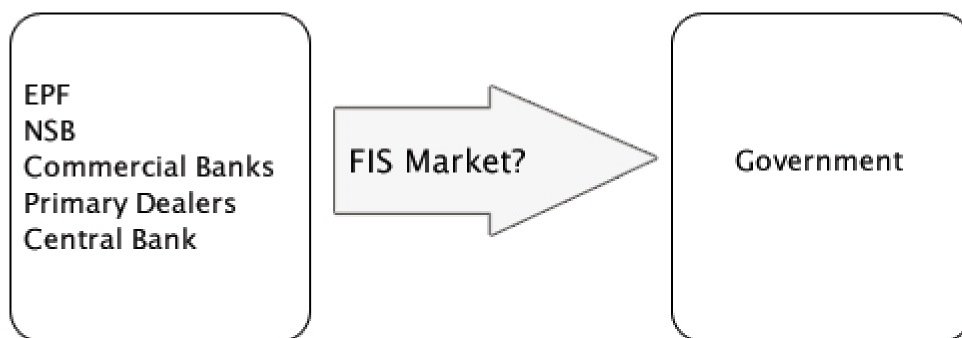

Diagram 6 - The FIS market dominated by the Government Securities and few Institutions

There is a role to be played by the various types of unit trusts and investment trusts that can create investment instruments backed by FISs. Such instruments as Treasury Bill Backed securities (TBBSs) when offered by such portfolio and fund managers will collect funds from the retail and high net worth investors. The unit trusts/ mutual funds can also offer funds that incorporate investments in a range of fixed income securities that will enable taking credit risk while at the same time pooling the credit risk. Sri Lankan investors in corporate debt did invest directly by themselves and learned the lessons when one merchant-Banking firm failed to honour the commitments. It is risky for individuals to hold corporate debt directly without holding diversified portfolios. The unsystematic risk would not be diversified. On the other hand a mutual fund investing in a large number of securities will not only diversify the risk but also pool the risk getting the benefit of the large numbers. Hence it is far safer for the investors in FISs to invest through mutual funds except in the case of Government securities where there is no credit risk to pool or business risk to diversify. An active role by the Unit Trust industry will definitely add value to the FIS market.

EPF being a dominant player and the resultant tendency to use the EPF on a non-market basis has both good and bad outcomes. In a rising rate scenario, the dominant players can come forward to stabilize the market. However it is a well-recognized principle that under normal conditions, dominance by few players is a symptom of a less efficient market.

If the market is confined to such few dominant players then, there is no doubt, there is very little width the market may have.

Even out of the dominant investor group, there is no firm demand at all times for securities in the long end of the term structure. This is a statement that sounds completely baseless given the large provident funds and insurance funds that exist in the system. Both these categories are long-term funds that invariably should have a high appetite for long-term investments. However, the reality is otherwise.

Though these entities have "long term funds" they do not have long term return commitments towards their suppliers of funds. For example, EPF does not guarantee a specified minimum return in the long run. Should we not encourage competing pension funds who would offer such value addition?

Similarly, the insurance companies who have long-term life funds do not guarantee a decent return over a long period. Instead they tend to assume a very low guaranteed rate and any surplus is passed on to the policyholders by way of bonuses. This essentially is a way of playing in the short end of the market.

They may be justified in resorting to such short-term investment horizon due to the following reasons:

1) Their investment objectives do not require the assurance of a decent long-term rate. Hence fixing the rates over long periods may not be necessary.

2) Particularly, given high volatility of interest rates, they may be concerned that fixing of returns for long tenors may coincide with low interest rate scenarios followed by rising rates. In such cases the decisions may be found to be wrong with hindsight.

3) There is no long term inflation rate view taken by the monetary authorities in the absence of the trendy policies such as inflation targeting that are pursued by certain other countries, of course, under different economic conditions and financial systems. This is substituted to some extent by the provisions of the Fiscal Responsibility Management Act and the medium term plans highlighted with regard to the fiscal policy in the Government Budgets.

4) When all the players concentrate on the short term investment horizons, the benchmarks are recognized based on such short term instruments. Those who commit into long term instruments may appear to be performing poorly at times of high interest rates. Of course it will be the opposite under low interest rate scenario that may follow a high interest rate scenario.

5) The blame may be put back on the non-existence of active trading of long term securities (say over six years) as a result of which the long term rate discovery and price transparency will be difficult. This is a "Chicken and Egg" situation. One complements the other.

Despite the above constraints and concerns, it is necessary that the economy at large is blessed with long term funds that seek long term fixed returns.

There are several benefits that not only the FIS market but also the economy at large will enjoy:

1) When funds are compelled to guarantee target long term returns, then they will be "asset hungry" for long term assets. The result is that a range of new long-term investment instruments will be sought after. This will lead to the development of the FIS market.

2) When there is demand for long-term assets, then the market will not over-react and shy away from long-term instruments even when there is upwards pressure on interest rates. Their need to match the long-term funds with long-term investments will result in a fairly stable demand for long-term instruments.

3) The members of the funds will enjoy stable returns with less volatility.

4) In case the economy shifts from a high interest rate scenario to a low interest rate scenario that may be sustained for several years, then the members of the funds will still be benefited by long term rates fixed earlier. As per the current practice it is most likely that in the event the economy settles for sustainable low interest rates, the members of the funds will face the low rates unprepared and continuously receive low interest rates. They would realize the mistake of not investing at fixed rates for long periods only when it is too late

c) A good variety of Issuers

We have already discussed the fact that the Sri Lankan Fixed Income Securities Market is highly concentrated on the issue of Government securities. We also discussed some "crazy" ideas as to how we can widen the range of instruments that are available in the market. Five models were discussed as means of gradually eliminating the Government's role in intermediating the raising of funds and using of funds particularly in development activities. Such package of actions will invariably result in creation of a large number of issuers and also a variety of instruments.

d) A range of Instruments including Derivatives

We discussed the range of FISs issued in the United States and also discussed the potential instruments that can be issued.

The range of instruments will invariably increase when the range of issuers increase. The differences in credit quality of such instruments will make the FIS market even more interesting to analyze. Such range of instruments will be made use of for different risk return profiles. There is also the potential to incorporate call and put options on such securities and issue them with such embedded options. The mortgage backed securities market is bound to give the taste of specific risks attached to amortizing bonds and prepayment options in the underlying mortgages.

A range of derivative products will be the natural reaction to deal with the complexities arising from a variety of instruments. Of immediate necessity are the wider use of two derivatives viz. Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRSs). There had been occasional use of these instruments but the market has not developed to a stage of being able to quote for

these instruments on an "over the counter" basis. Fear of derivatives seems to suppress the potential benefits.

The Primary Dealers exchanged a series of FRAs and IRSs in December 2002 with a view to identifying several issues including documentation, accounting and taxation. Although this gave insight as to the procedural aspects, the market appetite yet remains very low.

At a latter stage, of course, the market needs to be supported by futures and options. An alternative will be the use of foreign currency denominated futures and options for cross hedging provided the capital account transactions are permitted under the exchange control regulations.

e) Active and Sufficient number of Players

"Players" are the market makers who create and maintain an active market of securities. The main players in the Government Securities Market are the Primary Dealers and the Commercial Banks. Apart from them the money brokers play a vital role. Large institutions and funds such as NSB, EPF and ETF also help in creation of an active market in addition to their role as end investors.

How about swap dealers and option writers? People engaged in creating securitisation structures and issuing securitised paper? (Happening to some extent now). Rating Agencies competing for business instead of a single agency? Analysts who have got something to analyse beyond the "plain vanilla" Government securities?

f) A good Playground

A market place for trading in FISs is an essential element of a good securities Market. At the moment there are few routes of carrying out trades in the Government Securities Market.

Several infrastructural developments took place in the Government Securities Market in the year 2003 and in early 2004. On 8th September 2003, the Central Bank of Sri Lanka commissioned the Real Time Gross Settlement System (RTGS). On 3rd February 2004, the Central Bank commissioned its Central Depository for Government Securities and the Scripless Securities Settlement System.

The Real Time Gross Settlement System (RTGS) is a system that enables settlement of transactions between different parties participating in the system on a real time basis as against the previously used end of day net settlement. Further, transactions are settled one by one on a gross basis without netting off one another. This is also supported by settlement of securities in the Scripless Securities Settlement System (SSSS) where the securities trades between the parties can be effected within the same system. The result is a long awaited delivery vs payment where the movement of securities and funds happen simultaneously between the buyer and the seller. This has eliminated the settlement risk thereby creating a good market place where transactions related risks are minimized. Further, to enable settlement of securities in scripless form and also to be able to store the securities ready to

trade at any time without the hassle of physical delivery etc. the Central Bank also set up the Central Depository for Government Securities.

In October 2003, the Association of Primary Dealers (APD) concluded agreements between the APD, the individual Primary Dealers and Bloomberg SA to set up the Lanka Primary Dealer Bloomberg Bond Trader platform (LPBT). This commenced operations in November 2003. The LPBT is a trading platform for on line trading, trade recording and trade confirmation of inter dealer transactions open for all the Primary Dealers and Commercial Banks.

On 21st January 2004, the Colombo Stock Exchange launched 'DEX' a debt trading system that enables trade matching of transactions involving beneficial interest of Government Securities.

The series of developments in the market infrastructure has no doubt set the foundation for a better-developed FIS market.

Apart from the technological and infrastructure support, the market requires liquidity both in the instruments and the cash resources for smooth exchange of securities.

The market liquidity with regard to instrument development will be dealt with under a separate heading.

With regard to the cash liquidity, the market has a new development i.e. the Intra Day Liquidity (ILF) facility provided by the Central Bank against Government Securities. This helps reduction of any friction in settling large transactions while also awaiting other receipts of funds. In addition, the overnight liquidity requirements continue to be addressed by the Overnight Repo and Reverse Repo windows. The Repo window absorbs the excess liquidity at a minimum of the Repo Rate (presently 7% p.a.) while the Reverse Repo window enables meeting of shortages in the market at the Reverse Repo Rate (Presently 8.5% p.a.).

In addition, the Open Market Operations of the Central Bank introduced a system of auctioning the Repos for absorbing the excess liquidity. This enables those who have excess cash to pass it on to the Central Bank possibly at a rate above the Repo rate and below the Reverse Repo rate.

One weakness of the current arrangement for moving the liquidity out of or into the system to/from the Central Bank is the potential wide fluctuations of the Inter-Dealer, Inter-Bank overnight Repo rate. When the market is very liquid the rate tends to be above but closer to 7% p.a. (Repo Rate) and when the market is less liquid or when it is short of liquidity, same overnight rate tends to be around 8.5% p.a. (Reverse Repo rate). Such fluctuations of the wholesale market overnight risk free rate are not healthy and are not acceptable by International comparisons. A narrower rate band appears to be an obvious solution. The fluctuations in the overnight market tend to create panic and confusions throughout the term structure of interest rates and the long term rates too do tend to follow. The result could be undue volatility of the interest rates both short term and long term. Should the Government issue new long term securities under such circumstances the borrowing costs may be fixed at unduly higher rates for the full tenor of the instruments resulting in additional interest burden.

As an alternative to a narrower Repo and Reverse Repo rate Band, the monetary authorities can also consider a target Repo/Reverse Repo rate within a reasonable rate band. The target rate would lie in the middle of the Band. The system followed in Sweden for example is to have such target rate where fluctuations will be maximum of 10 basis points lower or higher than the target rate. This is achieved through a process of "Fine tuning". The wider band operates only as penal rates for those who fail to part with their excess cash around the target rate or those who fail to receive excess cash at a rate around the target rate.

g) Rules of the Game

Any market place needs discipline and rules to bring such discipline. These are rules that govern the day-to-day operational arrangement and not meant to be for influencing prices, demand or supply. The Government Securities Market and the Primary Dealer system in particular has been the subject of various Directions issued under the relevant Ordinances as per the authority vested in the Central Bank. Further, a code of conduct was introduced to the Primary Dealers being one of those rare communities to have one. Market practices of dealing are well established with minimum confusion. There is yet room for improvement in the areas of day count convention of Repos, haircut policies on Repos and the use of the Master Repo agreement already adopted etc.

In addition, an area that requires more clarity and consistency is the securitisation market. Accounting taxation and legal issues need to be clarified beyond doubt.

h) Information at no cost

Information is an essential ingredient of any market. New information means new prices if such information is material and relevant. The most basic form of information with regard to the FISs is the yields/prices at which they trade. Such information is disseminated through the electronic and printed media. More relevant for the price movements are the information that concerns the macro-economic environment including the inflation outlook and the potential exchange rate and interest rate movements. Analysts continue to gather and study such information so as to make informed decisions. A wide array of economic data are released to the market by the Central Bank of Sri Lanka and are readily available for the interested parties particularly through the newspapers and also electronic media.

A comprehensive FIS market would have had debts issued by several parties carrying different credit risks. In such a situation it would have been very important to analyse the performance of such individual issues to identify the effect on the credit quality and hence the risk premiums demanded on the yields. In the absence of a developed corporate debt market or other forms of FISs other than Government Securities, the importance of information to analyse issues at micro level does not arise. Hence the information dissemination process has highly concentrated on the past yields and macro economic aspects making it quite monotonous for an analyst.

The existence of a single large issuer, i.e. the Government, is somewhat similar to there being

only one company whose share is traded in an Exchange. The information dissemination and analysis process would not be interesting at all.

The use of credit rating has also lost its relevance, as the debt issues are limited. In a FIS market where corporate and semi Governmental debt issues are prevalent the rating agencies will play a much more active role.

i) Liquidity of the instruments through large volumes

The instrument liquidity is achieved by the issue of a sufficient volume of securities in a particular Bond series rather than having a large number of Bond series with each having a small quantity. The public debt department of the Central Bank has been successful to some extent in reducing the number of series sometimes re-opening the existing issues to achieve this objective. Further reduction encounters the problem of “Bunching Effect” where several bonds may mature together creating a burden of having to raise large sums of funds at once.

Provision for re-purchase of securities by the authorities prior to maturity will address this issue to some extent. Alternatively, gradual issue of new securities while managing the short-term deficit or surplus using short-term instruments may also help.

Another way of assessing liquidity of an instrument is to look at the bid and offer spread of the security at any given point of time. The bid and offer are quoted in a typical two way quote made by a dealer. If the spread is very thin then the instrument is considered liquid. If it is wide the instrument is not liquid. The liquidity of instruments is also a function of the liquidity of the market in general. Until end 2003, the Government Securities Market showed continuously narrowing two way quotes reflecting continuous improvement in trading. At times, quotes were made with les than a basis point spread. The quotes however have widened somewhat since then due a continuous period of political uncertainty and rising rates. Yet it is customary to quote with a spread of five to ten basis points.

j) Low Transaction Cost

An important feature of any developed market is that transactions should be cost free. (Or have very nominal transaction costs). The inter-dealer market has always been one with very low transaction costs. The Association of Primary Dealers (APD) has entered into arrangements with money brokers where the Primary Dealers enjoy volume based discounts reducing the transaction costs to very low levels. In addition, the Lanka Primary Dealer Bloomberg Bond Trader (LPBT) Platform works only on a monthly flat fee enabling unlimited transactions at zero incremental cost except for the RTGS/ SWIFT charges. The low transaction cost has been one of the key success factors in the Government Securities Market as compared with the equity securities market.

OPPORTUNITIES FOR THE COMMERCIAL BANKS

Commercial Banks in Sri Lanka are the most well placed institutions that can take advantage in the process of development of the Fixed Income Securities market. Taking such advantage is possible only if a positive view is taken where the Banks can plan to profit from the development of FIS market rather than considering such development of FIS market as a

threat. Such fears exist because some believe that development of FIS market will result in dis-intermediation particularly in the Corporate Debt Securities market. Such dis-intermediation, some feel, will leave the Banks without business for accepting deposits and lending money. Such fears are largely unfounded and the potential benefits outweigh such disadvantages.

The reasons why Banks are considered to have been placed very well to profit from the development of the FIS market are:

1. Banks control the largest share of financial assets in the economy. As at December 2003, the total assets of the Commercial Banks were Rs 1058.7 Billion, which was around 45% of the total assets in the financial system.

2. Banks have the largest pool of funding sources by way of deposits. The total deposits held by public with Commercial Banks as at December 2003 was Rs 651.2 Billion

3. Banks have the best accumulation of credit knowledge with regard to the existing and potential borrowers.

4. Banks have the best levels of pooling of risk within their asset portfolios.

With such mighty powers, Banks can participate in the FIS market in two ways:

• Securitising their own portfolios such as housing loans, leases etc. so as to achieve growth without being constrained by capital requirements.
The need for development of the securitisation market was already discussed.

• Encouraging, supporting, market making and retailing of the issues of corporate debt by the Banks' clients.

Take for example a term loan obtained by a corporate borrower of the Bank. The Bank can arrange for the borrower to issue debentures in lieu of the term loans and accept to subscribe to the issue of the debentures/bonds. The Bank, with or without the Bank's guarantee, can then retail such bonds.

By doing so, the Bank can achieve several benefits:

1. If the Bank trades the corporate debt, there will be trading income.

2. By arranging the term loan as a debenture, the corporate borrower will assume the interest rate risk, fixed until maturity. The Bank will be relieved of the need to raise matching funds in the liability side of the Balance Sheet, as the debenture once sold will not have an impact on the Asset and Liability matching of the Bank.

3. Unless the debentures issued by the Company are retailed after adding the guarantee of the Bank, there will be a reduction of the Bank's Risk Weighted Assets Portfolio resulting in a reduced capital requirement.

4. In the process of market making of such instruments, Banks will also generate additional income by way of capital gains.

5. Securitising of housing loans after pooling them together will particularly help Banks deal with the interest rate risk associated with the fixed rate loans while at the same time offering to the market a very useful long-term investment product. Recently the economy saw a rapid growth in the housing loan market. It is most likely that most Banks will "cap" their exposures to these long-term loans unless they could remove existing loans through securitisation to pave way for new loans. The Banks with their expertise and credit knowledge will become the machinery of mass scale production of housing loans and securitisation will arrange the parking facilities.

THE FUTURE PROSPECTS

Having run through several aspects of importance it is very clear that there is very high potential for the FIS market to develop further. What is necessary is to take some bold steps in moving towards such developments. In this regard the Associations of Dealers and Bankers, the Institutions and the organized investors, the Government and the regulatory authorities all need to play an active role. Market development is not anybody's duty: It is everybody's duty.

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