Recent trends of Sri Lankan Bond Market

I. Wasana Rathnayaka* and M.H.S. Dilrukshi
Australian Collage of Business and Technology, Colombo, Sri Lanka
**Corresponding author: wasana89esp@gmail.com*

Introduction

Bond markets are an absolute backbone for any economy. Without bond market, there would not be liquid cash available for companies to grow, the economy to develop and the government to invest in. Bonds are basically a small loans investors lend out to the government, companies, and all others who need the money for various needs. Bond market normally denotes to the Government bond market. There are some bond markets for corporate bonds and financial instruments. The bond market commenced its active operations in 1990's in Sri Lanka with the issuance of medium and long-term bonds. Apart from the direct effect of the bond market on the economy, bonds also effect to the many macro-economic factors in a country and those might course to raise money for its various needs and to help it finance public debt. To keep competition and win at primary issues and to make higher margins at secondary level need to be aware on market information.

Several initiations have been taken in recent years to provide an environment conducive for developing the bond market through financial sector reforms and restructuring programmes in Sri Lanka. The high debt/GDP ratio may be overstated, as 45 percent of public debt is foreign debt contracted at concessional terms with long repayment periods (Dheerasinghe, 2003). According to Karunasena (2009), continuation of efforts to develop the domestic bond market further, particularly paying more attention to the establishment of a separate public debt office, minimization of fiscal deviations, reliance on market-based borrowing strategy and ensuring of price stability, is necessary to ensure the development of an efficient and dynamic domestic bond market in Sri Lanka.

Sophastienphong at al. (2008) conclude that Sri Lanka has made much progress in developing its regulatory framework for the capital market. Sri Lanka should ensure the macroeconomic stability by reducing inflation and maintain the fiscal deficit at stable level for enhance the efficiency in bond market.

This study aims to identify concepts of main features and the recent trends of Sri Lankan bond market during the past decade. Further, the study examines the reasons for changes of Bond market in Sri Lankan during the period 2005- 2015.

Methodology

The study is based on secondary data which have been gathered by the Central Bank of Sri Lanka statistics. The aim of the study is identifying the trend of bond market in Sri Lanka in the past ten years. For this purpose, the study considered the primary market and secondary market operations and performance and Treasury Bonds had been considered.

Results and discussion

The development of Treasury bond market helps reduce government reliance on local banking system and international capital market in mobilizing commercial type borrowings to finance the resource gap. In turn, it would help to improve risk management in public debt; lowering risks in relation to interest rate, foreign exchange and refunding exposure, thereby making the economy more resilient to crisis. In addition, the developed Treasury bond market helps the Central Bank for efficient and effective monetary transmission mechanism and act as a benchmark for the development of the corporate bond market. Treasury bonds are traded through competitive auctions conducted by the Central Bank on a regular basis. Primary dealers who have been involved in the government debt market since 1992 have direct access to the primary auctions. The study found that Sri Lankan government bond market has been developing while the yield curve has been extending gradually towards longer maturities.
According to the present regulatory framework, primary dealers (11 PDs) should subscribe the entire sale and single primary dealer minimum investment level is set at 10 percent of the volume of sale to avoid any possibility of under subscription. Since the establishment of the primary dealer system, the Central Bank continued its role as a debt manager to develop the primary dealer system. According to Figure 1 Sri Lankan primary bond market shows the potential contribution to the financial market in Sri Lanka.

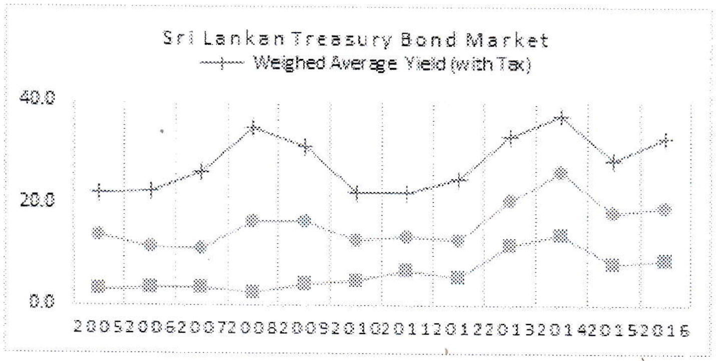

Figure 1 Linkage between maturity period, coupon rate and yield
Source: www.cbsl.gov.lk, (2016)

The secondary market operations, which have been developed initially for trading of Treasury bills were then extended to the trading of Treasury bonds in the market. Today, market intermediaries can freely transact and intermediate in the secondary market for government bonds. Main participants or intermediaries in the secondary market are primary dealers, commercial banks, finance companies and institutional investors.

According to the Central Bank statistics (2015), the total secondary market transactions of PD industry, which includes outright as well as repurchase transactions, increased significantly by 27.77 percent to Rs. 15,413.61 billion in 2015 from Rs. 12,063.29 billion in 2014. The increase can be mainly attributed to the increase in repo transactions by 43.65 percent to Rs.11,813.21 billion in 2015 from Rs. 8,223.56 billion in 2014. The ratio of repo transactions to total secondary market transactions in 2015 recorded at 76.64 percent compared to 68.17 percent in 2014.

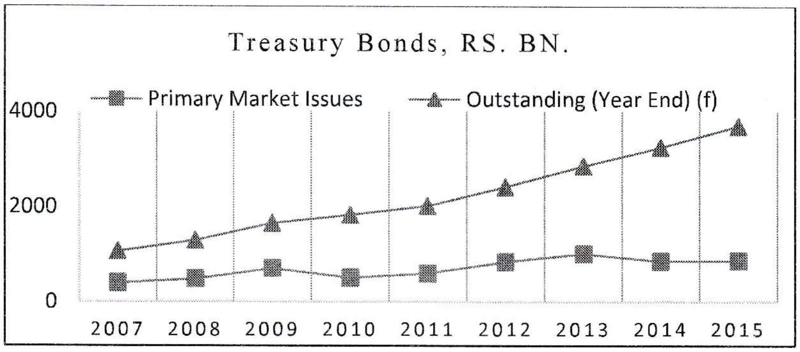

Figure 2 Primary market operations

Source: Economic and Social Statistics of Sri Lanka, 2016

The bond market in Sri Lanka shows an imbalanced development, more developments in the government bond market and slow progress of the corporate bond market. The Central Bank plays a vigorous role in developing the government bond market. This process aims the development of debt instruments, intermediary system, legal and regulatory system and improvement of payment and settlement system. Further, extension of bond trading to the stock market helps further development of liquidity in the bond market. This development helped to raise funds at a lower cost while providing investors a market based investment environment. In the corporate bond market, relatively small corporate sector, high cost of issuing bond under complex mechanism and limited investors coupled with the availability of funds from alternative sources at a rate closer to interest of government securities could be cited as main factors that prevented the development of the corporate bond market.

Majority of market players are still unaware of the advantages of developing the bond market to reduce risk in the financial system. Then, further development of the bond market essential to be accompanied with the well-designed awareness comparing to get the maximum benefit to all the stake holders in the future.

Conclusion

Well-built bond market is an essential element in a complete financial system, priority has been given for the improvements in the bond market. A settled domestic bond market helps to reduce foreign currency denominated commercial borrowings either from domestic or foreign sources, which could affect the net worth of borrowers through currency mismatch. When the revenue flow is tied to the local currency, raising funds through the local bond market provide a natural hedge that make neutral effect to the net worth of borrowers. Bond market would help to enhance the effectiveness of Central Bank's monetary policy implementation in the economy. Then CBSL would be able to conduct its monetary management more efficiently manner.

Moreover, poor performance in Sri Lankan bond market occurred, of bond market, due to inadequate encouragements in market participation in the local bond market. Lack of scheduled systematic auction in the primary market, high dependency on private placements with captive investors, total rejections of primary auctions and limited ability to issue bonds in the maturity and amount in accordance with market needs are the major weaknesses of the Sri Lankan bond market. Furthermore, major factors include relatively high transaction cost, taxation issues, lack of repo agreements, limitations to access to the central clearing and settlement systems, lack of facility to appoint nominees and inability or limitation to access to the Central Bank window for primary dealers are creating barriers to the market development.

In order to improve the attraction of Treasury bonds, several actions must be implemented to improve liquidity in the bond market. Under that reduction of high fragmentation in the bond market, introduction of re-opening system for selected on-the-run liquid bonds, extending the yield curve and introduction of index- link bonds would be practiced.

***Keywords**: Bond market, primary market, treasury bonds, secondary market.*

References

Central Bank of Sri Lanka. (various Years). Annual Reports. C, Sri Lanka: Central Bank of Sri Lanka.

Deerasinghe, K.G.D.D. (2003). Developing a Deep and Liquid Bond Market Experience of Sri Lanka, Central Bank of Sri Lanka.

Karunasena, A. G. (2009). *Development of Government Bond Market with Special Reference to Developing;* A Yield curve: Experience of Sri Lanka. Colombo: Central Bank of Sri Lanka.

Sophastienphong, K., & Mu,Yibin, Saporito,C. (2008), South Asian Bond Markets, The World Bank.