Assessment of the Constraints Faced in the Nigerian Bond Market

BY

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ABSTRACT

This study access the constraints faced in the Nigerian bond market. Bond market is a market in which debt instruments known as bonds are issued to raise funds to finance budget or projects. It is usually issued for a period of time more than one year. Bonds have different options such as redeemability, convertibility, etc. They can be purchased by an individual, banks, pension funds, mutual funds, portfolio managers, institutional investors. Bonds may be secured or unsecured. The causes of tightened liquidity in Nigeria's economy have largely been self-inflicted by misinformed CBN's monetary policy and the banking industry's greed to be dominant capital market operators and formidable commercial banks. The monetary policy rates have frozen liquidity in the bond market and this have created a huge gap in the federal debt management program that even the strongest capitalized banks have been struggling to maintain its reserve requirements and liquidity ratios. It is on this note that the study recommends that there is need for government to increase its budgetary allocation to the bond market which in turn will provides a secure and flexible investment outlet for investors and stimulates economic activities of the country.

KEYWORDS: Constraints, Bond Market and Nigerian

Introduction

It is clear that the Bond market holds a lot of positive prospect for the economy through its alternative financing role, diversification of risks, stimulation of capital investments, mitigation of bank's financial crises through its alternative financing function and stimulating infrastructural development amongst others. Arowoshegbe, Okunbor and Omoregie (2011) defined bond market as a market in which debt instruments known as bonds are issued to raise funds, and where such instruments are traded before their maturity. In a capital market, the segment where bonds are issued and traded is generally termed as the debt market (ADP, 2000). According to Soludo (2005), a well-functioning and developed bond market provides a secure and flexible investment outlet for investors as well as stimulates economic activities through provision of appropriate long-term finance for both government and non-governmental borrowers. Oteh, (2014) similarly noted that bond market like any other financial markets, comprises of the primary market where new debts are issued to participants, and secondary markets-where new and existing participants can buy and sell existing debt securities. He also noted that the market provides a platform for the funding of public and private expenditures on a medium and long-term basis (Oteh, 2014). The activities in the bond market provide opportunities for savings in the economy and also facilitate the movement of such savings into the promotion of business expansions, investments and project execution. Thus, the market contributes towards financial system diversification, reduces the concentration of risk in the banking system while promoting long-term savings (Soludo, 2005).

CBN'S Interest Rate Policy on Bond Market

Many banks extend margin loans and over leverage their assets by diverting liquidity from long-term investments that would have been more meaningful for the real sector of the economy to artificially inflate stock prices. Nwakanma (2011) asserts that investors in Nigeria's capital market have not had real alternatives in asset allocation due to lack of investment products in the equity market on the one hand and sloppy CBN's monetary policy rates for short-term money market rates and fixed income securities on the other hand.

The CBN's interest rate policy has rarely had any impact on the direction of capital movement. The wide discrepancies in interest rates ranging from the Treasury bills to Treasury notes/ bonds auctions, to monetary policy targets, to inter-bank lending offer rates, to prime rates, to consumer lending rates, etc. have made any rational expectations a luxury consideration for serious investors (Okoh, 2004). Simply, economic forecast of leading indicators like inflation, employment, consumer sentiments, and investments are often hard to compute. As a result, investors and traders do not, very often consider allocation of assets based on trends in the economy

Just as repos are vital for a vibrant bond market, interest rate policy plays even a more important role in bond trading. Since there is an inverse relationship between bond prices and interest rates, and since bond yields move in opposite direction to prices, bond traders need some signals from the CBN about the direction of interest rates so that they can calculate the risk factors associated with making fixed income investments versus long-term wealth creation and/ or preservation investments (CBN, 2010).

Bond Market

The Bond market is an environment where debt securities are issued and traded. According to Ajayi (2013), a bond is a debt instrument issued by a government or a corporate entity to raise fund to finance budget or projects respectively. It is usually issued for a period of time more than one year. It is an 'I Owe You (IOU)' with a pre-set interest rate called the coupon and it is redeemable at the expiration of the specified tenure. Governments and corporate bodies can borrow money through bonds to expand their businesses, modernize their production lines, increase their capital base, execute projects and provide infrastructures. Bonds have different options such as redeemability, convertibility, etc. Bonds are purchased by individuals, banks, pension funds, mutual funds, portfolio managers, institutional investors, etc. Therefore, a bond is instrument that carries a promise to pay back the principal with the accrued interest called the coupon, on a specified date, usually referred to as maturity date. Buyers or investors in bonds do not have ownership interest in the organization issuing the bond unlike buyers of equity in the stock market who have ownership rights in the issuing organization. It is then clear that a bondholder is a creditor to the issuer. As such, whatever happens to the bond issuer does not affect the bondholder. For example, should the issuer have financial difficulties or is to be liquidated, the bondholders as creditors will not lose their principal and interest payment rather they will be among the first to be settled before the equity shareholders. According to Kapoor and Pope (2011), companies issue bonds called corporate bonds and sell them to the public at various interest rates, and investors buy with the full knowledge that the company will repay the original principal with interest at the maturity date. Similarly, governments issue bonds and sell them to the public at various interest rates, and investors buy with the full knowledge that the government will repay the original principal with interest at the maturity date (Ajayi 2013). A bond's maturity date refers to the time when the bond's issuer must return the principal to the investors. Bonds with maturities of up to 5 years are referred to as short term bonds. Those with maturities of between 5 and 12 years are referred to as medium term bonds while those with maturities of more than 12 years are long-term bonds.

According to Castillo (2014), there are different types of bonds in the bond market. Bonds may be secured or unsecured. A secured bond is backed by collateral, meaning it has the money or physical assets that a bond issuer must give to investors if the bond defaults. Securing ensures that capital will be available to pay the principal on the bond. Unsecured bonds (sometimes called debentures) are not backed by any collateral. Instead, the issuer promises that the lenders will be repaid. Unsecured bonds could be issued in this manner either because the company does not have enough assets to collateralize or the company is well established and is therefore trusted to repay its debts. Unsecured bonds naturally carry more risk than secured bonds and therefore pay higher yields. Bonds can also be classified into Fixed Rate and Floating Rate Bonds. A bond whose interest rate stays the same over its lifespan is referred to as a fixed interest bond. A bond whose interest rate varies periodically over its life span is referred to as a floating interest bond. The changes in rates usually reflect economic conditions. A floating rate is usually pegged to another economic indicator such as Treasury bill rates or even inflation. Bond issues are usually announced to the public for interested participants to indicate their interest through a competitive bidding process.

The bond market is similar to other markets in the financial system. Like other markets, the bond market comprises of the primary market where new debts are issued to participants, and secondary markets-where new and existing participants can buy and sell existing debt securities. The activities in the bond market provide opportunities for savings in the economy and also facilitate the movement of such savings into the promotion of business expansions, investments and project execution. Also, the market provides a platform for the funding of public and private expenditures on a medium and long term basis (Oteh, 2014).

Bonds are listed and traded on the floor of the Stock Exchange. The price at which a bond is sold on a trading day is dependent on the demand and supply of the bond after considering other factors such as the interest rate in the economy, the creditworthiness of the issuer (credit rating), the term to maturity, other investment opportunities, the exchange rate, etc. All information about a bond is contained in a document called "The Trust Deed". Such information may include the terms and conditions, pay-back date, and the coupon. The annual coupon on a bond is referred to as the yield. The fact that a bond is a fixed income instrument notwithstanding, an investor who sells his bond holding before maturity may do so at a price higher or lower than the par value of the bond. Where he sells at a higher price, the returns on his investment will be higher than the coupon rate whereas if he sells at a lower price than the par value the returns on the investment will be lower than the coupon rate. Therefore, a bond like other investment instrument is a risky investment instrument.

In Nigeria, bonds issuing started in 1946 according to the Nigerian Stock Exchange report (2010) when the federal government raised funds and was channeling the proceeds to finance construction projects. This continued until 1960, when the Nigeria Stock Exchange (NSE) was established and became fully operational in 1961. After the establishment of the NSE, some of the bonds that were issued were on a yearly basis and referred to as development stock for on-lending to state governments to finance various projects in their states. The Nigerian bond market has continued to grow from what it used to be in the 60's through the various reforms embarked upon by the federal government to grow the Nigerian bond market to the extent that there has been significant improvement, such that many state governments come to the market to raise fund to finance their projects.

According to Ajayi (2013), prior to 2002 the Federal Ministry of Finance (FMoF) and the Central Bank of Nigeria (CBN) were the managers of the country's debts and the CBN was the main issuer of government debt securities. The Federal Government of Nigeria (FGN) and the Securities and Exchange Commission (SEC) of Nigeria therefore made the development of Nigeria's bond market an important part of capital market reforms. Starting in the year 2000, the SEC took the initiative by setting up the "Mobolurin Committee" to conduct an extensive review of the bond market and that effort was quickly followed by the Federal Government's commitment to setting up the Debt Management Office (DMO) to oversee the FGN bonds segment. Since 2003, the DMO has overseen the FGN bond market while the SEC leads the development of the other segments of the bond market in Nigeria. After a restructuring of the domestic debt markets, the Debt Management Office (DMO), which was originally established in 2000 to centrally coordinate the management of Nigeria's debt, resumed the issuance of longer tenured bonds in 2003, thereby resuscitating the bond market, while the CBN was mandated to act as the Issuing House and the Registrar (Ajayi 2013). This arrangement brought a significant success to the bond market, which had witnessed significant growth over the years, to emerge as one of the most liquid bond markets in Sub-Sahara Africa after South Africa, supported by a considerable increase in market capitalization and turnover.

According to a report by the DMO, the resuscitation of the Domestic Bond Market in 2003 was a landmark achievement which was intended to restructure the Government's domestic borrowing which was predominantly short term to long term and to develop the domestic bond market which had been moribund for about 20 years. To achieve these objectives, the DMO in collaboration with other stakeholders introduced several measures to deepen the market amongst which are: regular and transparent FGN Bond Auctions; the appointment of dedicated market makers known as Primary Dealer Market Makers to support the Bond Auctions and ensure an active Secondary Market; a Two-Way Quote based market; existence of Benchmark Bonds; a Sovereign Yield Curve extending to 20 years and, a diversified domestic investor base. In essence, a strong and well established domestic bond market had been developed through inherent local capacity without any foreign facilitation.

Based on the above and the existence of an active Two-Way Quote Interbank Foreign Exchange Market, the Nigerian Bond Market received international recognitions through the inclusion of FGN Bonds in Global Bond Indices. The inclusions were recognition that Nigeria was one of the few emerging market countries with a robust domestic bond market. Thus, FGN Bonds were included in J P Morgan's GBI – EM (October, 2012) and Barclays Capital's Emerging Markets – Local Currency Bond Index (March, 2013). Notwithstanding the benefits of the inclusion of

FGN Bonds in the GBI – EM, the DMO continued to introduce measures to attract more domestic investors to the Bond market particularly, non-bank institutions and retail investors in order to enlarge and diversify the investor base. The success of these measures and previous initiatives are evidenced by the high subscription levels at the FGN Bond Auctions and sustained activities in the Secondary Market in spite of external developments such as the end of the Quantitative Easing Programme of the US Federal Reserve Bank in October 2014 and the placement of Nigeria on Negative Watchlist by J P Morgan in January 2015. The other evidence is the increased participation of non-banks in the FGN Bond Markets. The following statistics are indicative of the level of diversification that has been achieved in the investor base the share of Allotment of FGN Bonds to Pension Funds at the Auctions grew from 20.28% in 2010 to 33.35% in 2014. The share of Non-Bank Financial Institutions in Allotments at the Auctions rose from 7.08% in 2010 to 20.93% in 2014. The share of Allotment at the Auctions to foreign investors dropped from 15.51% in 2013 to 3.34% in 2014, yet the markets remained stable.

Bond Market Constraints in Nigeria

The causes of tightened liquidity in Nigeria's economy in the past three years have largely been self-inflicted by misinformed CBN's monetary policy and the banking industry's greed to be dominant capital market operators and formidable commercial banks (Uchendu, 2016). The monetary policy rates in the past three years have frozen liquidity in the bond market and created a huge gap in the federal debt management program that even the strongest capitalized banks have been struggling to maintain reserve requirements and liquidity ratios with creative bookkeeping and questionable lending practices as the recent bank audits have demonstrated.

According to Nnanna (2003), the banking industry's greed has pushed many banks into bogus underwritings of initial public offerings (IPO) of securities of their own competitors as a way to create wealth for the principals and insiders of the organizations. The banks had liquidity for legitimate business investments that would have recorded the greatest economic expansion of all times in Nigeria, but they chose to extend huge loans to favored customers and clients for pre-IPO share purchases. Since the share purchases were not in companies involved in the real sector of the economy, the loans did not have much impact on the overall economy, except to generate more wealth for the people that were already wealthy.

From 2006 to 2008, the Central Bank focused narrowly on stabilizing the value of the naira relative to foreign currencies and holding down inflation. The inability of the CBN to manage short-term interest rates crowded out private capital in the massive economic expansion that the Nigerian economy had enjoyed in five consecutive years. The DMO's excellent ground breaking initiatives to manage government's deficit financing for capital projects, drained the much needed capital in the private sector through debt auctions at coupon rates that were not synchronized with the CBN's monetary policy targets. The liquidity crunch in the capital markets was caused partly due to the CBN's monetary policy rates and exchange rate regimes that favored the twelve biggest banks that were also the largest participants in Treasury securities auctions. Actually, Abu (2010) argued that the DMO's ongoing deficit financing initiatives in an uncoordinated monetary policy regime by the CBN overexposed the expanding economy to external shock that led to a panic sell off in the stock market by insiders which led to a market meltdown.

According to Iyoha and Oriakhi, (2002), the haphazard pricing of capital in the economy has confused and continue to baffle even the most sophisticated investors in Nigeria's capital market. The idea that capital can best be invested in shares of financial institutions rather than in the real sector of the economy, made many analysts to wonder where the true foundation of the economy lies. Many banks extend margin loans and over leverage their assets by diverting liquidity from long-term investments that would have been more meaningful for the real sector of the economy to artificially inflate stock prices. Nwakanma (2011) asserts that investors in Nigeria's capital market have not had real alternatives in asset allocation due to lack of investment products in the equity market on the one hand and sloppy CBN's monetary policy rates for short-term money market rates and fixed income securities on the other hand.

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Usman and Salami (2008) assert that despite its immense potentials, the domestic bond market is still in its infancy. The volume of transactions in the market is a minute part of the global market valued at over $50 trillion. Impediments which have stalled its development include:

- A limited diversity of investor base - presently, the major market players are limited to Banks, Discount Houses and Pension Fund Administrators.
- Floating of Government bonds experience bureaucratic delays, for instance, the legal requirement that an Irrevocable Standing Payment Order must be issued by the Accountant General of the Federation in respect of every bond issue, before an application is granted creates a bottleneck.
- Corporate bonds do not enjoy tax exemptions as Government bonds, resulting in the small percentage is issued. The BMSC in 2008 recommended a 10-year income tax exemption on corporate bonds to the National Assembly in year 2008, to encourage growth.
- A costly issuance process – The Securities and Exchange Commission, Nigerian Stock Exchange and other regulatory bodies charge high fees for raising debt capital. Thus, companies with relevant credit ratings to save costs, go to the Eurodollar markets for bond flotations. For instance, GT Bank in 2007 raised $350m in the international market with a five-year bond issue. Currently, transaction fees are being reviewed to motivate corporate entities to seek financing from the domestic market.
- Infrastructure for trading in bonds is inadequate: Bonds are currently traded on the Stock Exchange and over the counter. The BMSC is advocating for the

implementation of an automated IT bond auctioning and electronic trading platform to fully revitalise the Nigerian bond market.

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Conclusion

In conclusion, the constraint in the bond market of Nigeria is caused by the CBN's monetary policy and has created a huge gap in the federal debt management program that banks are even struggling to maintain. As a result, investors and traders do not, very often consider allocation of assets based on trends in the Nigerians economy

Recommendations

1. The constraints faced in bond markets which has led to stunted growth in the Nigerian economy can be handled by entrenchment of good governance and institutional ethics and a continuous implementation of internal solutions and stability in the political administration of the country.

2. There is need for government to increase its budgetary allocation to the bond market which in turn will provides a secure and flexible investment outlet for investors and stimulates economic activities of the country.

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