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Government Securities Market in the Maldives

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GOVERNMENT SECURITIES MARKET IN THE MALDIVES

*by: Aishath Sajny**

Abstract

This article outlines a brief overview of the evolution of the government securities market in the Maldives and specifically concentrates on the challenges for further development of a deep and liquid government securities market. It describes the benefits of overcoming these challenges and the measures that could be taken in order to overcome these challenges. It also highlights similar issues faced by other emerging countries and how they were tackled.

1. Introduction

Government securities market, which deals with tradable debt instruments issued by the government for meeting its financial requirements, performs a vital role in the economy and is the base of the financial sector in most countries. Developing a sound and strong government securities market in any country is a challenge that depends on the speed of financial sector development and complexity of the unique characteristics of each country's financial sector.

This article outlines a brief overview of government securities market in the Maldives and specifically concentrates on the challenges for the development of a deep and liquid government securities market, highlighting the benefits of overcoming these challenges.

2. Overview of Government Securities Market in the Maldives

There are two main types of debt securities issued by the government of Maldives: treasury bills (T-bills) and treasury bonds (T-bonds), and the Maldives Monetary

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Authority (MMA) plays the agency role in issuing these debt securities. Currently, all the securities are issued in the primary market. T-bills are issued under auction and tap system (private placements) where all the commercial banks, state-owned enterprises (SOEs), institutional investors and private companies are eligible to buy T-bills.

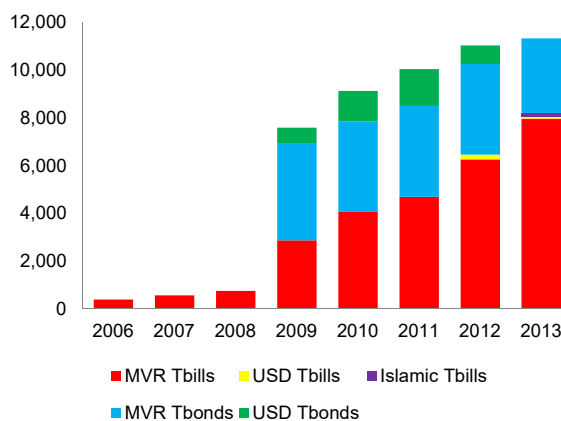
The main aim of issuing T-bills is to raise funds to meet the government budget financing requirements. In addition, the government has issued Maldivian rufiyaa denominated T-bonds (MVR T-bonds) to MMA and a USD T-bond to a commercial bank as a private placement.

3. Evolution of Government Securities Market in the Maldives

MMA introduced T-bills on 10 September 2006, replacing the MMA Certificate of Deposit (CDs), in order to move towards market financing of government deficit. T-bills were initially issued under tap system with a maturity of one month (28 day T-bills) and three months (91 day T-bills) and the investor base was limited to commercial banks and SOEs.

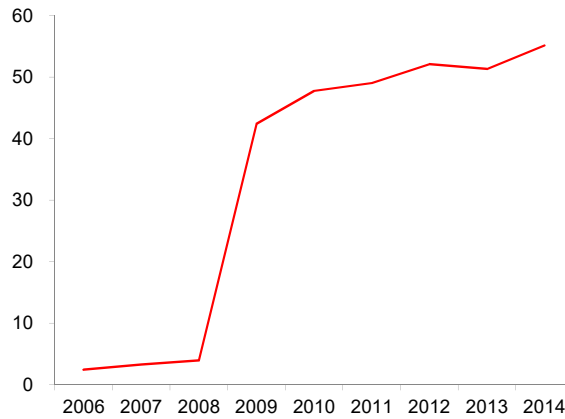
In order to develop government securities market and to finance the government budget deficit with the least possible cost, T-bills auction was introduced on 28 December 2009. After the auction system was established, T-bills maturity was extended to six months

Figure 1: Outstanding Government Securities, 2006 - 2013
(in millions of rufiyaa)



Source: Maldives Monetary Authority

Figure 2: Percentage of Government Sector to GDP, 2006 - 2014



Source: Maldives Monetary Authority

and 182 day T-bills was introduced on 5 July 2010 to provide a longer-term investment opportunity for investors, especially non-banks. Moreover, one-year T-bills (364 day T-bills) was introduced on 8 August 2012 with the aim of lengthening the maturity profile of the domestic debt. Furthermore, T-bills market made history on 22 August 2012 by opening T-bills market to private companies, targeting to deepen and diversify the market.

MVR T-bonds were issued after converting the existing debt of the government in 2009. The main objective was to improve the management of government cash flow and to strengthen MMA balance sheet. On 23 November 2009, the first USD T-bond was issued to a commercial bank in two tranches to overcome the economic stagnation and the US dollar shortage in the Maldives. The USD T-bonds was issued with a maturity of two years. Figure 1 and Figure 2 show the growth of the government securities market in the Maldives from 2006.

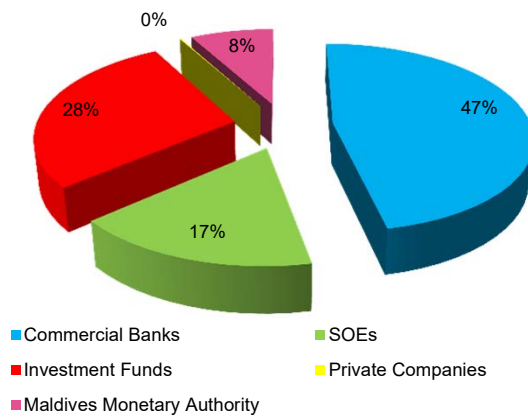
4. Challenges for the Development of Government Securities Market

Government securities market has shown a reasonable growth since the introduction of T-bills. Nevertheless, as experienced by most of the emerging market economies, the government securities market of Maldives also has been facing hindrances in further developments. Some of the major obstacles include having a narrow investor base, low appetite for long-term investments, lack of a market-oriented T-bonds and non-existence of an active secondary market.

4.1 Narrow investor base

Currently, commercial banks and Pension Fund are the main players in the T-bills market. Commercial banks are by far the dominant investors in the market holding

Figure 3: T-Bills Holdings by Participants



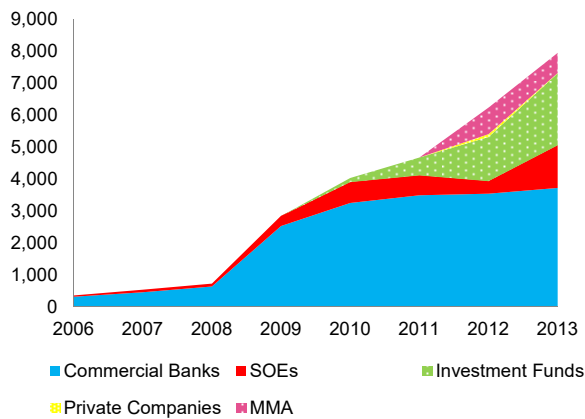
Source: Maldives Monetary Authority

about 50% of the total T-bills stock, out of which the largest two banks are holding more than half of the total supply. Furthermore, the recently introduced Pension Fund's share in the T-bills market is growing enormously; currently holding 31% of the total stock. Although T-bills market is currently opened to private companies, the market did not get enough support; hence unable to diversify the market further. The current holding of T-bills by category is shown in Figure 3.

A wide government securities market will contribute a range of benefits as discussed below.

- A broad investor base will diversify the market with participants of different investment patterns enabling to reduce the risk of reliance on a specific sector.
- High demand from a wider range of investors will enhance competitiveness while promoting competition among the financial institutions and speeding up the development of the overall financial sector.

Figure 4: Outstanding T-Bills by Participants, (in millions of rufiyaa)



Source: Maldives Monetary Authority

- A broad investor base will reduce the concentration of banking sector and the market would include investors of different nature, hence channelling an active secondary market and a money market in the long run.
- A broad and developed government securities market will be an attractive avenue for short-term and long-term investors hence encourage savings and will contribute to the development of the economy as a whole.
- A large investor base generates incentives for financial innovation, leading to greater market dynamism and lower transaction costs.

Therefore, participation of investors with different investment natures is vastly important to reduce the dominance of one sector and for the development of the securities market.

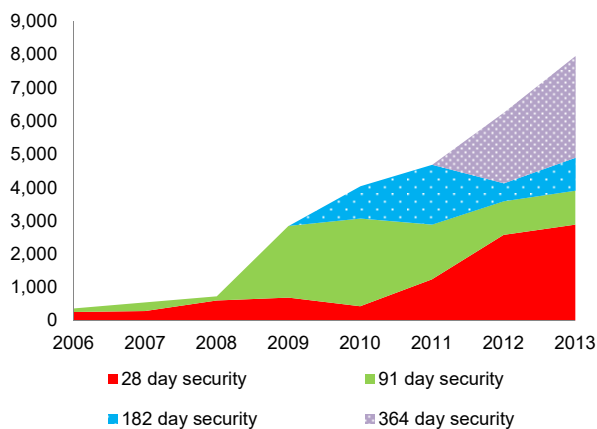
4.2 Low appetite for long term investments

T-bills were initially introduced with a maturity of 28 days and 91 days. Although 182 days and 364 days T-bills are offered every week, majority of the investors prefer short-term maturities. Particularly, it can be seen in Figure 5 that the holdings of 28 day T-bills have grown considerably higher since 2010. Consequently, the average time to maturity (ATM) has reduced and has resulted in bunching the domestic debt portfolio to the short-term period.

Figure 5 shows the diversion of long-term T-bills to short-term T-bills.

The main reasons identified for the funds' diversion are highlighted below:

Figure 5: T-Bills Holdings by Tenor, 2006 - 2013



Source: Maldives Monetary Authority

- Increase in the holding of commercial banks: Since commercial banks are the major investors in the T-bills market, they prefer to invest in short-term T-bills.
- Small variance in T-bills rates: T-bills market has proven that lack of competitiveness for longer maturities has created irrational rates although they are issued on an auction basis. Therefore, it has been observed that non-bank investors have also started diverting the funds from long-term to short-term T-bills.

Increasing ATM is essential to reduce the refinancing risk, interest rate risk and rollover risk, which will result in increasing investor confidence. Moreover, stabilising the

maturity profile is very important in order to develop a healthy T-bills market. Therefore, attracting long-term T-bills and T-bonds is essential for the development of government securities market.

4.3 Non-existence of an active Secondary Market for Government Securities

Currently, all T-bills are issued in the primary market. Although, T-bills are negotiable securities that can be transferred and pledged between the eligible participants, there is virtually no secondary market for T-bills. Only a handful of transactions took place in 2010; hence, the market for T-bills is very illiquid. As a result, most of the T-bills investors are relying on short-term T-bills and an inactive secondary market is also one of the hurdles for the development of T-bills market. The main reasons for the lack of liquidity in the secondary market are discussed below.

- Buy-and-hold strategy of investors: A narrow investor base that has insufficient incentives to actively manage their liquidity and interest rate risks.
- T-bills are held in an investment portfolio: By planning the in- and outflows, commercial banks create a T-bills portfolio that matches their major in- and outflows, reducing their need to actively manage liquidity in the secondary market.
- Dual role of commercial banks as both major investors and intermediaries: These dual roles may conflict in periods of excess liquidity and, as a general rule, the greater the portion of primary issues allocated to the agent bidding, the less are available to source for the bank's own book.
- Lack of a proper legal framework: Although T-bills are covered under the Maldives Securities Act, rules and regulations required for a secondary market are not fully covered in the current legal framework. Therefore, the investors are reluctant to trade the securities.

Box 1

Secondary Market For Government Securities

What is a Secondary Market?

The secondary market for government securities provides a platform for original investors to trade their holdings before maturity. Traditionally, in countries, the trading platform was over-the-counter before the introduction of trading in stock exchange. In an active and efficient secondary market, it is possible for investors to buy and sell existing issues on demand, at mutually acceptable prices, resulting in rapid exchanges with low transaction costs.

Pre-requisites of an active secondary market

In order for the secondary market to be active and efficient, the market requires:

- A clear structure and clearly established rules so that each party will be aware of their responsibilities
- An efficient system by which buyers and sellers can become aware of each other, and through which the prices of securities can be advertised
- An effective settlement system to ensure that the transfer of securities against money market takes place efficiently, at correct time and between correct participants

Benefits of an active secondary market

1. Government Financing

- Ensures stable government financing: In the absence of a deep and liquid secondary market, the government needs to open new issuance very often and is unable to sell long-term securities, hence increasing the frequency of rollover. This will create uncertainty in the debt market. On the other hand, a developed secondary market will reduce transaction costs and increase market liquidity, thus investors gain confidence and this will create demand for long-term government securities.
- Minimising debt servicing cost: Investors will be willing to accept lower yield if they are able to unwind their positions when they wish.
- Fiscal discipline: The market reaction to a newly announced government

budget is most instantly conveyed by the change in secondary market prices of government securities. The change in prices will in turn provide an ongoing disciplining device for government policies

- Government securities will be more attractive with no cost to government: Investors will be less hesitant to invest government securities if they know that their holding can be reduced or increased quickly through secondary market inexpensively and at any time.
- Successful sale of primary issuance: A broad and well-functioning secondary market contributes towards the successful sale of government securities in the primary market easily, hence achieving government financing requirements.

2. Monetary Policy

- Enhance central bank independence: A smooth issuance of government securities will reduce the likelihood of central bank financing to meet government budget requirement, hence allowing central bank more institutional leeway.
- Facilitates the implementation of monetary policy: A liquid secondary market will enable the outright secondary purchase and sale of government securities quickly, for liquidity management purposes and this will develop interbank repurchase market and help to achieve monetary goals.
- Developing the yield curve: A realistic yield curve can be shaped from a deep secondary market, hence providing information regarding future interest rates and inflation, which are key inputs into the setting of the monetary policy stance.

3. Financial Market Development

Apart from the benefits to fiscal and monetary policy, a developed secondary market will contribute to overall financial sector development by providing the institutional infrastructure for capital market, improving risk allocation and fostering the development of a derivative market.

4.4 Non-existence of a market based bond market

Presently, the government bond market is practically inactive although there are outstanding MVR bonds which were issued after converting the existing debt of the government in 2009. Apart from this, the government issued a USD T-bond on a bilateral basis which has matured now. Hence, market based T-bonds have not been issued so far.

Furthermore, MVR bonds are neither listed in the stock exchange nor traded in the secondary market hence, illiquid, despite being negotiable securities. However, MMA uses MVR bonds to conduct open market operations every week.

The government bonds are the backbone of modern securities market and it is beneficial to economic agents ranging from financial institutions to households, especially to the government and the central bank. Some of the main benefits are outlined below:

- Reduces cost of borrowing to the government: If T-bills are the only marketable debt instrument available for the government to raise funds, the entire government debt needs to be refinanced every year, hence increasing the interest rates. In addition, an active bond market allows the government to redeem the bonds and repay the debts during prosperous periods, hence reducing welfare cost of debt financing.
- Devolvement of a yield curve: Introduction of long-term bonds will contribute to the development of a yield curve which acts as a public good in the financial sector. The shape of the yield curve is essential to assess the market reaction to monetary policies and it is an indicator of the expected performance of the economy and inflation. It is also used as a benchmark for pricing other instruments of various maturities as well.
- Benefits to central bank: Most of the central bank's market operation transactions consisting of reverse repurchase and repurchase are conducted using government bonds as collateral. Therefore, an active bond market will make these short-term instruments more liquid, thus facilitating the conduct of effective monetary policy.
- Capital market development: Introduction of a bond market will give an alternative investment opportunity to the long-term investors (investment fund and even the households with long-term investment needs) and help to diversify the investment portfolio. Since they do not have short-term

cash requirements, it is important for them to have long-term investment opportunities instead of rolling over the investments. This will help to execute other related financial transactions such as pledges and collaterals.

5. Country Experiences in Overcoming Similar Challenges

A vibrant government securities market offers a wide range of benefits to the financial sector as well as the economy. Therefore, it is very important to overcome these challenges for further development of this market. Moreover, Maldives is not the only country faced with these issues. Most of the emerging economies face similar problems. Hence, the rest of this article highlights the experiences of other countries.

Reducing the reliance on single sector and diversifying the T-bills market is highly important for the development of the market. Major investors dominating the government securities market is common in many countries. For example, two to three banks account for a market share of over 70% in Iceland, Malta and Sri Lanka.

A key challenge faced by most of the countries is finding means to broaden the investor base. Many countries have minimised the dominance of one sector by promoting institutional investors and attracting foreign investors to the government securities market. It has been observed that institutional investors, such as pension funds, insurance funds and mutual funds of many countries have played a key role in the development of government securities market by promoting wholesale funding. Notably, in countries like Latin America and Singapore, pension and insurance reforms have played a vital role in the development of a domestic bond market in recent years.

Moreover, direct and indirect participation of individuals helps to broaden the investor base of most of the countries. Indirect participation could be through mutual funds. In recent years, many countries have promoted mutual funds to promote small investor base. Mexico is a good example where it relaxed the regulation that restricted mutual fund's investments to be placed in short-term instruments and it has played an active role in government securities market.

Foreign investors can also play an important role in broadening the investor base. Allowing foreign investors to enter into government securities market will increase the participation while increasing competition which will generate incentives for financial innovation. However, this is a controversial issue for some countries, as it is believed

that opening the domestic market to foreigners will make the market more vulnerable to market volatility and also, foreign investors with their enormous resources is a threat to some extent as they may dominate the domestic market. Taiwan is a country which developed capital market by allowing foreign investors to enter into the financial sector.

It is really important to develop a strategy to shift the investments from short-term securities to longer-term investments. Many countries have reversed the short-term maturity profile of government securities market by promoting a liquid bonds market and secondary market.

Developing a sound and liquid government bond market is not an easy task for any country and solely depends on the speed of financial sector development in such a country. Nevertheless, the basic elements for building a strong bond market are similar. And these elements include: number of investors with long-term financing and investing needs, intermediaries to channel these borrowers and lenders, infrastructure to provide a conducive environment for these transactions, and a regulatory body. As discussed above, lack of a broad investor base and low demand for long-term investments and lack of a secondary market are the main challenges for the development of a liquid government bond market in the Maldives. Moreover, underdevelopment of the necessary infrastructure is also a major obstacle.

The experience of Central Bank of Sri Lanka in the development of its T-bonds market is an inspiring one. The development was not easy for Sri Lanka and a series of measures had been taken since 1977. The main focus of these measures was on developing an efficient bond market characterised by a competitive market structure. Hence, market-oriented bonds were issued by gradually increasing the tenor. Furthermore, continuing efforts to develop the domestic bond market, particularly paying more attention to develop a strong legal framework and reliance on market-based borrowing strategy has enabled the remarkable development of the bond market in Sri Lanka.

Consequently, most of these countries have developed a liquid secondary market by widening the investor base and establishing a strong bonds market. The reason being that then only there will be a real need for fund transfers, which will activate the secondary market.

6. Conclusion

This article highlights the challenges in further development of government securities market in Maldives for and benefits of an active secondary market. Although the T-bills market has shown a considerable growth, it has to be noted that in Maldives, the government securities market is not mature enough to utilise the benefits described in this article. Lack of a narrow investor base, low appetite for long-term investments, non-existence of an active secondary market and a lack of market-oriented T-bonds are major hindrances. Therefore, based on the experiences of other countries, government securities market need to pass several stages of development and extensive measures need to be taken gradually to address these issues. Such measures include, developing the infrastructure required for a smooth functioning of a securities market, expanding the investor base, creating a liquid secondary market and promoting long-term securities and introducing new products such as Islamic bonds and other shariah compliant securities to fuel Islamic finance market in the country.

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