Bond Market Governance and Oversight

Learning from a comparative study of institutional frameworks and market development

Policy Brief #3

frontclear
A financial markets development company

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I Institutional frameworks and market development

"One major prerequisite for sound government securities market development is the legal, regulatory, and supervisory framework."[1] - The World Bank

Money and government bond market development are intertwined – ***"an active money market is a prerequisite for government securities market development."***[2] It is universally recognised that sound governance and oversight frameworks are of the utmost importance to market development. Without appropriate oversight and governance, market development is typically slowed and sporadic. Yet guidelines regarding best practice with regards to governance and oversight frameworks are not explicitly detailed in any obvious policy documents. This Policy Brief, the third in the Frontclear series, provides insights into the creation of an institutional framework model to assess governance and oversight models for money and bond market development in emerging and frontier countries.

Frontclear reviewed and documented the main findings from a comparative study on governance and oversight frameworks for money and government bond markets. The study's purpose was to provide lessons based on practical experience across select Sub-Saharan African (SSA) countries, namely Ethiopia, Ghana, Kenya, Nigeria, and South Africa. The country selection is deliberate – the five markets are quite divergent relative to both level of market development and the approach taken to governance and oversight frameworks. The insights reflect experience-based learning applicable to other countries.

Intertwined money and government bond markets

A well-functioning money market allows for the evolution of predictable, more stable short-term rates that will be priced in fixed income markets such as government and corporate bonds and mortgage debt instruments. The interbank market determines interest rates for short tenors of interbank exposures, ranging up to typically 12 months. This interbank term structure of interest rates can inform the pricing of other products, such as interest rate derivatives and floating rate loan products. Changes to the interbank market rate are therefore easily transmitted to other important segments in the market. Without a well-functioning interbank market that allows for price discovery and distribution of liquidity, other financial markets like bond and some derivatives markets would become less liquid or dry-up[3]. Liquid and inclusive interbank markets have the ability to reduce the costs of government borrowing and to improve the stability of the currency.

1 World Bank (2001), Developing government bond markets: a Handbook.
2 Ibid.
3 Frontclear Study: Interbank Market Indicators (2021), p.5.

II ‘Fit to purpose’ governance and oversight

Frontclear has developed a three-stage money and bond market development model, which reflects 'nascent', 'emerging' and finally 'connected' markets. Each is illustrated in Figure 1 and as a guideline, the model describes evolution over time and concurrently with higher levels of liquidity. To illustrate, an 'emerging' market is typically categorised with an incidental secondary bond market wherein the repo market is dominated by a few top banks operating in a system with laws, regulations and market infrastructure that do not support legal and settlement certainty. The focus at the 'emerging' stage is the establishment of a deeper secondary market by reforming sub-optimal systems. At the 'nascent' stage, the focus is to develop a structured and subscribed primary market with the required regulation to underpin a secondary market. At the final development stage, 'connected', the focus is to deepen domestic participation to include non-bank financial institutions (NBFIs) and other domestic institutional investors. Expanded trading volumes require more sophisticated market infrastructure such as a central clearing counterparty (CCP).

FIGURE 1
Stages of market development

GDP

1 Create foundations and knowledge

Nascent Market
- Primary market dominated
- Missing legal and regulatory framework
- Missing market infrastructure
- Central Bank dominated market

Focus: Market readiness
- Deepen regulatory and market knowledge
- Monetary policy incentives
- Basic laws and regulations
- Fit for purpose government securities market
- CSD for government securities

Opening
2 — 3 years

2 Reform the market

Emerging market
- Thin secondary market
- Incidental bilateral money market transactions
- Tier-1 (top-level) bank dominated market
- Incomplete/unharmonised legal and regulatory framework
- Sub-optimal processes and systems
- Central Bank dominated and limited to no oversight

Focus: Market practice
- Extensive legal and regulatory reform
- Reduce risk in infrastructure and systems
- Advanced capacity building
- Preliminary oversight framework development

Mid-development
3 — 5 years

3 Expand inclusion in the market

Connected market
- Deep secondary market
- More common bilateral and multi-party money market transactions
- Broader market participation
- Evolving legal enforceability
- Volume warrants stronger oversight

Focus: Market participation
- Fine-tuning governance with growing oversight-framework development
- Continued legal reform to align best practices
- Diversification of market participants (local institutional investors)
- Advanced market infrastructure (e.g CCH/CCP)
- Advanced capacity building for new participants

End-target
5 — 8 years

Applying the stages to the countries studied yields insights into the role of governance and oversight frameworks with regards to market development. In particular, what balance of governance and oversight is relevant to further the money and bond market at each stage of market development? This Policy Brief highlights the lessons from experience drawn from the study.

SNEAK PEEK

Coordination is key

The norm appears to be significant and often unavoidable overlap in the mandates of regulators; the exception being a nascent market such as Ethiopia. Despite overlapping mandates, some markets such as Ghana, have successfully realised significant, recent reforms. The differentiating factor has been the effective and decisive coordination between regulators, underscoring their articulated common vision for the market. These qualities demonstrate that overlapping mandates do not need to hamper market development.

III Departing from a common lens

A comparative study of money and bond market governance and oversight frameworks is only useful when the analysis departs from a common lens. A common lens involves four defined market functions: 1) governance; 2) oversight; 3) market feedback; and 4) coordination. Each function may or may not exist in a particular money and bond market framework.

Definitions

Governance is defined as setting the regulations, i.e., the creation of the legal and regulatory system governing money and government bond markets. There is a hierarchy to the law: 1) acts of law, 2) regulations, 3) directives, and 4) guidelines.

Oversight is defined as setting the rules, i.e., the creation and monitoring of boundaries for market behaviours. The oversight function has two aspects: 1) the monitoring and supervision of market participants with respect to the adherence to the governance framework; 2) the monitoring and supervision of market players with respect to the rules.

Market Feedback is defined as gathering feedback from the market to share with institutions within the governance and oversight functions. The market feedback function targets input to: 1) strengthen laws, regulations and rules; 2) improve how they are operationalised.

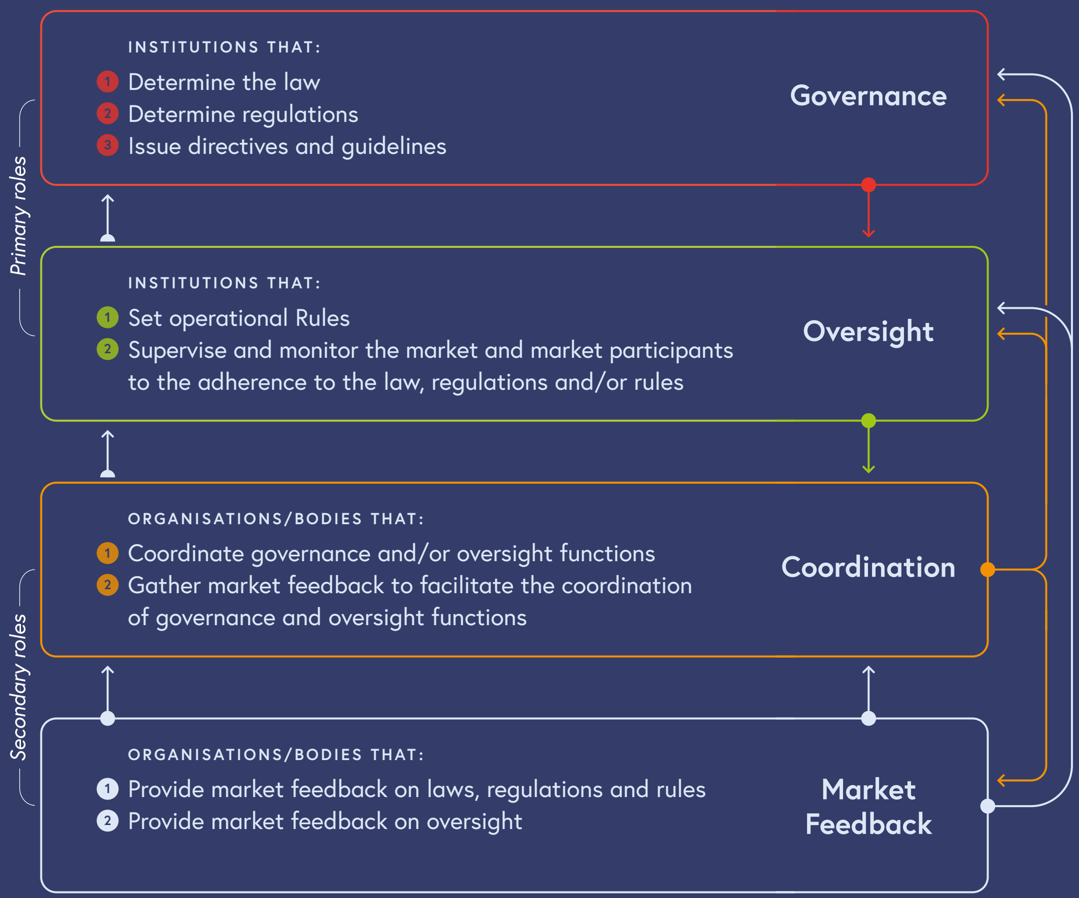
Coordination is defined as the organising of actions and decisions by institution(s) with governance and/or oversight functions. The coordination function crosses organisational boundaries where more than one institution is involved.

The model, combined with the above definitions, completes the common lens. The model, developed for the purposes of the study, reflects on money and bond market governance and oversight frameworks from three angles. Each is explained and illustrated in the following pages.

1

Function angle

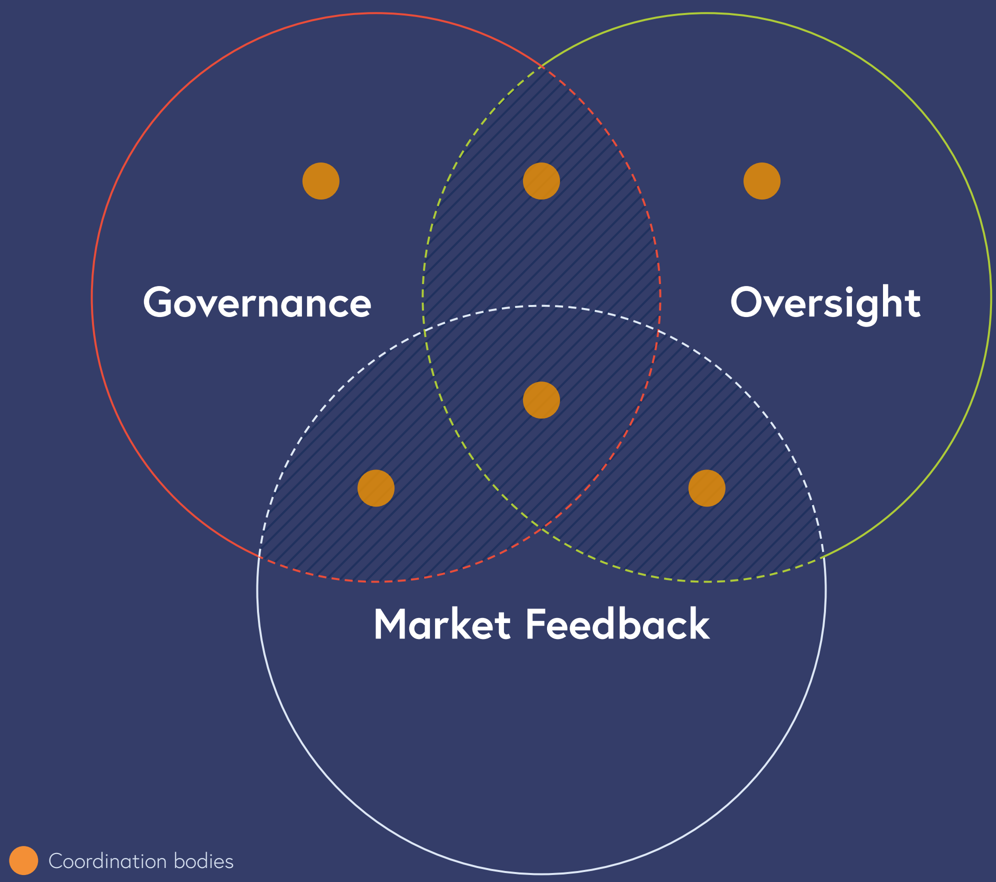
Reviewing from this angle illustrates, in an organigram-like format, the presence and functions (or mandates) of all institutions in the governance and oversight framework. The functions are divided into primary roles – governance and oversight – and secondary roles – market feedback and coordination. There may be multiple institutions with mandates for each function. There may be institutions that have mandates across multiple functions. For example, both the central bank and the capital markets authority can hold both governance and oversight functions with overlapping mandates. This angle also shows the key reporting lines between institutions.



2

Interaction angle

Reviewing from this angle illustrates the degree to which the market's governance and oversight framework involves active coordination by an organisation or between groups of organisations (a body). The angle details the different organisations or bodies that coordinate their mandate(s). A specific mandate may be to coordinate across governance and/or oversight institutions. It may also be to gather market feedback to support governance and/or oversight. A market can reflect a complex web of organisations and bodies involved in coordination, with complementary and overlapping mandates. Alternatively, it can reflect a single, all-encompassing coordination body.



3

Organisation angle

Reviewing from this angle details the organisational characteristics of the coordination function by assessing the market's coordination institutions/bodies against nine parameters. It is important to review based on actual market practices as they may deviate from documents such as a Terms of Reference.

PARAMETERS	OPTIONS	DESCRIPTION
1 **Membership**	Public Private Public and private	Membership refers to who the members of the organisation are.
2 **Participation**	Mandatory Voluntary	The participation describes whether the members are mandated to participate or whether it is on a voluntary basis.
3 **Selection**	Elected Self-selected Selected	Selection describes how the members of an organisation framework are chosen.
4 **Seniority**	Low Medium High Highest	Seniority refers to the level of seniority of the person that represents a member in the organisation.
5 **Structure**	Committee Autocratic Board of directors	The structure describes how decisions within the organisation are taken.
6 **Decision-making**	Binding Effectively binding Consultative	Decision-making refers to the power a decision by the organisation has.
7 **Responsibility**	Integrated Delegated	Responsibility refers to whether the mandate is fully rested within the coordination body, i.e., whether decisions taken are implemented by the coordination body itself or by its members.
8 **Engagement**	Formal Informal	Engagement refers to the way members engage with one another.
9 **Political balance**	Conflicting interests A common vision	Political balance refers to whether members have conflicting interests amongst members or whether members have a common vision for the market.

All three angles combine to form the comparative model that together with the aforementioned definitions, are the common lens through which each of the selected country bond markets has been studied.

IV Lessons from experience

The study applied the above definitions and model to assess money and bond market governance and oversight frameworks across Ethiopia, Ghana, Kenya, Nigeria and South Africa. These assessments produced both observations and learnings, relevant to the creation of effective governance and oversight frameworks that support the market's development (see Figure 2).

The overriding lesson is that a well-functioning bond market governance and oversight framework is aligned to the market development needs – fit to purpose.

FIGURE 2
Governance and oversight frameworks according to the stage of development

GDP

1 Nascent market

One decision maker

- The central bank is the driver behind reforms and has decision-making power
- Coordination with the market and other regulators is important, but this coordination is likely informal
- The central bank is the most natural coordinator as it regulates the banks

ETHIOPIA

2 Emerging market

Joint decisions by regulators

- Joint decision-making amongst regulators and integrating market feedback is paramount:
  A strong governance and oversight coordination body with the highest level representation and decision-making power is ideal
- Sub-committees of the coordination body should integrate market practitioners and support the drafting of policies
- There should be no competing coordination bodies with overlapping mandates
- The coordination body should have the full support of all regulators and market actors

KENYA & GHANA

3 Connected market

Market-driven SRO

- A body with a strong oversight-mandate driven by the market is likely to emerge
- Regulators should allow the market to take centre stage and drive development
- The regulatory coordination body that emerged in the emerging market phase should delegate oversight to the SRO
- Joint regulatory oversight of the SRO
- Continued governance coordination through the coordination body
- Continued integration of market feedback through the sub-committees
- Integration of the SRO into the coordination body organisational structure

NIGERIA & SOUTH AFRICA

Experience from a nascent market

In a nascent market, the central bank is likely the main, if not sole driver, behind market reforms. The focus is on developing the primary market for government securities, creating monetary policy incentives, and putting in place the basic laws, regulations and market infrastructure for the development of a money and bond market. Actual interbank transactions are few to none, while the central bank lays the groundwork by becoming a repo/reverse-repo counterparty to the financial sector through Open Market Operations (OMO). Applying the comparative model, the institutional angle is quite straightforward, with just one or two regulators involved and a dominant governance function leading the charge. Consequently, there is a low level of potentially overlapping mandates and limited interaction required with organisational complexity at a minimum.

EXAMPLE

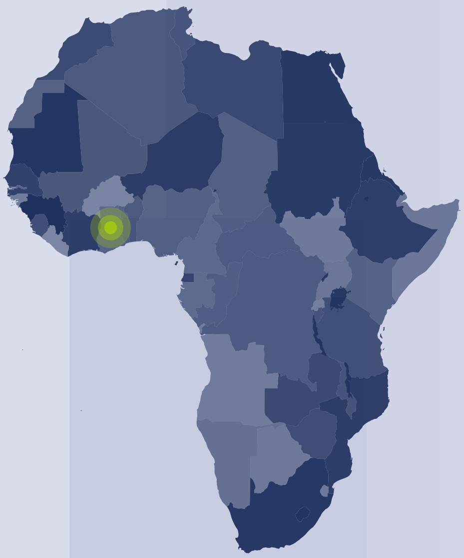
Ethiopia

Ethiopia is an example of a nascent market. The regulatory landscape is limited to the National Bank of Ethiopia (NBE), highly linked to the Ministry of Finance (function angle). The NBE is driving market-related developments with an active agenda including the adoption of Open Market Operations and Standing Facilities Directive (2021) and the Capital Markets Proclamation (2021). The latter lays the groundwork for establishing a Capital Markets Authority (CMA). The NBE is making great strides to define key bond market terms and instruments, eligible legal documentation and the infrastructure required for an eventual market. From both the interaction and organisation angles, the Ethiopia case is transparent. Market function is dominated by governance and with interaction among a few government stakeholders. The NBE secondary bond market development is driven by mandatory, senior and self-selected membership. Decision-making is binding.

Experience from emerging markets

Many of Sub-Saharan African bond markets, as exemplified in those assessed by the study, are at the emerging market stage. An important goal is to expand the market's depth and participation beyond the incidental transaction among top players. The focus for such markets, like Kenya and Ghana, is on the system barriers that limit participation. Major steps to remove risk-related obstacles include securing netting arrangements and the enforceability of repo and derivative best practice documentation, for example. From a function angle, multiple regulators are involved. The inter-linkages between the primary and secondary bond markets for government securities connect a Ministry of Finance and a Central Bank. Similarly, those between secondary bond markets for government securities and the development of a corporate bond market, converge the interests of a Central Bank and an SEC or CMA.

In most of the countries reviewed, overlapping mandates among regulators is common and often unavoidable. They can lead to conflicts and disjointed approaches to governance and oversight as well as other market development initiatives. The experience is often a slow pace of reform due to the parallel regulatory coordination structures and the need for most, if not all parties, to agree to reforms. Worse, in case of dissenting regulatory authorities, the reform process is significantly delayed or even halted altogether. However, there are examples where reforms have been introduced quickly and successfully through effective coordination of the governance function.



EXAMPLE

Ghana

Ghana is an example of an emerging market with an effective money and bond market development governance framework. The Ghana Fixed Income Market (GFIM) is the singular, high-level decision-making body coordinating its member regulators across their oversight and governance functions (Interaction angle). The Bank of Ghana is the main driver behind the agenda, reforms and market development initiatives.

GFIM-determined reforms to the money and bond market's legal and regulatory framework are delegated for implementation by the relevant regulatory authority within its existing legal mandate (e.g. regulations and directives) and the Ministry of Finance has the overriding responsibility for the drafting and approval of Laws (function angle). The Ghana Stock Exchange (GSE) is the GFIM member holding responsibility for its Secretariat. GFIM sub-committees such as the Technical Sub-Committee, serve to gather market feedback on proposals to develop the market.

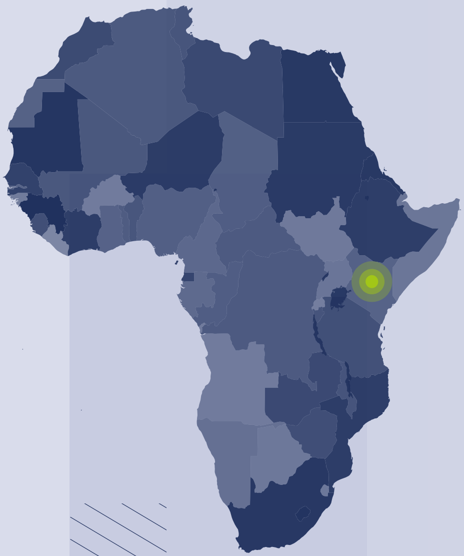
The organisational parameters of the GFIM are central to its success and include the mandatory participation of all relevant regulators and represented at senior and selected levels. The structure is clear with a Secretariat managing the agenda, planning and organisation. Members engage in a formal manner that produces effectively binding decisions then delegated to line regulators for implementation. Perhaps the most relevant parameter describing the GFIM, is the common vision held across the member regulators.

Fast-paced change

- **JANUARY 2019**
  Free of Payment (FOP) transfers become the market standard;
- **OCTOBER 2019**
  Launch of the Repo Guidelines, recognising GMRA under UK Law for cross-border transactions;
- **JULY 2020**
  Adoption of the GMRA as an eligible financial contract to which the netting provisions under the BSDTI Act (2016) apply; and
- **JANUARY 2021**
  Adoption of all 'global standard documentation' as eligible financial contracts for all derivatives and securities repurchase and lending transactions.

The coordination and effective organisation of the governance function is the highest-level priority at the emerging market stage, with an independent oversight function being less justifiable (and feasible) given relatively low market volumes. Regulators are often one step removed from the market, making it more challenging to judge the potential impact of governance reforms on the bond market's actual practitioners. The structural integration of market feedback becomes crucial. A fit to purpose governance coordination framework is able to integrate market feedback in a manner to efficiently support implementing the regulatory agenda.

The experiences studied underscore that individual regulators have the tendency to create own parallel coordination bodies, wherein they are in more direct control of the respective agendas and decision-making capacity. Competition versus complementarity often arises where regulators have diverging visions for the market. This leads to the setting-up of multiple bodies coordinating the market feedback. Each differs in priorities and processes, segmenting market practitioners and the market feedback they provide on the development agenda. Consequently, in such a money and bond market, the governance and oversight framework is inefficient, being heavy on market consultation and light on binding and decisive change.



EXAMPLE

Kenya

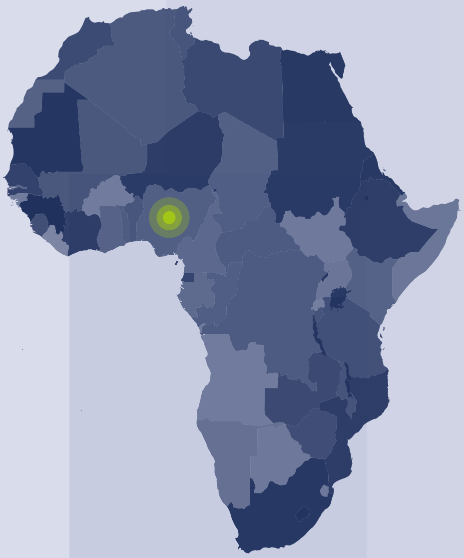
Kenya is an example of an emerging market. From the function angle, like Ghana, there are multiple regulators governing the Kenyan bond market's regulations and laws and respective oversight, with primary players being the Central Bank of Kenya (CBK) and the Capital Markets Authority (CMA). The Nairobi Stock Exchange (NSE) has oversight responsibility for its members dealing in corporate and other private bonds and equities. The governance and oversight coordination function is ample, organised hierarchically to either the CMA or the CBK. Market feedback institutions are present in the market, largely as associations (e.g. Bankers' Association, ACI, etc).

Kenya's market participants are engaged and regulators actively gather market feedback through the six coordination bodies and the corresponding working groups. While approximately half of the coordination bodies feed into the Capital Markets Authority (CMA) as their lead, the others connect to the Central Bank (CBK). Occasionally, additional coordination bodies for market feedback are developed and disbanded. The interaction angle reflects a strong fragmentation with many bodies coordinating market feedback and limited coordination among them. They have overlapping mandates and institutional representation.

Speed of reform is challenged by the relatively extensive and fragmented coordination function. The organisation angle highlights that while participation often involves a good cross-section of the market, it is often voluntary with a widely dispersed level of seniority. In many cases, senior participation is delegated to more junior staff. Decision-making is largely consultative and lacks certainty as feedback to senior officials happens outside of the coordination body. The relative lack of common interest among the coordination bodies, can lead to lengthy and even side-tracked efforts to press reforms forward.

Experience from connected markets

In connected markets, regulatory and legislative frameworks are in place, to a degree reducing the relative importance of the governance function in the continued development of the money and bond market. Nonetheless, the setting of regulations is still relevant. For example, to secure regulatory changes needed to expand the bond market participation to include other domestic investors such as pension funds, and to develop market infrastructure better suited to larger and more diverse transaction volumes (e.g. CCP). Still, compared to other market development stages, it is in a connected market where the (independent) oversight function grows. The increasing number of transactions and by different types of market participants, requires further 'rule-setting' to ensure accountability, coordination and monitoring.



EXAMPLE

Nigeria

Nigeria is an example of a connected market, wherein a multitude of organisations coordinate regulators governing the market. To a degree, there is cross-representation and unharmonised goals, which can hinder market development. The notable exception is the Parliamentary (Senate and House) Committees on Capital Markets, which draw heavily on market expertise to efficiently draft and review laws. Key organisation parameters contributing to the experienced success of their coordination function are clear rules of engagement, mandatory participation by selected persons and a common goal at-hand. An example is the case of the Company and Allied Matters Act (2020), whereby a consortium of legal and financial market representatives came together and were divided into sub-committees to redraft sections of the Act, following which each sub-committee presented the drafted report to the Senate and House of Representatives Capital Markets Committees for the legislative process. The CAMA puts in place statutory enforcement of netting arrangements, a crucial requirement to ISDA and GMRA enforceability.

Nigeria effectively coordinates market oversight and feedback. FMDQ is a Self-Regulatory Organisation (SRO) with a government mandated role to oversee the fixed income segment, while other SROs address other asset classes. Effective coordination (organisation angle) stems from a membership structure wherein market actors are required to participate and comply with FMDQ rules; hence, formal and binding. While FMDQ has no official coordination role relative to governance, it is a private company that has public, regulatory representation on its Board.

South African experience

Nigeria's experience contrasts with South Africa, where the Bond Exchange is a sub-section of the Johannesburg Stock Exchange (JSE) – an SRO covering oversight of multiple asset classes. Market feedback perceived this to stall the momentum in market development, previously driven by the dedicated Bond Market Development Committee chaired by the National Treasury and reporting to the Financial Markets Liaison Group (top-level regulator coordination). The potential lesson lay in the disconnect between the current oversight and governance structures.

No matter the stage of market development and the corresponding weight placed on governance and oversight, an effective process to define and adopt reforms – regulations and/or rules – involves well-organised coordination.

Coordination depends on best-practice parameters

1. Shared vision for the market;
2. Highest level representation, seniority, with the ability to take decisions on behalf of the respective institution;
3. Streamlined coordination with limited or no overlapping and competing mandates among coordination bodies;
4. Mandatory participation in coordination bodies and not delegated; and
5. Formal structures with agreed targets, agendas, scheduling and recorded decisions.

V Conclusion

The study finds that there is no one-size fits all governance and oversight framework. Clear lessons emerge from the multi-country study after applying the definitions and comparative model. Furthermore, the study yielded the development of the comparative model itself, the applications of which are much broader. It can be used to assess the approach to money and bond market governance and oversight in any given country.

The common finding across all, is the concept of a 'fit to purpose' money and bond market development framework. Herein, the governance and oversight coordination body(ies) function(s) and interact(s) in a mandate and approach best suited to the market development vision, goals and needs. The stage of a market's development is a key determinant to the optimal bond market governance and oversight framework.

The main and potentially sole-driver of effective money and bond market development at the initial two stages: A single to multi-regulator, structured and coordinated effort with the central bank (or apex regulator) taking a leading position – either explicitly and/or through moral suasion. The priority is to establish an effective governance framework wherein regulators develop the laws and systems required to support a thriving market. In later stages of bond market development wherein market volumes and liquidity are deepened through the expanded participation of domestic investors such as NBFIs like pension funds, the role of oversight gains at least equal importance. Herein, the need for establishing market rules and the monitoring of market operational behaviours relative to those rules, becomes vital. The market's practical experiences can then be articulated as input back into the overall bond market's governance and oversight framework, towards even further development.

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