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Government bonds can galvanise Gulf markets

A deepening of the local markets would enhance the GCC states' credit profile.

THE GCC IS COMING TO TERMS with a sustained decline in the oil price, a situation that analysts predict will not change anytime soon.

Traditional policy options for dealing with constrained resources include reducing or postponing investment programmes and restraining current spending. On the funding side, states can draw on their national reserve funds and increase non-oil revenues by instituting taxes and fees. While all of these options are viable, the current circumstances also call for issuing bonds and Sukuk both in domestic and international markets, and for lasting effect, in their own currency in order to spur development of local debt markets.

Robust, local government bond markets will create risk-free yield curves that are crucial for the pricing of risk and duration contributing to the deepening of the regional financial markets and creation of financial hubs. Developed local markets can also complement the access to international bond markets that is enjoyed by large enterprises while at the same time facilitating access to sources of long-term capital for private companies, thereby aiding diversification.

A deepening of the local markets will also enhance the credit profile of the GCC states themselves while sending a strong message to the international financial community about sound management and governance.

But it is important to get the details right. While there is no one-size-fits all policy for local government debt markets that can be implemented concurrently in all states, there are some key principles that will serve any of them well if they choose to take this path.

Government debt issuance and management is a specialised discipline. More often than not, a government acts through its ministry of finance or treasury, which may create a debt management office responsible for borrowing strategies and designing the government debt market. These debt managers should also obtain input from market participants and service providers such as local exchanges.

Local banks are the main customers as they need these instruments to manage their liquidity as well as for compliance with regulatory norms, namely Basel III. As governments should not absorb all the liquidity to the detriment of lending, it is important to diversify. Consideration should be given to allowing participation by international institutional investors. These investors can bolster demand and enliven the secondary market by buying when others are selling and selling when others are buying, thus preventing the "one way traffic" characteristic of markets where banks are the only holders. Authorities can also consider how to involve local non-bank institutions and whether individual investors should have access to this mainly wholesale market.

This is not time for financial wizardry. Instruments should be easy to price, pledge, buy and sell. Sharia-compliant investors may prefer Sukuk with defined underlying assets so that their trading can be deemed permissible by Sharia scholars.

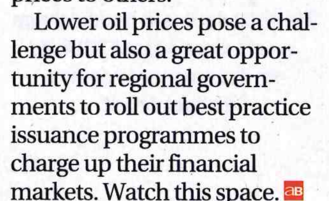
It is vital that securities are issued through a market-oriented price discovery process. The method used with the most success in advanced markets consists of competitively bid auctions open directly to banks and through them, to a wider universe. Auctions need to be conducted according to published term sheets and standardised conditions of issuance.

Government instruments are typically safe-held on the books of a central bank, a local central securities depository (CSD), if one exists, or on an international CSD accessible to local banks. The depository should handle both the cash and securities legs of transactions and should be capable of Delivery versus Payment (DvP), meaning that the payment and transfer of ownership of the securities should be simultaneous and irrevocable. Governments do not have to list their bonds on an exchange, but may well choose to benefit from exchange rules to provide an added degree of confidence to investors.

The issuer will typically develop and communicate an issuance calendar, with regular issues of bonds and Sukuk of varying maturities and of sufficient size. Plans can change during the course of the calendar period, but the market traditionally rewards consistency.

Issuance programmes can be implemented and planned carefully beginning with short-term bills and by placing more emphasis as soon as practicable on medium (three, five and ten years) and then longer coupon bearing maturities. With a market-based process firmly established, banks and other investors can absorb longer tenors more successfully.

Trading can be permitted on exchanges provided the costs are very low and that banks have no obstacles to trading with one another. Market participants are best allowed to choose where they execute, either over-the counter (OTC) or through an exchange. Secondary market liquidity is typically driven by a set of institutions chosen by the issuer according to criteria. Those institutions must quote firm "bid" and "ask" prices to others.



Lower oil prices pose a challenge but also a great opportunity for regional governments to roll out best practice issuance programmes to charge up their financial markets. Watch this space.