A roadmap for strengthening Nepal's bond market

February 2020

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Introduction

Financial markets are necessary for productive deposit and deployment of funds. Debt markets are a significant component of financial markets. Currently, the Nepalese bond market comprises only the primary market. Trading activities have been limited in the Nepalese markets. This paper aims to assess the current bond market scenario in Nepal. In this paper, we have highlighted why the Nepalese bond market is lagging and the challenges faced by the market. We have also suggested methods to create a pathway towards progressive bond markets and enumerated the regulatory, infrastructure, institutional and participation-based areas of improvement and support.

Importance of a developed bond market in the financial system

Financial markets play an important role in the mobilisation of financial resources through financial intermediation and encourage the flow of funds from surplus units to deficit units. An integral part of financial markets is the bond market. A healthy bond market enables efficient mobilisation and allocation of resources, provides a variety of funding avenues to the public and private sector, provides a variety of investing avenues, finances development activities of the government, reduces the pressure on institutional financing and assists in the development of a reliable term structure for interest rates.

Current scenario of the Nepalese bond market

The Nepalese bond market is yet to reach a stage of maturity. In Nepal, debt securities are issued by both the government and corporate organisations. Beyond primary subscription, the trading volume of these bonds is minimal due to which market-based price discovery and yield curve generation is a difficult process. In terms of secondary trading of government securities, treasury bills are traded over the counter to some extent. However, there is no existing trading platform for trading of such securities in the secondary market.

Outstanding domestic bonds
(in NPR billion for fiscal year 2075/76*)

	Bonds	Amount	Percentage
1	Treasury bills	146.8	32.4%
2	Development bonds	297.3	65.6%
3	National Savings bonds	-	0%
4	Citizen Savings bonds	8.4	1.9%
5	Foreign employment bonds	0.5	0.1%
6	Special bonds	-	0%
	Total	452.9	100%

Source: Public Debt Management Department, Nepal Rastra Bank

*2075/76 is the latest financial year as per the Nepalese calendar

Legacy constraints on the development of the bond market

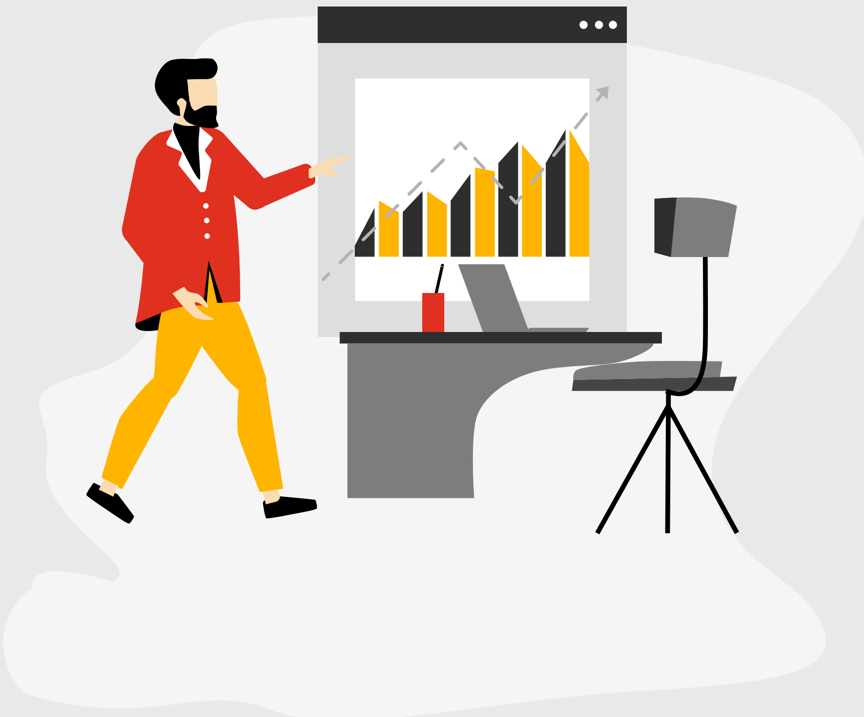
Lack of demand and supply has always been significant, owing to lucrative funding and investment alternatives.

Interest income on bonds draws a higher tax than the interest earned on fixed deposits. This discourages investor participation in the bond market.

To ensure seamless trading in the secondary market, an electronic trading platform, a central depository and a settlement system are needed.

Poor corporate governance, weak regulatory controls and disclosure standards have contributed towards lack of investor confidence.

Political instability, slow macroeconomic environment and limited regulatory support have stunted the growth of the bond market.



Imperatives for the development of the bond market

We believe the steps to be taken to develop the bond market in Nepal can be categorised under four pillars – (i) wider participation, (ii) adequate infrastructure support, (iii) policy and fiscal support from the government and regulators, and (iv) institutional support. Development of these aspects is essential to achieve an active bond market in the country.

Steps to strengthen the bond market in Nepal

Pillar I	Identify the potential participants and their corresponding roles in the secondary bond market.
Pillar II	Create necessary technology infrastructure for smooth functioning of the secondary market.
Pillar III	Remove the bottlenecks in the existing policies, guidelines and create trading desks in financial institutions.
Pillar IV	Identify industry bodies and self-regulatory organisations (SROs) for expert guidance and adequate information dissemination.

Source: PwC analysis

Wider market participation

- Bond market participants have differing needs in terms of interest rates, investment horizons and issuer risks, which are useful to create demand across maturity profiles. That's why a healthy mix of investors is necessary to develop the secondary market.
- Banks currently have negligible held for trading (HFT) and available for sale (AFS) portfolios due to the lack of a secondary market trading. Hence, creation of trading books is of utmost importance.
- At the initial phase, trading can be started in government securities and later can be scaled to include corporate securities as well.
- Regulators need to identify other potential participants in the market, such as:
  - insurance companies
  - mutual funds
  - provident and pension funds
  - collective investment schemes
  - deposit insurance corporation
  - retail investors.
- Incentivising policies can be developed to encourage high-quality large corporates to issue both short- and long-term debt securities to meet their funding requirements partially from the market. It will allow banks to mobilise funds to the small and medium enterprises (SME) sector.

Adequate infrastructure support

- The central bank may develop a negotiated dealing system (NDS), which will act as the electronic trading platform in the secondary bond market. It will help in:
  - enabling seamless trading
  - ensuring market-based price discovery
  - anonymous quoting and accepting of prices.
- Improving and automating the central depository as well as the clearing and settlement system is of utmost importance. It will help to reduce the cost of trading.
- The central bank may establish a comprehensive primary dealer framework for the bond market. It aids in bringing in a higher number of and stronger primary dealers in the market.
- Electronic trading platforms and clearing systems expose institutions to cybersecurity risks. Hence, development of an adequate cybersecurity framework for banks, other participants, the Securities Board of Nepal (SEBON) and the Nepal Stock Exchange Limited (NEPSE) is necessary.
- Due to lack of trading in the secondary market, yield curve is not available. To create a well-defined yield curve, debt management policies are to be aligned to benchmark points.

Policy and fiscal support from the government and regulators

- Higher impetus is required for budgeting and planning of government issuance of securities. Policies and strategies should be created to enable prudent public debt management.
- There is a need for tax reforms from both the issuer's and the investor's point of view. The Inland Revenue Department (IRD) can rationalise the policies to develop a forward-looking tax structure in order to encourage long-term issuance.
- Regulators can review the existing policies to ensure the securities laws are in tandem with other relevant rules and guidelines. Insolvency and bankruptcy laws can be developed to raise investor confidence.
- Investor protection and corporate discipline framework has immense scope of improvement in Nepal, as the country has consistently scored a low 58 from 2013 to 2020 in the Minority Investor Protection Index. Regulators can review the existing guidelines to strengthen the same for investor confidence.

Institutional support

- NEPSE's role in protecting investor interests, observing transparency, quality disclosures and quality corporate governance is vital for boosting investor confidence. Hence, NEPSE may review its existing guidelines in relation to the bond market to ensure those are aligned with protection of investor interests.
- Investors may not have the essential expertise for assessing the credit risk of issuers. Credit rating agencies may bridge this gap by providing independent opinions on the credit risk of issuing entities and facilitating bond market trade.
- For effective communication, awareness, information transfer and reasonable financial research, the presence of self-regulating industry bodies and active financial journalism in the industry is necessary.
- The central bank and SEBON need to encourage the presence of industry associations and SROs as they provide an anchor for the code of conduct to be followed by issuers, brokers, and fund managers, among others.

How can PwC help

1. Identify possible participants and the purpose they will be serving towards development of the market
2. Review the public debt management policies, Nepal Rastra Bank (NRB) and SEBON's policies and guidelines to identify gaps in incentivising different types of investors
3. Develop a market infrastructure – NDS, clearing house, depository systems, etc.
4. Develop the primary dealer framework for the bond market
5. Review and improve the cyber security framework
6. Rationalise the tax structure in a forward-looking manner

Conclusion

The bond market in Nepal faces unique challenges in terms of market participation, regulatory guidance and rationalisation of policies, along with macro-economic and political uncertainties. In lieu of these challenges, it is necessary to build a robust foundation for a healthy method of transferring funds from savings to investments, with sophisticated financial markets as a medium. As suggested in this paper, a four-tier approach is a prerequisite for a well-functioning bond market which shall result in increased participation by both supply and demand sides, a robust infrastructure which enables a transparent and seamless trading environment, strengthened and rationalised regulatory guidance and augmented investor confidence to encourage good corporate governance.

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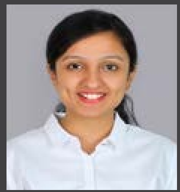

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VB/February 2020 - M&C 4443