Part 2 – Explaining the Bond Market

The history and status of the Botswana bond market that we discussed in the previous publication has laid a foundation for exploring several topical issues about the bond market and we shall be sharing these discussions up until the end of September. One of the most important immediate discussions is about what the bond market is and what bonds are.

The bond market is commonly referred to as the debt market and it is also referred to as the credit market or a market for borrowing and lending. It exists alongside the equity or stock market and primarily serves as a platform where government and corporate entities can issue their bonds or debt instruments to the public and receive money in return, and also as a platform where such bonds can be bought and sold among investors once they have been issued and listed on a Stock Exchange.

In Botswana, the bond market is relatively small in comparison to the equity market. The nominal value of bonds listed on the BSE represent close to a quarter of the market capitalization of the domestic companies on the Exchange. Globally, the bond market is larger than the equity market. Commonly, government is the largest borrower in the bond market and such is the case in Botswana with government accounting for 66 percent of the total bond market capitalization. It is this phenomenon that has truly spurred the participation of several other entities who needed to use government bonds to benchmark their own individual bond issuances.

So what is a bond? A debt instrument, an instrument of indebtedness, a debt investment, a fixed income instrument, a long term borrowing – these are some of the common words that describe a bond. Basically, a bond is a loan agreement between a borrower and a lender where the borrower promises to pay back the lender the original amount after a certain period of time and with regular interest payments during the period of the loan. Say an entity decides to borrow money from the public and it issues a bond. The entity becomes known as the issuer and those lending money to it, in return for holding the bond, become known as bondholders.

The issuer (borrower) promises to pay the bondholder (lender) some interest periodically (monthly, quarterly or semi-annually) at pre-set dates in the future until the bond matures. The borrower also promises to repay the initial money or principal amount invested by the lender after the bond matures. The lender expects to receive some income in the form of periodical interest that is paid as compensation for lending. These interest payments are called coupons and the interest rate that specifies the amount of interest to be paid by the issuer is called the coupon rate.

A long time ago, ownership in bonds was in the form of a paper certificate. That is, at issuance the issuer would give the bondholder a certificate confirming indebtedness and bearing the terms and conditions of the debt agreement in exchange for the money they are receiving from the bond holder. Further, and until the early 1980s, a bond was issued as a paper certificate with paper strips of coupons attached to it. In order for a bondholder to claim their interest earned from a bond, they had to tear off a coupon from the bond certificate and mail it to the paying agent. That was the origin of the term "coupon", which means the interest a bond pays, and "coupon rate" which means the interest rate paid on the bond. These terms continue to be used, although the issuance of bonds with physical coupons attached does not.

Who are the participants in the bond market? The greatest appeal about the bond market versus other avenues of accessing borrowings is that it provides a platform for accessing long term borrowings. Government and corporates need this long term capital to invest in long term development projects. At present, the longest dated bond on the BSE is the BW012 which matures in the year 2040, and it is a 25 year bond from its issuance date in 2015. On the BSE, the government, parastatals and corporates are some of the existing borrowers in the bond market and under these 3 categories there are 15 entities or organizations including those companies that have also listed their equity on the BSE.

Insurance companies, pension funds, foundations, endowments and individual investors are some of the lenders in the bond market. As you would note, lenders such as pension funds and insurance companies find the bond market attractive to participate in as it provides a variety of bonds in terms of tenure or maturity, types of interest payments, and so forth in which they can invest the pension contributions and insurance annuities that are ordinarily long term in nature, whilst providing steady interest income throughout. Any entity or individual who can lend money for investment purposes can invest in bonds.

In other markets, it is also common that municipal authorities or district councils, cooperative societies, hospitals, universities, schools and different types of private and public companies can borrow money from the public through bonds. Primarily, what is important is for the organization to demonstrate its credit worthiness to the public or to investors it is raising capital from.

Ordinarily, for a lender to lend money to an organization they should have confidence and trust that the organization is worthy of the credit and is able and willing to pay back the money. Similarly, the public or investors in bonds have to trust that the management of the organization will continue to operate the organization in a manner that will ensure their ability and demonstrate their willingness to repay the money. The borrower must therefore be creditworthy in the eyes of lender or bondholders. For example, a trusted and creditworthy issuer such as the Government of the Republic Botswana can borrow money from the public with a promise to pay a reasonable interest rate over a certain period of time. With the proceeds, Government could use the money to fund development expenditure such as the building of roads, schools, hospitals, dams, and other projects. Bonds are therefore a relatively easy, quick and transparent way of raising large sums of capital.

Since bonds are listed the BSE, the role of the BSE in the bond market is to regulate the issuers of bonds by ensuring that the issuers comply with the continuing obligations such as disclosure of information to bond holders, fulfilment of payment obligations and so forth. The BSE also provides a platform where the bonds can be bought and sold by the public after they have been issued and listed. In line with its mission statement, it is responsible for operating the bond market in a fair, transparent and efficient manner for all the stakeholders in order to optimize national economic development. Hence, the bond market is a pillar of Botswana's economy.

This article was written by BSE Product Development Manager, Mr Kopano Bolokwe, as a build up to the 2016 Botswana Bond Market Conference and was published during the week of 2 September 2016.