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Responding to the Crisis: Changes in OECD Primary Market Procedures and Portfolio Risk Management

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Tougher issuance conditions related to the surge in government borrowing needs are the reasons why issuance arrangements have not always been working as efficiently as before the crisis. This prompted debt management offices (DMOs) in the OECD area to review existing issuance policies and procedures. The crisis also had an impact on the use of indicators or guidelines relating to the key risks of the maturity structure of issuance or outstanding debt.

Although OECD issuance procedures are likely to differ considerably at the level of technical standards and detailed institutional arrangements, increased integration of global financial markets has encouraged the standardisation of financial instruments and convergence of general issuance procedures. As a result, OECD issuance policies and procedures are broadly similar with a high degree of transparency and predictability.

However, in response to tougher issuance conditions, DMOs have implemented changes in existing issuance procedures and policies that may have led to a somewhat greater diversity of primary market arrangements and procedures. The paper also reviews strategies and indicators for the management of the debt portfolio. Although issuance procedures and targets for portfolio management may have become somewhat more opportunistic in some jurisdictions, debt managers continue to emphasise the importance of transparency and predictability.

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I Introduction

Existing issuance arrangements did not work always as efficiently as before the crisis

Before the crisis, increased integration of global financial markets had led to a situation where OECD issuance policies and procedures were broadly similar with a high degree of transparency and predictability. However, tougher issuance conditions related to the surge in government borrowing needs are the reasons why existing issuance arrangements and procedures have not always been working as efficiently as before the crisis. The crisis also had an impact on the use of indicators or guidelines relating to the key risks of the maturity structure of issuance or outstanding debt. These considerations, in turn, have put the spotlight on the adequacy of existing issuance policies, procedures and portfolio management strategies. The review in this paper shows that in response to the crisis, DMOs have implemented changes in existing issuance procedures and policies that may have led to a somewhat greater diversity of primary market arrangements and portfolio management procedures.

Changes in issuance policies, procedures and portfolio management strategies

Sections II and III provide an overview and update of issuance procedures in the OECD area based on a recent OECD survey. It is explained that, prior to the crisis, an increasingly integrated global financial landscape had encouraged the use of broadly similar issuance procedures and policies. Section IV shows how the explosion in borrowing needs has worsened the issuance environment and tested heavily the performance of existing issuance procedures. Tougher issuance conditions, in turn, have led to changes in issuance procedures (section V). Changes in portfolio management strategies and procedures are discussed in section VI. Section VII discusses the need to review primary dealer arrangements, while the final section concludes.

II Increasingly similar issuance procedures and policies in the OECD area?

Differences in issuance procedures…

It is widely accepted that government debt issuance procedures and operations should be designed in such a way that they take into account the interests of both issuers and financial market participants[1]. Since policy judgements, economic and financial situations as well as market practices and conventions can be expected to differ, issuance procedures are also likely to differ among OECD jurisdictions. In particular at the technical level, standards, architecture and operations for selling securities, primary dealer systems and other primary market arrangements may differ significantly. These technical and institutional variations may reflect a response to specific structural conditions in markets, policies and differences in traditions and conventions.

..especially at technical level

However, an increasingly integrated global financial landscape, and the resulting increase in competitive conditions to achieve the cheapest funding, has encouraged the use of broadly similar issuance procedures and policies that facilitate or encourage liquid markets.

…the convergence of OECD public debt policies

More generally, there is wide recognition that broad and deep primary and secondary markets are instrumental in lowering the cost of borrowing for the government.[2] This, in turn, has been a key driver in the growing convergence of OECD debt management policies.

DMOs use broadly similar issuance procedures with high degrees of transparency and predictability

It is therefore not surprising that Debt Management Offices (DMOs) have as stated objectives the development of government securities markets that are liquid and efficient, with market participants operating in a transparent debt policy environment. As a result, we can observe broadly similar issuance procedures and operations with a high degree of transparency and predictability in all OECD countries.[3] For example, the widespread use of auction calendars and electronic auction systems is evidence of the results of this transparency objective in primary markets.

The emergence of global benchmarks

Globalisation has also contributed to the emergence of a number of "standard" financial products centered on a few "global benchmarks" such as the 10-year German Bund and 10-year US Treasury Bonds, serving as liquid pricing vehicles for other markets.

Importance of electronic systems

Electronic systems are increasingly used in primary markets.[4] Automation of auction procedures increases their efficiency vis-à-vis the use of manual procedures as it enhances speed, reliability and cost-effectiveness. Improved electronic auction systems are therefore important for streamlining the process of submitting bids so that auction results can be processed and disseminated more quickly. More sophisticated systems are also needed to allow institutions to bid directly in auctions.

Auction most common method

Auctions are the issuing procedure most commonly used among the OECD countries. However, some (usually smaller) countries combine auctions with the syndication of benchmark bonds in order to provide a quick build-up of outstanding volume and greater certainty of issue. Regarding the introduction of new instruments, many issuers (also larger countries) conduct the first issue via a syndicated offering. Subsequent issuance is then undertaken via auctions.

OECD policies and market conventions function increasingly as global standards

In sum, OECD countries have seen an increase in the convergence of the composition of debt (maturity structure and instrument type), increased similarities in issuance procedures, and increased standardisation of market conventions. Integrated markets and the spread of OECD leading policy practices and market standards, in turn, have influenced developments in government debt issuance around the world. Consequently, the standards embedded in the issuance policies, procedures and portfolio strategies found in the Surveys among OECD members (see sections III, VI and VII) represent increasingly global standards. The Annual OECD Global Forum on Public Debt Management is serving as the principal vehicle for the world-wide dissemination of these standards, leading practices and related policies.

Table 1a. Overview of issuing procedures in the OECD Area

	Auctions		Auction type		Tap issues		Syndication
	Long-term	Short-term	Single-price	Multiple-price	Long-term	Short-term	
Australia	x	x	x	x			x
Austria	x	x		x			x
Belgium	x	x		x	x	x	x
Canada	x	x	x	x			
Czech Republic	x	x	x	x			x
Denmark	x		x		x		x
Finland	x		x		x	x	x
France	x	x		x			x
Germany	x	x		x	x		x
Greece		x	x				x
Hungary	x	x		x		x	x
Iceland	x	x	x	x			x
Ireland	x	x		x		x	x
Italy	x	x	x	x			x
Japan	x	x	x	x			
Korea	x			x			x
Mexico	x	x	x	x	x	x	
Netherlands	x	x	x	x	x		
New Zealand	x	x	x	x	x	x	
Norw ay	x	x	x				
Poland	x	x	x	x			x
Portugal	x	x		x			x
Slovak Republic	x	x	x	x	x	x	x
Spain	x	x		x			x
Sw eden	x	x		x	x		x
Sw itzerland	x	x					
Turkey	x	x		x			
United Kingdom	x	x	x	x	x		x
United States	x	x	x				
Total	28	26	17	23	10	7	20

1. Australia	Recommenced issuance of linkers. First issue via syndicated offering.
	Subsequent offering via single-price auctions. Nominal debt is sold via multiple-price auctions.
2 .Austria	Syndication for portion of each issue.
3.Belgium	Syndication used for benchmarks bonds.
4.Canada	Syndication used for foreign currency debt issuance (for foreign exchange reserve funding purposes only).
	A single price auction format is used for issuance of inflation-linked bonds.
5.Czech Republic	Syndication used for "Eurobonds", single-price for T-bills, multiple-price for bonds.
6.Denmark	Long term foreign issuance is primarily conducted via syndication.
	Commercial Paper (CP) programmes are used for short-term foreign issuance.
7.Finland	Issuance of T-bills via multiple-price auctions.
8.France	Syndication is usually used once a year, essentially for the first issuance of a new line.
9. Germany	Syndication for the first issuance of a linker, its first re-opening and its first tap.
	Syndication used for second USD bond.
10.Greece	Syndication used for first issuance of medium- and long-term bonds and linkers. Public subscription for retail investors.
	Introduction of syndications for all types of bonds and re-openings. Switch to single-price auctions for T-bills.
11.Hungary	Some T-bills are sold via tap sales or via subscription for retail investors. Syndications for forex debt issuance.
12.Iceland	Syndication or private placement is used for bonds in foreign currency; Dutch Direct auction for long term bonds.
13.Italy	Syndication for first tranche of long term bonds and for Global bonds. Private placement used for external debt.
14.Korea	Syndication for first issuance of inflation-linked bonds and foreign exchange stabilisation bonds.
	Switch from single-price to multiple-price auctions. Also buy-back auctions in multiple-price format.
15.Mexico	Foreign currency debt is issued via investment banks.
16.Netherlands	Dutch Direct Auction (uniform price) is used for longer dated bonds.
17.New Zealand	Tap sales are used for external debt (both long and short term). Auctions are primarily used for domestic borrowing operations.
18.Poland	Syndication is used for external debt. Use of retail agents for domestic securities. Single-price auction is used in supplementary auctions.
19.Portugal	Syndication is used for first issuance of bonds. Direct negotiations for MTN and ECP programmes.
20. Slovak Republic	Syndication is used for tranch of each issue.
21.Spain	Syndication for new long benchmarks and foreign currency debt. The auction format is a mixture of single- and multiple price.
22.Sweden	Syndication for foreign currency debt and occasionally for domestic currency bonds.
23.Turkey	Direct sale to institutional investors and public offers to retail investors. Single-price auctions are used only for inflation-linked bonds.
24.United Kingdom	Taps for market management are reserved for exceptional circumstances only. Introduction of syndication.
	Use of single-price auctions (linkers) and bid--price auctions (nominal bonds and T-bills).

Source: Responses to the 2009 Survey of the OECD Working Party on Debt Management.

III. Results from a recent survey on OECD issuance procedures and policies

The principal issuing procedures are auction and tap

An increase in the use of syndication

The principal issuing procedures are auction and tap. The responses show that almost all OECD countries use auctions for issuing new long-term debt, while 26 DMOs also use auctions for issuing short-term debt (Table 1a). Interestingly, syndication is now also being used by a number of larger countries and not only by smaller countries for selling benchmark bonds. This procedure is usually credited with achieving very rapidly a high initial outstanding volume, thereby boosting liquidity and achieving greater placing certainty with lower borrowing costs. Syndication is often also used for the first-time issuance of new instruments such as linkers or ultra-long bonds. Table 1a shows that 20 OECD countries are now using syndication for issuing debt. This is an increase compared to earlier surveys, including a previous OECD study[5] showing a considerable increase in the use of syndication among Euro-zone countries.

Use of tap issues

Tap issues are less frequently used, with 7 OECD DMOs using taps for issuing short-term debt and 10 for long-term debt.

Multiple-price preferred auction type but almost half of DMOs uses both auction formats

The preferred auction type tends to be the multiple-price format.[6] However, in 17 countries single-price[7] auctions are used as well. Twelve countries employ both types of auctions. In the US, single-price auctions are used for all Treasury auctions. Nonetheless, although the main auction types in OECD are broadly similar, they often vary in terms of operational and technical details.

IV. The explosion in borrowing needs has worsened the issuance environment

Borrowing needs have increased significantly in response to the soaring costs of financial support schemes and other crisis-related expenditures as well as recession-induced falls in tax income and an increase in recession-related expenditures. Many OECD governments are therefore facing a further increase in expected deficits. As a result, it is estimated that the gross borrowing requirements of OECD governments for 2009 will be close to USD 16 trillion. The tentative outlook for 2010 shows a stabilising borrowing picture, at around the same level. The 2010 funding outlook is, however, surrounded by an unusually high degree of uncertainty.[8]

Strong supply has worsened issuance conditions

This dramatic increase in the supply of government paper has worsened issuance conditions, with some OECD debt managers reporting liquidity pressures in secondary markets and sometimes weak demand and distortions in primary markets. Delegates from the OECD Working Party on Public Debt Management (WPDM) confirmed the following trends and developments: (a) dramatically increased borrowing requirements and concerns about possible market absorption problems[9]; (b) changes in issuance methods, including more flexible auctions, introduction of auction fees, and the use of distribution methods other than auctions such as syndication, Dutch Direct Auction

(DDA) procedures and private placement (see section V); (c) changes in optimal sovereign portfolios (driven by new benchmarks with a greater emphasis on short-term paper and a reformulated cost-risk trade-off – see section VI).

V. Tougher issuance conditions have led to changes in issuance procedures

Softening of demand has led to postponed or less successful auctions

These dramatically increased borrowing needs have, in turn, led to sharply increased competition in raising funds. Additional competition also came from the issuance of government-guaranteed bank bonds. Issuance conditions have therefore become tougher with reports about a softening of demand at some auctions, leading to postponed, failed or cancelled auctions. These developments, together with the decline in the number of primary dealers (section VII), are raising important policy issues such as:[10]

- The risk to the success of auctions and greater auction tails.
- The risk to the liquidity of Treasuries in the secondary markets.

Future issuance could become more challenging

Less successful auctions have been ascribed to uncertainties about potential market absorption issues and volatile market conditions. All in all, DMOs have been very successful in raising funds. Difficulties surrounding auctions can therefore best be interpreted as “single market events” and not as unambiguous evidence of systemic market absorption problems. However, the future could become more challenging given that the still rising issuance trend is occurring hand in hand with increasing overall debt levels. For example, total marketable debt of central governments in Japan, the US and euro zone stood at nearly USD 21 trillion, more than double the level a decade before. In 2009, it is projected to be over USD 27 trillion.[11]

DMOs have adopted changes in issuance procedures

In response, several DMOs have adopted changes in issuance procedures so as to address the consequences of increased competition in raising funds and (potential) market absorption problems. For example, many DMOs have introduced more flexible auction calendars and/or more flexibility in the amounts offered. Issuers have also introduced new distribution facilities.

Maintaining direct investor relations more important than before

Maintaining investor relations has become even more important than before with many DMOs reporting greater urgency for organising road shows for large (foreign) investors. To that end, during crisis periods direct contacts with investors (including via road shows) are essential, in particular to explain changes in the overall situation and policy-framework. Moreover, especially in the current, challenging circumstances characterised by high government borrowing needs, many DMOs observed that a broad and diverse foreign investor base remains essential in maintaining a diversified and liquid domestic government bond market.

Table 1b. Recent changes in issuing procedures and instruments

Australia	More flexible auction calendars. Issuance of inflation indexed bonds recommenced in H2 of 2009 in order to broaden investor base. First issuance of inflation-indexed bonds via a syndicated offering. Subsequent issuance of inflation indexed bonds is planned to be via single-price auctions. Auctions for all nominal debt are via the multiple-price format.
Austria	More emphasis on investor relations.
Belgium	Tap for long term debt. Increased placement of EMTN.
Canada	Re-introduction of 3-year maturity. Reduction in the regular buy-back programme but maintained switch operations in long-end to support market liquidity. Introduction of additional benchmarks for 2-year and 5-year sectors.
Denmark	Use of private placement in foreign markets in 2008. T-bill programme terminated in 2008. Greater use of auctions instead of tap sales.
Finland	Diversification of funding sources. More emphasis on investor relations. More coordination with PD's. Higher syndication fees. Active use of demand-supply windows.
France	Increased flexibility for better matching demand. On several occasions off-the-run bonds were issued since the 2nd half of 2007.
Germany	Tap for long term debt. More frequent auctions.
Greece	Beginning 2009, auctions of T-bills changed to single price format. Syndication used for all types of bonds and re-openings.
Hungary	More flexible auction calendar (bi-weekly bond auctions with dates but without tenors in calendars). More flexibility in the amounts offered. Introduction of top-up auctions (non-competitive subscription) and auction fees. More frequent use of re-openings of off-the-run bonds and buy-back auctions. Planned introduction of exchange auctions. Introduction of direct, regular meetings with institutional investors.
Iceland	Single price auctions (for long term bonds) are used together with multiple price auctions.
Ireland	Syndication has been added as funding tool. Auctions also in use for short term debt.
Italy	More flexible procedures. The range of offered amounts for on-the-run bonds increased. Possibility to offer additional off-the-run bonds as response to highly volatile market conditions. Adjustment of auction pricing mechanism for nominal bonds, linkers and floaters (issuer sets discretionally the total allocated volume within the previously announced range). In BOT auctions participants are required to send their bids in terms of yield. Modification of method for calculating share in auctions. The range of the maturity of bonds sold to PDs at non-competitive prices is also extended. Introduction of re-openings of old bonds.
Korea	Since September 2009, single price format of auctions was changed to a multiple price format. Introduction of conversion offers.
Mexico	Tap issues of both short and long term bonds.
Netherlands	Increased frequency of bond auctions (of off-the-run bonds). Extended repo - and commercial paper facilities (longer maturity, extra foreign currency issuance). Extended T-bills programmes.
New Zealand	Introduction of new long term bond. Tap issues for short term debt. Monitoring foreign markets for finding attractive foreign borrowing opportunities. Introduction of a new facility of ''reverse tap tender''.
Norway	Instead of both auction types, only single price auctions are now being used.
Slovak Republic	Contemplation of following (future) operations: (a) Direct selling and buy backs in secondary market; (b) Underwriting auctions (single price based on price discovery via syndication); (c) Buy backs and exchange auctions.
Turkey	'Revenue indexed bonds'' are introduced in order to broaden the investor base.
United Kingdom	Mini tenders were introduced in October 2008 as a more flexible supplementary distribution method alongside with the core auctions programme. In 2009-10 the DMO is using syndicated offerings to supplement its auction programme (as of 1 October 2009, three syndicated offerings have been held). Introduction of a post-auction option facility.

Source: Responses to the 2009 Survey of the OECD Working Party on Public Debt Management.

Preferences investors key consideration

Transparency at core of relations with market

This means taking into account both the preferences of foreign and domestic investors, including when making changes in issuance procedures and techniques. DMOs should also pay attention to (improving) all forms of communication, including the construction of high-quality websites. Although issuance programmes have become somewhat more opportunistic, a transparent debt management framework remains at the core of good relationships with the market. In this context, primary dealers' principal job is to sell debt, while the principal task of DMOs is to explain how they (and the government more generally) operate.

Increasing interest in syndication

Table 1b provides an overview of the major changes made in issuance procedures and/or the conditions for using existing systems and techniques in response to the crisis and tougher issuance conditions. For example, as noted, there are reports about an increasing interest in the use of syndication. As noted, this selling method is credited with the potential to rapidly achieve a very high initial outstanding volume of issues with better placing certainty than auctions. This may, in turn, lead to higher liquidity and lower borrowing costs. However, syndication also has potential downsides such as a more limited reach among potential buyers, more risk averse investors than dealers participating in auctions, and higher intermediation costs.

More frequent auctions with more flexible and opportunistic procedures

There are already signs that liquidity pressures, rising borrowing requirements and risk-averse behaviour of investors are forcing debt managers to modify their fund raising strategies. Regarding the operation of auction schemes, many DMOs are operating more frequent auctions with auction schedules having become more flexible and opportunistic. The maturity of debt is becoming shorter. There is growing use of foreign liabilities, and debt managers are using a wider range of instruments, including bills and notes.

Transparency and predictability remain key

These changes, while understandable, create some risks. As debt managers become more opportunistic, issuance programmes are becoming less predictable. That may not be desirable in the long term. DMOs emphasise therefore that they will continue to operate a transparent debt management framework supported by a strong communication policy. Transparency and predictability are instrumental in reducing the type of market noise that can unnecessarily increase borrowing costs.

Some DMOs introduced auction fees and the UK mini-tenders

Some DMOs were considering introducing (or have introduced) auction fees. Others argue that fees are not effective and/or not consistent with the principle of open auctions. Mini-tenders were introduced by the UK DMO alongside the scheduled auction calendar in order to mitigate liquidity problems.[12]

Suggestions for studying joint issuance in Euro-zone

On several occasions, suggestions have been made that Euro-zone issuers[13] should explore practical ways to issue government paper jointly. This debate seems to have gained some traction from recent issuance problems, with several European countries being forced to cancel bond issues due to lack of interest by investors. These problems have revived discussions about closer co-operation in the form of joint issuance policies, including the issuance of a joint European short-term debt instrument that would be able to attract additional investors due to its increased issuance size (and resulting liquidity).[14]

Increased retail issuance…

…complicated by financial stability considerations

Another possible change in issuance strategies may be a stronger emphasis on retail issuance so as to broaden and stabilise the investor base. Increased use of electronic systems has made it easier to reach retail investors directly. However, a possible downside concerns a lack of cost-effectiveness(although the greater use of electronic means has improved the scope to reduce distribution costs). A new complication in some countries is the financial stability perspective. Although the introduction of additional retail funding instruments may lead to lower borrowing costs, this policy move may not be desirable in the current crisis situation in which banks try to strengthen their balance sheets by increasing retail deposits. Hence, in some markets, additional competition from retail instruments issued by DMOs may not, at the moment, be desirable on financial stability grounds.

VI. Survey of the Impact of the Financial Crisis on Debt Portfolio Management Strategies[15]

Why portfolio management?

Managing key risks associated with debt portfolios

This section reports the results of a survey conducted in October 2009 on the impact of the financial crisis on the portfolio management strategies of members of the OECD Working Party on Debt Management. Government debt managers need to monitor and manage the key risks associated with their debt portfolios in order to reduce the cost of debt for their respective governments, at least on average over the medium term. Portfolio management can also help manage the volatility in the government's balance sheet and its net worth. Most managers seek to some degree to balance the cost and risk of their debt portfolios, where the risks include refinancing risks, repricing risks and interest rate risks.

Use of different strategies and indicators

Different debt managers may use different strategies and indicators to monitor portfolio risks and guide their portfolio management. Some use targets or limits for indicators such as average duration, modified duration, or the proportion of the portfolio subject to refinancing or price refixing within a specified period. Some use broader guidelines related to the maturity structure of their issuance or outstanding debt, and its distribution between different debt instruments.

The crisis complicates portfolio management with implications for the issuance task

Unusual volatility in markets, such as during the recent global financial crisis, and sharp changes in governments' borrowing requirements, can make it more difficult to maintain debt management strategies. This may have consequences for the ongoing cost of debt servicing and future gross borrowing requirements. For example, if the amount of short-term debt in the portfolio increases, the amount of debt maturing in the short term, and requiring to be refinanced, will be higher, adding to the future issuance task.

Focus of the OECD survey

What are the changes that have been made in the management of interest rate risk?

The survey aimed to identify what changes debt managers have made in the management of the interest rate risk of their portfolios in response to changes in their financing tasks following the financial crisis. The survey asked debt managers that have had a benchmark duration target in the recent past:

(i) What was the target duration and how often was it reviewed?

(ii) Is the target set on the gross debt portfolio or a net debt portfolio (gross debt less cash and other assets)?

(iii) Has the funding task become more variable and/or more difficult to forecast in the last year?

(iv) If so, has the variability in the funding task impacted upon your capacity to achieve the duration target?

a. If the target has been achieved, has it been necessary to augment your existing approach with additional instruments or techniques? If the approach was changed, how did you decide upon the appropriate response?

b. If the target has not been achieved, what has been the response? (For example, have you modified the target or discontinued duration targeting altogether?)

The survey also asked, more generally (whether or not agencies have duration targets), what changes had occurred in the duration and maturity structure of their portfolios over the last two years?

Summary and conclusions

Seventeen responses to the survey were received and some other countries provided additional information at the annual meeting of the Working Party held on 20-21 October 2009. This summary includes information from both sources.

Half respondents use duration target

About one third of the respondents indicated that they currently have a duration target as a primary portfolio management tool. Two respondents target it indirectly and two use it as a secondary target. Half do not use it as a target.

	Is there a duration target?	
Yes	6	29%
No	11	52%
Secondary/Indirect Target	4	19%

Duration targets vary from two to seven years

Of those who had a duration target, about half measure it against a gross debt portfolio and half against some form of net debt portfolio. Targets and ranges for those countries targeting duration either as a primary measure or as a secondary measure, vary from two years to seven years.

Country	Benchmark Duration Target	Lower Bound	Upper Bound
Austria	5.85 years	5.1 years	6.6 years
Denmark	3.25 years	2.75 years	3.5 years
Finland	-	-	-
France*	7 years	-	-
Greece	4 years	3.5 years	4.5 years
Hungary	2 years	2 years	3 years
Poland	-	2.5 years	4 years
Slovakia*	4 years	-	-
Switzerland*	-	-	-

* Duration is only used as a secondary/indirect target

Countries that manage their portfolios using a benchmark duration target generally review the target at least annually, with some undertaking more frequent reviews following the increased variability in outcomes as a result of the crisis.

The funding task has become more variable and difficult

The majority of respondents considered that the funding task has become more variable and/or more difficult in the last year, with most noting a substantial increase in the amount of government debt issued over forecasts.

	For those with a duration target: Has the funding task become more variable and/or more difficult to forecast in the last year?		All respondants: Has the funding task become more variable and/or more difficult to forecast in the last year?	
Yes	7	70%	13	62%
No	2	20%	2	10%
No answer	1	10%	6	29%

Switzerland is an exception as it reduced its central government gross debt (from a peak of CHF 130 billion in 2005 to CHF 119 billion in 2009, which is expected to fall further) due to continuing budget surpluses and the sale of the government's stake in UBS. It reduced its bond issuance, allowing debt to mature whilst maintaining short-term borrowing. As a result, funding has become less difficult and less variable and previously announced issuance targets are being under-achieved. Its main challenge is deciding how far to let government debt outstanding decline without limiting the bond market's ability to function.

Increased variability in duration and other portfolio benchmark measures

Respondents generally reported increased variability in duration and other portfolio benchmark measures. However, of the ten respondents with some form of a duration target, only two did not achieve their targets and less than half reported that changes in the funding task had impacted upon their capacity to achieve their duration target. Of those that met the duration target, none had made changes to the target in the last year and none had introduced additional instruments or techniques in order to achieve targets.

Of the two countries that did not meet their duration targets, one has revoked the target and the other is reviewing its approach in the light of its experiences over the past year.

	For those with a duration target: Has the target been achieved?	
Yes	7	70%
No	2	20%
No answer	1	10%

	For those with a duration target: Has this variability in the funding task impacted on the capacity to achieve the duration target?	
Yes	4	40%
No	5	50%
No answer	1	10%

DMOs report falls in duration and maturity measures

Many respondents reported falls in duration and maturity measures for their debt portfolios. In some cases, this reflected increased government funding requirements and/or the fact that investor demand was focused towards the short end of the curve.

VII. How urgent is the need to review primary dealer arrangements?

Primary dealer arrangements differ

Primary dealer (PD) systems in the various OECD countries are quite different in terms of obligations/requirements, either in technical detail or even in broad terms. For example, market making (MM) rules in secondary markets are often part of the set of PD requirements, but not in all jurisdictions[16]. In addition, some OECD countries either do not possess PD systems or dealers are formally (or *de jure*) not recognised as such by the issuer. See Tables 2a, 2b and 2c for an overview of requirements imposed on (candidate) primary dealers in the OECD area.

PD arrangements have not been working as efficiently as before the crisis

Tough issuance conditions are the reasons why existing PD arrangements have not always been working as efficiently as before the crisis. This raises the question of whether requirements as summarised in Tables 2a, 2b and 2c need to be revised, temporarily or on a more permanent basis.

Changes in model of co-operation?

Another primary market issue is whether the broader business model of co-operation with PDs needs to be changed. The business models in the US and Japan are based on the philosophy that DMOs have a hands-off relationship with PDs. For example, the US Treasury, through its issuing agent (the Fed of New York), has a hands-off approach with all its primary dealers; it sees its task ending with the conditions of primary issuance and is therefore only concerned with on-the-run securities. In both the US and Japan, market-making responsibilities in secondary markets are not imposed on primary dealers (Table 2b). However, this hands-off relationship does not preclude a meaningful dialogue with the market. For example, in Japan, primary dealers are being consulted about important debt management policies such as the JGB issuance plan and buy-back programmes. In the case of Germany, banks are not formally designated as primary dealers. Instead, a selected international group of banks, called the Bund Issuance Auction Group,17 bid in auctions.

Table 2a. Primary market requirements for becoming a Primary Dealer

	To participate regularly in auctions	Minimum participation in every auction	Minimum average annual/quarterly participation in auctions	To bid in each auction	To ensure placement of debt	To avoid distortion to auction prices	To allocate sufficient resources to support issuer
Austria	X	X				X	X
Belgium	X				X	X	X
Canada	X	X		X		X	
Czech Republic			X			X	
Denmark							
Finland	X				X		X
France	X		X	X			X
Greece	X		X		X	X	
Hungary	X		X		X	X	X
Iceland	X	X		X	X	X	
Ireland	X					X	X
Italy			X			X	
Japan	X	X		X		X	
Netherlands	X					X	X
Norw ay	X			X			
Poland							
Portugal	X		X		X		
Slovak Republic						X	
Spain	X	X		X	X	X	
Turkey	X		X		X		
United Kingdom	X		X	X	X	X	X
United States	X			X			
Total	17	5	8	8	9	14	8

Note: In Korea, only primary dealers can participate in auctions although there are no formal requirements.

Source: Updated Survey of Italian Treasury.

Debate about market-making obligations

In contrast to a more general hands-off approach, several DMOs played a more activist role by giving PDs direct incentives or privileges in return for market-making (MM) obligations. This approach may reflect the challenges faced in fragmented and/or smaller markets. In some jurisdictions, however, the effectiveness of MM-obligations is under discussion. This debate is in part fuelled by the ongoing financial crisis and may lead (or has led) to changes in the current market infrastructure, including via the introduction or presence of multiple electronic trading platforms.

Table 2b. Secondary market requirements for becoming a Primary Dealer

	To be a market maker	To ensure adequate trading volumes and turnover	To quote a certain number of securities	To trade at tight bid/ask spreads
Austria	x	x		
Belgium	x	x		x
Canada	x		x	x
Czech Republic	x		x	
Denmark	x			
Finland	x			
France	x		x	
Greece	x	x	x	x
Hungary	x	x	x	
Iceland	x	x	x	
Ireland	x		x	x
Italy	x	x	x	
Japan				x
Korea	x	x		
Netherlands	x		x	
Norw ay	x			
Poland	x		x	
Portugal	x			
Slovak Republic				
Spain	x		x	
Turkey			x	x
United Kingdom	x	x	x	x
United States		x		x
Total	19	9	13	8

Source: Updated Survey of Italian Treasury.

Insolvent and fragile balance sheets of PDs may negatively affect their future operations

Primary and secondary market activities have been negatively affected by both insolvent and fragile balance sheets of primary dealers. Many DMOs expressed concerns about this development and its implications for future operations. In several countries, recent events are accelerating a longer-term trend of a reduction in the number of (active) primary dealers. For example, the number of primary dealers transacting in US Treasuries declined from its peak of 46 in 1988 to 21 in 2007 and to 17 active primary dealers as of September 2008. Consequently, this raises the following policy issues:[18]

Additional reasons to review PD obligations and privileges

- The risk of lower competition in the primary market, possibly weakening the price discovery process.
- The risk of dominance in the government securities market by

a few large banks.

- The risk of overall higher funding costs to finance government operations.

These issues may be additional reasons to review existing PD requirements (obligations) and privileges.

Table 2c. Organisational requirements for becoming a Primary Dealer

	Minimum net regulated capital	To be shareholder in secondary market trading company	Capacity to place securities to w ide range of investors	Sufficient human resources and expertise	Capacity to add value regarding specific products	Geographica l location	Guarantees for the settlement of bonds	Capacity to attract new investors	Ability to sell to a w ide variety of retail clients
Austria	X		X	X	X			X	
Belgium	X	X	X	X	X			X	
Canada	X			X		X	X		
Czech Republic						X			
Denmark	X		X	X					
Finland			X	X		X		X	
France				X		X			
Greece	X		X	X		X		X	X
Hungary	X		X	X					
Iceland	X			X			X		
Ireland			X	X	X	X		X	X
Italy	X		X	X	X				
Japan									
Korea	X			X					
Netherlands	X		X	X	X			X	X
Norw ay			X	X					X
Poland	X		X	X			X	X	
Portugal		X	X				X		
Slovak Republic	X						X		
Spain	X		X	X			X	X	
Turkey	X								
United Kingdom	X		X	X			X	X	X
United States	X								
Total	16	2	14	17	5	6	7	9	5

Source: Updated Survey of Italian Treasury.

VIII. Conclusions

Worsening issuance conditions and changes in issuing procedures

The worsening of issuance conditions manifests itself via greater risks (a) in primary markets in the form of less successful auctions and greater auction tails; and (b) in secondary markets in the form of liquidity pressures and price distortions. These (potential) problems are encouraging changes in issuance methods, including the use of distribution methods other than auctions such as syndication, Dutch Direct Auction (DDA) procedures and private placement. Especially during crisis periods, direct contacts with large (foreign) investors (including via road shows) are more important than before, in particular to explain changes in the overall situation and policy-framework. All forms of communication are of importance, including high-quality websites. In this context, primary dealers' principal job is to sell debt, while the principal task of DMOs is to explain how they (and the government more generally) operate.

Many DMOs are using more flexible auctions with issuance programmes becoming less predictable and more opportunistic. That may not be desirable in the long term. DMOs emphasise therefore that they will continue to operate a transparent debt management framework supported by a strong communication policy. Some debt managers are considering introducing (or have introduced) auction fees. Others argue that fees are not effective and/or not consistent with the principle of open auctions. Mini-tenders were introduced by the UK DMO alongside the scheduled auction calendar in order to mitigate liquidity problems.

Challenges and changes in debt portfolio risk management

For most DMOs, the funding task has become more variable and/or more difficult, with most noting a substantial increase in the amount of government debt issued over forecasts.

Debt managers generally reported increased variability in duration and other portfolio benchmark measures.

Many DMOs reported falls in duration and maturity measures for their debt portfolios. In some cases, this reflected increased government funding requirements and/or the fact that investor demand was focused towards the short end of the curve.

How urgent is the need to review primary dealer arrangements?

Tough issuance conditions are the reasons why existing PD arrangements have not always been working as efficiently as before the crisis. This raises the question of whether current requirements need to be revised, temporarily or on a more permanent basis, including whether the broader business model of co-operation between DMOs and PDs needs to be changed. An assessment also needs to be made of the viability of market-making (MM) obligations in relation to possible changes in the current market infrastructure such as electronic platforms.

Primary and secondary market activities have been negatively affected by both insolvent and fragile balance sheets of primary dealers. Many DMOs expressed concerns about this development and its implications for future operations. In several countries, recent events are accelerating a longer-term trend of a reduction in the number of (active) primary dealers.

NOTES

[1] This includes the notion that financial market participants (in particular primary dealers or selected groups of banks) can also function as (*informal)* partners of governments when it comes to government debt issuance.

[2] Supporting domestic capital markets is therefore an *indirect* debt management objective. It is an indirect one as it is a means to achieving the *direct* objective of minimising borrowing costs subject the preferred level of risk.

[3] It is widely recognised that issuers, investors, dealers and tax payers have benefited from transparent, efficient, robust and reliable issuance procedures for government debt; see Blommestein (2002).

[4] See chapters 1 and 4 in Blommestein (2002).

[5] Blommestein and Schich (2003).

[6] At a multiple-price auction, bonds are sold at the actual bid price of successful bidders.

[7] At a single-price (uniform-price or Dutch) auction, all bonds are sold at the same lowest accepted price.

[8] Blommestein and Gok (2009).

[9] This rapid and massive increase in government issuance can be expected to push prices of government debt down and yields up. However, the following financial crisis/recession-related factors are likely to mitigate or delay this supply impact on prices and yields: (a) the (projected) fall in output that is likely to keep expectations of future inflation in check; (b) high risk aversion (credit and liquidity) that is encouraging a flight to safe and liquid assets; (c) low official interest rates; (d) the impact on (longer-dated) government debt of quantitative easing policies pursued by some OECD central banks; (e) the high demand for government paper for use as high-quality collateral.

[10] US Treasury (2008).

[11] Blommestein and Gok (2009).

[12] The UK DMO circulated last year a consultation document about supplementary distribution channels (including mini-tenders) (UK Debt Management Office, 2008).

[13] Euro-zone countries include: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain.

[14] SIFMA/EPDA (2009).

[15] Survey by Neil Hyden, AOFM, Australia.

[16] Note that also MM rules may vary in terms of technical detail.

[17] Hence, the members of this group of banks are not formally designated as primary dealers. As of 1 October 2009, the number of internationally operating banks stood at 27.

[18] US Treasury (2008).

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