

## **BUILDING SUPPLY FOR GOVERNMENT DEBT SECURITIES**

### **- THE PORTUGUESE EXPERIENCE -**

#### **1. Introduction**

Let me start by thanking the World Bank (WB) for this initiative: the 1<sup>st</sup> Regional Bond Market Development Workshop. This event has been an opportunity to share views and experiences among debt managers from which all of us, I am sure, will learn a lot.

In my name and on behalf of the Portuguese debt agency, the IGCP, I would like to thank the organisation for having invited me to join this international group of experts, thus allowing me to also profit from these enriching discussions. I would also like to thank the WB – let me take a moment to address a special word to our host – for giving me the possibility to come to Brazil, a country where I feel at home although it is only my first visit here.

#### **2. Main topics of the presentation**

Having been invited to present the Portuguese experience on the debt management strategy and the key importance of developing simultaneously an efficient primary market, I hope you will allow me to quickly go back in time. I would like to briefly describe the gradual implementation of a market driven borrowing strategy in Portugal and our steps in establishing efficient primary and secondary markets.

[I am not going to address the importance of a very efficient secondary market, because it is out of the scope of this panel, but I will be ready to comment on this as well. The way a secondary market operates has a direct impact on the primary market, therefore also indirectly affecting the borrowing strategy of the sovereign issuer.]

The Portuguese debt management experience through the last two decades can be considered a successful case study in which some of you may mirror your own experience.

We came from high levels of public and national indebtedness in a context where financial markets were almost non-existent. The banks and the financial sector had been nationalised.

But, we were able to progressively introduce the required changes that led us to build up a modern public debt market within the new domestic barriers defined by the Euro zone boundaries. Although we now face the direct competition from the other Euro area sovereign issuers, the strong presence of important international intermediaries and the very large share of foreign investors in the Portuguese public debt market prove that we succeeded.

The introduction of gradual changes in the debt management strategy went in parallel with the successful stabilisation of the Portuguese political, economic and financial situation. From the beginning of the '80s when the funding strategy could only rely on borrowing through the issuance of non-tradable debt, we came to a situation where the borrowing strategy is investors driven. This has been particularly the situation since 1999.

### **3. Portuguese government debt management**

In the last 20 years, 4 periods can be identified.

**(i) From 1980 to 1985, the State financing was based on non-tradable debt instruments.**

Domestic financing depended also, to a large extent, on loans directly placed in the Central Bank.<sup>1</sup>

The change in the political regime that took place in Portugal in 1974 led to a significant intervention of the State in the economy in the following years. This political change of economic regime, together with the effect of the oil shocks in the second half of the '70s produced high inflation, and macroeconomic and public finance imbalances. Public deficits and

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<sup>1</sup> At the time, external financing was mainly involving loans granted by multilateral institutions, like the World Bank.

the stock of the debt increased significantly. The domestic financial market was restricted to banking intermediation conducted by a group of nationalised banks.

The first tradable instrument was created in 1985 - the Treasury Bills (BT) – at the time with a twofold objective: the financing of the State budget deficit and the conduction of the monetary policy.

At the end of 1985, tradable debt represented merely 29 per cent of the total debt.

**(ii) From 1986 to 1992, important structural reforms were implemented allowing the development of domestic debt instruments.**

After becoming part of the European Economic Community, in 1986, Portugal gradually started liberalising its capital markets up to 1992. In 1989 the privatisation programme, still in course today, was initiated. In 1990 the first macroeconomic stabilisation programme was launched aiming at the integration in the European Monetary Union.

The State financing was then progressively carried out relying increasingly on the use of tradable instruments. However, in a context of relatively high inflation, preference was given to floating-rate instruments. The first domestic fixed rate Treasury bonds - the Obrigações do Tesouro (OT) - were issued, but with maturities not exceeding three years.

In April 1992, Portugal joined the Exchange Rate Mechanism of the European Monetary System and the complete liberalisation of capital movements then occurred.

In 1992, the tradable debt had increased to 62.5 per cent of total debt, although domestic fixed-rate Treasury bonds (OT) accounted for less than 8 per cent.

**(iii) Between 1993 and 1996, the Portuguese Treasury bond yield curve starts to be defined.**

It was only in 1993 that the fixed-rate Treasury bonds (OT) with 5, 7 and 10-year maturities<sup>2</sup> were first issued in Portugal. Domestically<sup>3</sup>, debt management took on the objective of contributing to the development of the Portuguese capital market. The target being the creation of a Treasury yield curve.

At the end of 1996, tradable debt instruments already accounted for 72 per cent of total debt, with fixed-rate Treasury bonds representing 25 per cent.

In December 1996, the IGCP was created as an autonomous debt management agency. The creation of the IGCP was an important step in establishing the conditions for a smooth adaptation of the country to the scenario of the Euro. This decision was taken in view of the high degree of financial skills required for an efficient and accurate discharge of the activities of issuing and managing the public debt in a unified market. Republic of Portugal's name would be in competition with other sovereign, supranational and corporate issuers.

**(iv) In 1997 the preparation of debt management for the Euro was started.** The State's financing and Government debt management were oriented by the adaptation to the new environment to be created by the introduction of the single currency. To broaden and consolidate a base of investors in the Euro market and to increase the liquidity of Government debt became the main objectives of debt management.

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<sup>2</sup> The instability which affected European markets in 1994 and the volatility of domestic interest rates discouraged the use of fixed-rate instruments, raising instead the interest in floating-rate Treasury bonds (OTRV) which started to be issued with 5 and 7-year maturities. In 1995, the regular issuance of OT was resumed, with 3, 5 and 10-year maturities, complemented by the occasional issuance of OTRV.

<sup>3</sup> With the liberalisation of capital movements in 1992, Portugal re-entered the international capital market at the start of 1993, after several years' absence. External financing rapidly assumed innovative characteristics with successful placements. To grant greater flexibility in the access to international financial markets, the Republic negotiated an MTN Programme (Global Medium-Term Notes) and an ECP Programme (Euro Commercial Paper). A stand-by facility was also arranged to meet occasional treasury needs and to safeguard against adverse conditions in the access to markets.

The Primary Dealers' (PD) role as agents for the distribution and placement of debt in the primary market was reinforced as well as their participation as market makers in the secondary market. Strategically, the access of non-resident banks to the PD group was promoted.

At the end of 1998, tradable debt instruments accounted for approximately 77 per cent of the total Government debt while fixed-rate Treasury bonds represented about 53 per cent of the total.

#### **4. The borrowing strategy in the Euro**

In 1999, the debt management strategy would face a very different environment: instead of the Portuguese Escudo market, a larger domestic market with eleven sovereign issuers "competing" for the same currency, the Euro. By that time, an OT yield curve had been established. But, new challenges would have to be overtaken.

Debt strategy and market performance would be evaluated according to the best international standards. Market participants would require liquid and efficient debt markets. Electronic trading conditions would become very important competitive factors. Predictable and transparent borrowing programmes would be rewarded.

Liquidity became one of the most – if not the most – important factor behind the spreads displayed by the sovereign debt in the Euro zone. Size and tradability were going to have an impact on yield spreads. In 1999, when confronting spreads and credit ratings, the dimension of the issuer emerged as a key distinctive factor, penalising small debtors.

The Portuguese borrowing strategy would have to aim at increasing the liquidity of the Portuguese Treasury bond yield curve. However, although having foreseen that liquidity would be a very important factor in the Euro environment, this feature has, in fact, proven to be even more important than previously anticipated.

The Portuguese debt agency adjusted the borrowing programme mid 1999, thus acknowledging the great importance of liquidity. Consequently, the outstanding amount of each Treasury bond line was increased even further than previously announced. The 10-year benchmark was increased to EUR 5 billion, almost two times the average size of the Treasury bond lines issued in the years

before 1999. Nevertheless, this level was established by the Portuguese debt agency as the maximum amount per OT line to keep the refinancing risk under acceptable levels.

The EUR 5 billion had been the threshold level established for a security to be accepted for trading by the electronic pan-European platform EuroMTS, created in the first half of 1999. The Portuguese debt agency, recognising the importance of joining the group of the Euro sovereign liquid debt issuers, decided that it was worth “paying the price”.

From then on, the main option has been to implement a funding strategy aiming at building up a Portuguese Treasury bond yield curve able to respond to the liquidity parameters demanded to a small Euro sovereign.

Moreover, to support the liquidity of this market, all borrowing needs have been channelled through the domestic Euro debt market. The domestic Treasury bonds (OT) have been the only medium and long-term tradable debt issued. No foreign issues were launched since September 1999. Besides, since the start of 2001, a buyback programme is being implemented, through which old and less liquid securities are bought back and cancelled. To refinance these issues, liquid OT lines are reopened.

The option to issue “opportunistic” bonds in foreign and international markets – even if relatively less expensive – has been completely discontinued to give priority to the domestic Treasury bond market. In a short-term horizon, this option may prove to be less cost effective, but it is considered the less risky on a medium term horizon. Therefore, it is expected to pay off!

If the “opportunistic” option had been followed, there would have been no need to establish the electronic wholesale secondary market. Inefficiencies in the primary market would not have been perceived as that important and the placement would have relied mainly on foreign or international syndicated issues or private placements. The strategy followed was, nevertheless, the opposite one.

Debt market efficiency was going to be evaluated against the best practises in the Euro zone. Small borrowers would try to put themselves ahead of innovation to compensate their relative small size. Primary and secondary markets would have to operate efficiently to reduce the liquidity premium.

International players, accessing the Portuguese Treasury bond market, should be in an equal footing with Portuguese market participants, considering either primary or secondary market. Recent electronic developments were going to play a very important role in increasing markets efficiency and in offsetting any remaining (administrative) barrier.

Repos markets and settlement systems would be scrutinised, as well. Domestic settlement systems would be required to operate under international standards and any operational feature discriminating foreign against domestic market participants would be necessarily abolished. Portuguese PD decided to move from the domestic settlement system to Euroclear and Clearstream.

Against this background, the debt management strategy was going to be transparent and its implementation very much predictable. Portuguese debt managers decided to disclose at the start of the year the main lines of the borrowing programme, previously discussed and analysed with the group of PD.

Primary and secondary markets should also be very transparent. Their activities should be disclosed to the other market participants.

The recognition of the importance of electronic trading, which underwent major changes since 1999, has led Portugal to support the creation of a domestic electronic trading platform based on an MTS platform.

## **5. Building up an efficient primary market**

An efficient and transparent primary market with the regular participation and the commitment of a relatively stable group of financial intermediaries are pre-conditions to a liquid and efficient secondary market. The aim of increasing the efficiency of primary and secondary public debt markets will have an impact as a driving force on the debt borrowing strategy.

The Portuguese government debt managers have given a strong emphasis to the advantages of liquidity. Therefore, a policy of regular issuance according to a pre-announced calendar in a

limited number of maturities has been followed. Borrowing has focused on the issuance of Treasury Bonds - Obrigações do Tesouro (fixed-rate OT) in Euro in the most liquid maturities: 5 and 10 years. In the meantime, as a consequence, the Portuguese debt agency has been using the derivatives market to manage the duration of the debt portfolio.

The new Portuguese Treasury bond lines have been launched via syndication with relative large issue sizes and increased through auctions. The preference given to the placement through syndication<sup>4</sup> of the initial tranche of the new series of Treasury bonds is warranted by the belief that it is the most effective way to achieve simultaneously a significant initial size (more than 10 times the indicative amount of auctions held in 1998) at an efficient and controlled price. Simultaneously, it helps to achieve a wide and diversified investors distribution, particularly within the Euro zone, and increases the visibility of the Republic of Portugal's name and of its debt instruments.

Since 1999, the final size of each new OT line has been, on average, two times larger than those issued up to that date. The size of the auctions in 1999 were also three times larger than those held before; in 2000 the average size was five times larger than in 1998 and in 2001, six times.

But size was not perceived as the only component of liquidity. The primary market (as well as the secondary market) is required to operate very efficiently. Tradability is the other component of liquidity with an increasing role helped by the recent electronic innovations.

Meanwhile, the technical support to the auctions was radically changed. The fax system, previously used for bidding at the auctions, was replaced by an electronic system: the Bloomberg Auction System.

This system is in operation since the start of 2000. It allows the Primary Dealers and other auction participants to introduce and update bids until the cut-off time (strictly controlled) and have faster access to auction results thus incurring in fewer risks. The issuer, the Portuguese debt agency, having the possibility to observe in real time the reception of the bids, is able to reduce the time for a decision on the allotment of each auction. In 2000 the average time from

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<sup>4</sup> In these syndicates only the PD can act as underwriters. The position of each bank in the syndicate depends on their performance in Treasury bond market.

the cut-off time of bids to the release of the auction results to the participants was less than 5 minutes<sup>5</sup>.

Moreover, the strategy to enlarge and consolidate the investors' base in the Euro market would rely not only on an efficient distribution mechanism – the new auction system – but also on the establishment of efficient distribution channels. These channels were perceived as essential aiming at creating an international network for the effective distribution of the Portuguese debt.

The abolition of domestic currencies and of the resulting exchange rate risk would involve the elimination of an important barrier to capital movements and would lead to a strong and fast integration of financial markets within the economic area covered by the single currency. The government debt markets would be the most rapidly integrated.

Sovereign borrowers would have to pursue the establishment of a regular base of investors in particular, across the whole Euro area. The new context would naturally be competitive, since eleven sovereign issuers, used to a dominant role in their own domestic markets, would have to dispute the same domestic space. Furthermore, international globalisation of capital markets would tend to put competition also out of the Euro area barriers.

## **6. The strategic role of the Primary Dealers**

The primary dealership system was introduced in Portugal in 1993. But only in 1998 the role of the Primary Dealers gained a new strategic dimension.

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<sup>5</sup> Portuguese OT are increased through multi-price auctions, that include a competitive phase whose participation is open to all PD (and other auction participants) as well as a non-competitive phase. Before every quarter, the debt agency releases an indicative calendar of the auctions, although it may be periodically adjusted to borrowing requirements and to the corresponding financing strategy. A predefined monthly day tends to be used. Each institution can make up to five bids, whose total value may never exceed the amount announced for the competitive phase of the auction. Participating institutions are informed of the bids that were accepted and of the overall results of the auction immediately after (on average in 2/3 minutes after the cut-off time). The overall results of the auction are also immediately announced to all market participants at the IGCP pages in REUTERS (IGCP04) and Bloomberg (IGCP). The subscription at the non-competitive phase of the auction is made at the highest yield accepted in the competitive phase. The maximum amount each PD can subscribe in the non-competitive phase corresponds to the percentage of its participation in the competitive phase of the last three bond auctions, considering only the amount placed through the PD.

By then, new selection rules were defined to limit only to one institution the participation of each major domestic banking group, thus inducing the development of critical mass on the domestic operators. Also in 1998, the status was first granted to non-resident banks. Six foreign banks, internationally recognised, and representing the major markets deemed to be preferential targets, were thus added to the group of Primary Dealers. They were defined as the principal channel for distributing the Portuguese debt. A network for the regular distribution of debt within the Euro zone had been created.

With a credible and relatively stable group of Primary Dealers, with a recognised distribution capability, worldwide and within the Euro zone, committed to the development of the Portuguese debt market, the Portuguese debt agency established an ongoing partnership for the continuous distribution of the Portuguese debt - either through auctions or syndicates - and for creating a liquid and efficient wholesale secondary market.

The PD status is granted for periods coinciding with the calendar year and may be renewed annually, depending on the fulfilment of several duties. The PD have several duties and rights that are summarised below.

#### Duties of the PD

- Participate actively in bond auctions by bidding and by subscribing a share not lower than 2% of the amount placed at the competitive phase of the auctions;
- Participate actively on the secondary market for Portuguese government debt securities, ensuring the liquidity of these instruments;
- Participate in the wholesale electronic market (MEDIP - MTS Portugal)<sup>6</sup> as market maker, maintaining a share not lower than 2% of this market's turnover;
- Operate as privileged consultants to the issuer in the monitoring of financial markets;
- The compliance with the minimum quotas in the primary market and in MEDIP-MTS Portugal, mentioned above, should be observed considering a two-year period.

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<sup>6</sup> Where they are also required to be shareholders.

### Rights of the PD

- Participate in the competitive phase of the bond auctions and have exclusive access to the non-competitive phase;
- Preference in the formation of syndicates;
- Access to the facilities created by IGCP to support the market, namely the “last resort” repo window facility;
- Preferential counterparty in the active management of the public debt;
- Privilege hearing in matters of common interest.

### **7. Some conclusions may be drawn**

- The debt management strategy has to take into consideration a country’s political, economic and financial environment, particularly, the monetary and foreign exchange policy.
- A strategy aiming at developing an efficient public debt market can foster a country’s financial modernisation.
- A debt strategy has to incorporate investors’ preferences. A small borrower competing (now) in global markets needs to rely on a group of efficient financial intermediaries. The debt manager has to monitor permanently the participation of these important players in the primary and secondary markets, in order to be ready to adjust the borrowing strategy. A flexible approach has to be permanently “at hand”.
- Issuers have to be ready to adopt new and adequate technical development. For instance, in the issuance of bonds – electronic auctions, e-bonds; in how secondary markets operates – e.g. wholesale electronic platforms – and in debt management – front to back office portfolio management systems.