Key issues in reshaping the public debt management framework of the new EU members

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Key issues

• Foreign currency, domestic currency and the investor base
• Predictability and benchmark bonds
• Flexibility and derivatives instruments
• Visibility and investor relations
• Auctions and syndication
• Borrowing requirements and refinancing risk
• Short-term funding
Reduced foreign currency debt

• When entering the currency union, a country’s foreign currency debt (if such debt exists) will shrink. The portion of foreign currency debt that is denominated in euro will become domestic debt, and the related foreign currency risk will disappear.

• Even during the transition period before membership, given a fixed rate against the euro in the Exchange Rate Mechanism (ERM), the foreign currency risks of euro debt will diminish.

• During the ERM phase, there is flexibility through derivative instruments to rapidly change exposure between euro and other foreign currencies like US dollars and Japanese yen. It will be possible to adjust the foreign currency debt to the level desired when entering the currency union.
Reduced foreign currency debt (cont.)

- Investors gain a corresponding change in the foreign currency exposure of their asset portfolios. The currency risks of investments in euro-securities will disappear for domestic investors.

- There will no longer be any currency risk argument for choosing domestic government bonds instead of bonds issued by other euro area countries. This will influence the portfolio structure of domestic investors.

- Foreign investors with euro as their base currency will be able to buy government bonds issued by the new EU members without taking any currency risk.

- Currency union membership will lead to adjustments in the bond portfolios of domestic and foreign investors. To a greater extent, domestic investors will buy foreign bonds and vice versa.
Changes in the investor base

• The investor base has increased considerably since accession to the euro zone. In Finland the number of investors has increased from 25 before EMU to about 800 after. 90% of Belgian government bonds were owned by Belgian investors, this figure is now 50%.

• The foreign-owned share of outstanding bonds has risen, helped by an increase in the number of foreign primary dealers. The share of foreign bids in auctions has increased sharply.

• With foreign ownership increasing, there is a growing need to obtain a better picture of the investors. Better and more reliable statistics are needed. More syndication in the Belgian government’s bond offerings has resulted in more information about the investor base.

• The Dutch State Treasury Agency also aims for more knowledge about its investors. The share of domestic ownership has fallen since EMU accession from 70-80 per cent to now around 50 per cent.
Greater flexibility

- When the new EU members join the currency union, their Treasury bonds will not serve as reference loans for the pricing of fixed income securities. Instead, the French and German yield curve will be the main source of reference for government debt instruments issued by the new member countries.

- As a participant in the currency union, the new members will borrow in a much larger market, with a broader investor base.

- Today the new EU members Debt Offices have a responsibility for maintaining the domestic bond market, since they are the dominant market player. In the currency union, they will be an important but relatively small player. This means that their flexibility will increase.
Predictability vs. flexibility

• Good arguments for Debt Offices to base its borrowing strategy on predictability and transparency. This policy predominates among small sovereign borrowers in the euro zone.

• Borrowing focus on building large, liquid benchmark Treasury bonds. This creates good liquidity as well as a broad, stable investor base. Under such conditions, it is possible to borrow at lower costs than if borrowing took place completely flexibly.

• Alternative would be to give up the idea of large benchmark loans. Borrowing could be flexible, opportunistic with issuance based on market anomalies, niches and demand. Choice of currency and maturity would be determined by what is cheapest at the moment.

• Arguments in favour of such a policy is strongest for borrowers with very good creditworthiness and a limited borrowing requirement.
Predictability vs. flexibility (cont.)

- Most governments borrowing requirements are probably too large for this strategy to be realistic. This strategy might work well periodically, but during periods of less favourable market conditions, borrowing costs might be very high.

- There would not be a stable investor base that regularly and actively buys the governments debt instruments. During periods when governments are forced to issue large amounts, borrowing costs would probably be so high that over time the strategy would not be compatible with most governments’ objective of cost minimisation.

- This strategy would also result in higher borrowing and refinancing risks.
Other aspects of flexibility

- A predictable strategy does not mean mechanical borrowing according to a pre-set timetable. The point is that the borrower’s strategy should be clear and easy to understand. For example, when choosing maturities and issue volumes at individual auctions, smaller countries can apply a degree of flexibility.

- Elements of opportunistic borrowing may be appropriate and may fit into a strategy that is based mainly on predictable borrowing, using liquid benchmark loans.

- The room for flexible borrowing depends on what room the entire funding requirement provides. Most borrowing takes place in standard maturities such as 5 and 10 years.
Other aspects of flexibility (cont.)

- Good opportunities via derivatives such as interest rate swaps or interest rate futures to create exposure in terms of duration or allocation of maturities that is desirable from a risk standpoint.

- Possible to separate the issue of which maturities are the cheapest for borrowing and the exposure that a government wants to achieve with reference to costs and risks.

- The new EU members will be small market players in the currency union. Their issuance cannot influence the euro benchmark yield curve and their Debt Offices does not have privileged information about monetary policy.

- Good potential to be flexible when choosing duration and exposure to interest rate risk. Scope for more active management of duration, than what is possible in the present situation.
Increased efforts to gain visibility

• In order to create focus in a large market, after joining the currency union a number of debt offices in Europe have begun to devote more resources to making themselves visible.

• Belgium have increased their efforts on marketing. The Debt Agency has one employee responsible for meeting investors.

• In order to generate greater market interest, auctions are concentrated on fewer dates, with larger issue volumes. The small countries each hold five to ten auctions per year.

• Syndication is quite common when new loans are introduced in order to gain market attention, quickly generate large volumes and thereby create liquidity in the loan. The small countries (except the Netherlands) have used syndication in their borrowing since joining the currency union.
Auctions

- Auction is still the most common technique for selling government bonds in EMU. Most small countries are devoted to auctioning large volumes of government bonds on a small number of occasions.

- One advantage of concentrating auctions on few dates is that this leads to greater focus. Large volumes also reduce the risk that one investor buys the whole auction, which may create lock-in effects.

- In Belgium, about 60 per cent of bond issuance is done by auction. Government bonds are auctioned four or five times per year with a five-year and a ten-year maturity at each auction.

- The Netherlands has a tap system for issuing bonds. The Treasury Agency posts prices in the MTS electronic trading system. Dealers then submit bids until the auctioned volume is sold. A total of ten such electronic tap auctions are held per year.
Syndication

- Syndication has expanded as a form of borrowing in small countries since the advent of the European currency union.

- The arguments for syndication is that it generates greater attention in the market. It is an effective way to reach a broad investor base and makes use of the expertise and broad networks of the banks. Large volumes can be sold in a short time. A new loan quickly achieves good liquidity and is spread among many investors globally. A broad investor base creates the prerequisites for a low liquidity premium and thereby ensures low long-term borrowing costs.

- About 40 per cent of Belgium's bond volume is issued via syndication, mainly in the form of introducing new loans. In Finland, a full 90 per cent of sovereign debt volume is issued through syndication. Portugal issues about 40 per cent of its targeted volume directly through syndication when a loan is introduced.
Syndication (cont.)

• Syndication has become common among small countries in the currency union but this form of technique is not without problems. Commissions to banks that lead syndications have been reduced in recent years but they still represent large amounts of money.

• This need not be more expensive for the issuer if the loan is successful. Many government bonds that have been issued by syndication have carried an “all-in” cost, that is, costs including commissions, very close to the interest rates quoted in the market.

• The liquidity and the low premium created by syndication can be utilised at subsequent auctions. In the end, perhaps the costs will to a large extent be borne by the investors.
Combining auctions and syndication

• Choosing banks to lead a syndication are often based on a systematic assessment of market shares in primary and secondary markets. Countries with this type of selection process have had problems with overbidding at auctions.

• Capturing market share at auctions boosts the chance of being included in future syndications. The banks count on getting back what they overbid at auctions from later syndications. The problem is that only those that are part of the syndicate get their money back. This may, in turn, lead to a reduction in the number of dealers, which implies problems for the market in the long term.
The Netherlands have introduced a new model for the issuance of government securities. This model, the “Dutch Direct Auction”, is reminiscent of syndication, with the difference being that no lead-managing banks are appointed and that the Treasury Agency itself administers the order book. All dealers may submit bids on behalf of their customers on equal terms.

The main reason for launching a new form of auction is to improve the Netherlands’ capacity of reaching a broad investor base. This has become increasingly important in the currency union, since the share of foreign ownership and the number of borrowers has increased.
Strategies to ensure efficient borrowing

• As central government debt has decreased in the small countries, their borrowing requirement has decreased. To create large, liquid loans, it is necessary to have a large funding requirement. Otherwise there is no room to issue sufficiently large volumes to provide liquid benchmark loans every year.

• To ensure a suitable borrowing requirement, different strategies can be pursued. Most countries aim for a maturity profile that will ensure sufficiently large redemptions each year. The loans are allocated in a way that distributes redemptions as evenly as possible each year.

• All countries have buy-back programmes and exchange programmes for bonds with twelve months or less remaining until maturity. Buy-backs and exchanges aim at smoothing cash flows by spreading out the repayment of bonds. They can also be used in order to boost the liquidity of benchmark loans by creating a funding requirement.
Short-term funding

- The share of short-term funding in overall government debt fell in the countries studied when they joined EMU. The main reason was that they were forced to concentrate their borrowing on bonds in order to create large liquid loans.

- Lately, interest in short-term funding have increased again. Interest rates on short-term government securities are closely linked to the ECB’s policy rate. Short-term T-bills issued by euro zone countries are closer substitutes than bonds with different issuers. Compared to the bond market, there is a stronger tendency for the Treasury bill market to remain mainly domestic.
Short-term funding (cont.)

• There is not the same argument for less frequent T-bill auctions as there is in the bond market. Since Treasury bills are mainly used for government cash management, there is reason to hold more frequent auctions.

• Liquidity management will be simplified in various ways when the new EU members join the euro zone. The market will become substantially deeper, and their Debt Offices’ can work with more counterparts than today. Not least, they can use other national debt offices as counterparts. This means that credit exposure to individual institutions during periods of cash surpluses will decrease.
Conclusion

The European currency union has led to intensified competition among sovereign borrowers. This applies in particular to small countries and will greatly affect any new EU member in case of membership in the currency union. A number of interesting conclusions can be drawn from the experiences of small countries:

- Their overall strategy is to borrow cheaply by creating large liquid benchmark loans.
- It has become increasingly important for borrowers to generate attention in a large market. This has led to increased marketing resources, larger auctions and greater focus on syndication.
- Small countries concentrate their borrowing in a few markets and in a few debt instruments.
- Countries with small borrowing requirements need strategies for generating sufficiently large yearly debt issuance volumes.