STRENGTHENING LIABILITY MANAGEMENT IN LOCAL CURRENCY SOVEREIGN BOND MARKETS

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PLAN

1. Specificity of Liability Management (LM) vs. Public Debt Management (PDM)

2. Rationale of liability management operations (LMO) in local currency bond market (LCBM)

3, Historical evolution

4. Strengthening LM in markets at their initial stage of development

I. SPECIFICITY OF LIABILITY MANAGEMENT (LM) vs. PUBLIC DEBT MANAGEMENT (PDM)

PDM : its **function** is to provide financing to the government. This implies incurring new liabiliies . Its **objective** is to minimize cost and/ or risks

LM : its **objective** is also to minimize cost and/ or risks but Its **function** is to restructure oustanding borrowings to improve the composition of the existing debt portfolio. Therefore, LM provides no additional funding .

A a result, the scope of the risks covered is narrover in LM than in PDM

Eg. LM is normally not involved in the management of legal risks, operational risks ,credit risk, contingency risks, etc. unless the hedge can also restructure an already outstanding debt.

II. RATIONALE OF LIABILITY MANAGEMENT OPERATIONS (LMO) IN LOCAL CURRENCY BOND MARKET (LCBM)

The main rationale of LM is to support market development. It does so by

. decreasing refinancing risk

. deinforcing the creation of benchmarks

. increasing price transparency

The instruments used most often in the LCBM are bond buy back (BB) and bond exchanges (BX) . Derivatives are less used than in the international markets

As the LCBM market develops

. the focus of LMO increasingly shifts to **enhancing markt miquidity**

. the volume and scope of LM widens (with the exception of markets that are intrinsically liquid (eg. US, Germany; Switzer land)

III. HISTORICAL EVOLUTION

LMOs in LCBM have evolved in three stages as their objective widens

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Step 1 : to decrease the refinaning risk (RR) created by large maturities

a. Buy Back of short maturities Advantages

lower RR (prefunding)

lower interest rate risk (smoothened maturity profile)

creation of a borrowing need which accelerates the issuance of new benchmarks

b. **Bond exchanges** : a bond with a short remaing life to maturity is retired from the market with the issuance of a longer maturity bond.

decreased market risk (the two transactions are simultaneous)

further increases price transparency

facilitates lengthening of the average life of the debt portfolio

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HISTORICAL EVOLUTION

Step 2: Increase the liquidity of the debt portfolio

Exchange of two bonds both with long maturiities

Initially switches to retire an illliquid bond
Thereafter also

. switches between illiquid bonds to facilitate market making (Canada)
. systematic exchange offer of previous benchark against new (Turkey)
. offer market makers a selling opportunity to lighten unwanted positions (Denmark**)**

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HISTORICAL EVOLUTION

Step 3 (not necessarily after step 1&2): **Other &&objectives**

Eg.:

. to correct market distortions (Italy arbitrages)

. to support the good functioning of the market (Brazil simultaneous buy/sell auctions)

. to restore issuer's access to the market (Ireland in 1992)

. to create a borrowing need to be able to keep issuing (Denmark in mid nineties)

IV. STRENGTHENING LM IN DEVELOPING MARKETS

In view of the multiple and significatic advantages of LM, one may wonder why LM is not used earlier in some developing markets

The reason is that LM operations confront developing markets with three challenges, particularly at their initial stage of development

. Selecting the **instrumen**t which is most appropriate to them

. Selecting the **procedur**e for using the selected instrument

. Convincing investors and issuer that they have a common vested **interest** in cooperating to put the selected procedure in place

DEVELOPING MARKETS
CONFRONTED CHALLENGES

1, Selecting the instrument

. Standing liquidity cushion

. Ad hoc liquidity cushion (cash management)

. Committed line of credit

. Bond buy back (BB)

. Bond exchange (BX)

Each instrument has some advantages and drawbacks.

BB and BX are the most efficient ones due to their ancillary benefits (contribution to market development)

DEVELOPING MARKETS
CONFRONTED CHALLENGES

2, Selecting the procedure

BB : Reverse auction
OTC : BB window , reverse enquiry or bilateral trading

BX : Tender at a fixed exchange ratio
Auction price: uniform or multiple
bids : DMO sets price of source bond or of destination bond
type : open or closed
Combination of auction and tender (Colombia)
Two separate auctions (Finland)

Both : regular or ad hoc program ? Timing of the announcement, etc.

DEVELOPING MARKETS
CONFRONTED CHALLENGES

3, Implementing the selected procedure

Challenges:

. both issuer and investors are concerned by what they perceive to be a cost

. Most Investors are buy and hold and they are little sensitive to the fact that the mirror image of the issuer's refinancing risk is their re-investment risk.

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ROLE OF MULTILATERAL ORGANIZATIONS

Experience shows that exchanges of experiences between debt managers confronting similar issues are often an efficient way to get the right reforms implemented. thing done.

Therefore , multilateral organisations provide a useful contribution when they support peer learning which is critical in this case

ROLE OF MULTILATERAL ORGANIZATIONS

.In this case, the objective of peer learning is to help in :

. assessing the procedure best adapted to the market concerned

It is not necessarily the simplest one (ref. reverse auctions)

. addressing three major issues which have to be resolved first

price discovery (uncertain reference rate)

minimizing the issuer's funding risk

minimizing the investors' reinvestment risk

This applies particularly to markets at an early stage of development.

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THANK YOU FOR YOUR ATTENTION