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ADVISORY SERVICES

Developing local currency bond markets
in emerging economies

A WORLD BANK INITIATIVE

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Bond Buy Backs and Switches

Baudouin Richard

Gemloc Peer Group Dialogue

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THE WORLD BANK

Outline

- Objectives for bond switches and buy backs
- Procedures
- Switch vs. buy back
- Auction vs. OTC
- Regularity - Frequency
- Announcement of parameters
- Reference for price setting
- Taxes

Objectives

Main

1. Cash flow management

- Refinancing risk
  - Bonds close to maturity: spread repayment
  - Longer maturity bonds: smoothen debt redemption profile
- Utilization of excess cash (e.g., India)

2. Increasing liquidity and price efficiency of secondary market

- Build benchmarks
  - Larger (refinancing risk can be managed)
  - Faster (retiring illiquid bonds = issuance)
- Yield curve
  - clean (retire illiquid bonds)
  - keep updated when no issuance needs (e.g., Denmark, Malaysia, South Africa)

Objectives (cont.)

Other

- **Adjust composition of debt portfolio**
  - e.g., decrease floating, increase inflation linked bonds (Brazil)
    lengthen average life of debt (Turkey)
- **Market arbitrage:**
  - Retire bonds trading cheap → budget saving (Poland)
- **Market support**
  - Help market makers unload long positions (EMU in 09/10)
- **Price transparency**
  - Enhance or restore (Brazil buy & sell auctions in May 06)

Consensus

- **DMO should not compete with the secondary market**
  - Function of degree of development of the market (e.g., PDs or no PDs)
- **Operations which work best are those initiated upon market request**

Many Variations

Bond exchanges

- Fixed ratio
- Auctions

Bond Buy Back

- Two auctions (reverse and standard)
- One auction (reverse)
- Buy back window
- Bilateral OTC

Bond Exchanges

Fixed exchange ratio

- Attractive to investors: no winner's curse
- Attractive to traders: free call option
- Drawback to issuer: market risk

Exchange auction

- More advantageous to issuer: 1) No market risk; 2) Competition
- Multiple variations:
  - multiple price / single price
  - open / close
  - set price of source or of destination stock

Bond Buy Backs

Two auctions

- Reverse + standard (Finland) → “almost like an exchange”

One auction

- Marketing event
- Size

Buyback window

- Fixed price for a certain period

Bilateral OTC

- Flexible + possible link with cash management

Exchange vs. Buy Back

Rationale

Exchange

- No refinancing risk
- Useful when supply of securities is small (e.g., Colombia)
- Works best with bonds of similar duration

Buy Back

- Refinancing risk BUT:
  - Larger amounts (more investors are potentially interested)
  - More flexible & easier to manage
  - Cash management tool

Auction vs. OTC

Rationale

	Advantages	Drawbacks
Auction	• Size • Competition • Transparency	• Need for administrative preparation • Image risk if fails
OTC	• Flexibility • Administratively lighter	• Need for DMO to quote a price

Questions:

- Should the DMO inform PDs when it contemplates to start quoting prices in the OTC market ?
- Should the DMO appoint an agent (for auction or OTC) ?

Regularity - Frequency

- **General information announced** either ad hoc or in annual / quarterly / monthly calendars. Ad hoc includes on market request.

- **Detailed information** about specific terms and maturities announced anywhere from 30 days to 1 day in advance of the auction

- **Drawback of too frequent operations**
  - Not possible to make them a market event any longer
  - Market gets tired
  - Less incentive for market to quote aggressively (next chance follows)

Announcement of Parameters

Market consensus: Important to Announce

- **Objectives pursued**
  - e.g., smoothen borrowing requirements, increase liquidity and/or price efficiency of secondary market
- **Retiring bonds from the market when their remaining life to maturity is below "x" months**

Minimum amount?

- Risk of impacting the price offered by investors
- DMO image risk if actual amount is smaller

Maximum price?

- Potential incentive for the market to bid that price
- Alternative → reference to average secondary market prices before the announcement of the operation

Reference for Price Setting

Possibilities

- Observed market price
- Refinancing cost
- Internal analytics

Tax on Capital Gains

In Europe

- Used to be an issue during the 90s
- Possible legal provisions to ensure tax neutrality (i.e, re-investment)
  - have been debated in some countries (e.g., Belgium)
  - do not seem to have been actually implemented
- No longer an issue today
  - Most transactions currently apply to bonds with a short remaining life to maturity (management of refinancing risk)
  - Some bondholders manage their tax planning by simultaneously taking capital losses to offset the gains

In Peer Group Countries

- **Is this an issue?** (e.g., Morocco)

THANK YOU!

Website: www.gemloc.org
Email: gemlocta@worldbank.org