Public Debt Managers’ Insights on Trends and Policies to promote Secondary Markets in Large Markets

April 2017
Thoughts on Liquidity.

Liquidity has declined since the financial crisis. Fixed income markets have been hit harder.

Global liquidity has been plentiful thanks to years of monetary easing by central banks, but market liquidity, has gone in the opposite direction and it could get worse, at least temporarily if financial conditions continue tighten.

- The main reason for falling liquidity? Traditional liquidity providers have become more risk averse. New rules on capital requirements, proprietary trading and risk assessment are hastening this lack of liquidity.

- Moreover, Market liquidity is concentrated in the most liquid securities and deteriorating in the less liquid ones. This environment reflects cyclical\(^1\) as well as structural changes\(^2\) affecting financial markets conditions.

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\(^1\) Changes in risk appetite

\(^2\) Tighter risk management or Regulatory constraints
The effects observed in other markets have not been fully observed in the Mexican markets.

**Federal Government Local Debt Issuance**
(billion pesos, 30-day moving average)

**Fixed-Rate Bond Traded Volume in Secondary Market**

Source: MoF; Banxico & Bloomberg.
Regulatory changes have limited the intermediaries’ market making abilities and willingness to build up large inventories.

**Banks Holdings in Fixed-Rate Bonds**

(% of total outstanding)

**Average Ticket in Secondary Market**

(million pesos)

Source: MoF & Banxico.
In contrast, liquidity measured by turnover ratio and bid/ask spread have shown steadiness.
Markets in Mexico: Snapshot on Liquidity

- **Diminished liquidity** across financial markets is a **structural phenomenon** that affects all market participants (i.e. issuers, investors and intermediaries).

- Thus, **liquidity and efficiency enhancement** in local debt markets is a **shared responsibility** between each of these participants.
Quick conclusions from the diagnostic carried out by the MoF

1. Primary Dealers, not only in Mexico, have lost participation in the market.

2. The possibility of trading securities in large amounts has declined drastically.

3. These facts are more evident in the case of other fixed income securities; quasi-governmental and corporate.

4. Organic demand growth could cause securities to end up in steady hands, difficulting their rotation.
Mexico’s Policy Response.

Mexican Authorities are committed to promote opened, liquid & efficient markets.

- Mexico’s Policy response has been oriented towards promoting efficient markets.

- Public Debt Strategy has contributed to foster liquidity in Securities’ issued by the Mexican Government.

✓ There is no single policy action (no silver bullet) to build up liquid markets.
Policy Response: An appropriate policy mix has contributed to foster liquidity in Mexican markets

1. **Clear Public Debt Strategy**
   - The Public Debt Strategy seeks
     1. Liquid yield curves
     2. Benchmark Size Bonds created by reopening policy

2. **Market Friendly Toolkit**
   - **Policy**
     - Market Maker Program
   - **Tools**
     - Exchange transactions
     - Buybacks

3. **Strong Communication**
   - Predictability and Reliability
     1. Quarterly Auction Calendar
     2. Annual Borrowing plan
Clear Public Debt Policy

The main objectives of the Public Debt Policy are:

1. Meeting financing needs at reduced costs, on a long-term horizon and with low levels of risk.

2. Maintain access to a wide range of debt markets.

3. Build up yield curves with high liquidity and an efficient price discovery process across its securities.

4. Creating benchmark size bonds by making use of the reopening policy.
The market maker program has been in place for the last 17 years. One of its main objectives is to foster liquidity in government securities.

During this time, the market maker program has undergone several modifications in order to adapt to market conditions and align incentives between authorities and primary dealers in the best way possible.

<table>
<thead>
<tr>
<th>Rights</th>
<th>Obligations</th>
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<tbody>
<tr>
<td>1. <strong>Greenshoe</strong>: Additional <strong>purchase</strong> of securities by exercising an option for a percentage of the amount auctioned (25%) <strong>at the same levels</strong> of the previous day primary auction results.</td>
<td>1. <strong>Bidding</strong> on the auctions of either treasury bills, fixed rate or inflation-linked bonds <strong>for a minimum amount</strong>.</td>
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<td>2. <strong>SLF</strong>: Market makers have access to a securities lending facility through the Central Bank.</td>
<td>2. <strong>Present quotes</strong> for each type of securities they are market makers of, across all maturities <strong>for a minimum amount</strong> of 20 million pesos.</td>
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<td>3. <strong>Exclusive</strong> participation in the <strong>syndicated auctions</strong> of the Federal Government securities along with a fee.</td>
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2 Toolkit – Liability Management Transactions

- Since 2016, various liability management strategies have been executed to increase the efficiency and improve the debt profile of the portfolio.

<table>
<thead>
<tr>
<th>External Debt</th>
<th>2016</th>
<th>1Q</th>
<th>2Q</th>
<th>3Q</th>
<th>4Q</th>
<th>2017</th>
<th>1Q</th>
<th>Going Forward</th>
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<tbody>
<tr>
<td><strong>August 2016</strong></td>
<td>• 2.78 bn USD debt neutral transaction to refinanced 70% of 2017 market obligations.</td>
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<td><strong>October 2016</strong></td>
<td>• 1.9 bn EUR debt neutral transaction to cover 100% of 2017 external obligations.</td>
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<td><strong>March 2017</strong></td>
<td>• 3.15 bn USD debt neutral transaction to provide liquidity, refinance 30% of 2019 external obligations and improve maturity profile.</td>
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<td>Mainly debt neutral LM transactions to increase efficiency and improve the debt amortization profile.</td>
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<td><strong>Local Market</strong></td>
<td>May 2016</td>
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<td>• Use of Banxico’s surplus to repurchase of 97.95 bn pesos involving fixed-rate bonds and Udlbonos maturing from 2016 to 2018.</td>
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<td><strong>October 2016</strong></td>
<td>• Two exchange transactions that allowed to refinance 90.1 bn pesos of securities maturing between 2016 and 2018.</td>
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<td><strong>6 exchange transactions YTD</strong></td>
<td>1. Refinace 32.5 bn pesos of obligations maturing between 2017 and 2019.</td>
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<td>2. Foster liquidity in new benchmark issues (11 bn pesos).</td>
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<td>3. Improve price discovery process across the yield curve (20 bn pesos).</td>
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<td>Continue executing exchange and repurchase transactions to improve the debt profile and contribute to develop a healthy local debt market.</td>
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3 Strong Communication

- An important part to foster liquidity is to increase the predictability and reliability of the Federal Government as a constant issuer in debt markets.

- A strategic part of the communication strategy is to publish the following documents:

  - **Annual Borrowing Plan**
    
    In this document the Federal Government discloses the public debt policy for the ongoing year and the set of strategies to fulfill such policy

  - **Government Securities Auction Calendar**
    
    The MoF discloses every quarter the details regarding the issuance of Federal Government securities in the sovereign debt market. In this document issues, amounts & frequency are publish.
Pro-Liquidity Agenda

- In addition to the Mexico’s policy mix to foster liquidity in debt markets, the MoF is actively working with major participants (Primary Dealers, Pension funds and other Issuers) across markets in order to enhance liquidity across them.

- The MoF created **working groups** in order to develop a pro-liquidity agenda. This agenda has been created in order to:

1. Identify possible **improvements** in the **market infrastructure**
2. Promote **efficiency and transparency in the price discovery process**
3. **Foster liquidity & better practices** in debt markets