

GEMLOC: Peer Group Dialogue Meeting

Minute 3

Date:	February 28, 2011
Place:	Conference call led by the WB/Gemloc Team in DC Supported by GoToMeeting conference tool
Time:	8 a.m.-9.30 a.m. (EST time)
Attendees:	<ul style="list-style-type: none"> • Costa Rica: Mauricio Arroyo, Bernando Gonzalez, Kattia Monge, Melissa Solano (National Treasury) • Kenya: Daniel Ndolo (Central Bank), Stella Osoro (Ministry of Finance) • Morocco: El Hassan Eddez (Ministry of Economy and Finance) • Pakistan: Muhammad Ali Malik (State Bank of Pakistan) • Peru: Elizabeth Toledo (Ministry of Finance) • Romania: Angela Carabas, Angela Banu, Alexandra Tudoran, Anca Pirvu (Ministry of Public Finance) • Sri Lanka: CPS Bandara, EH Mohotty, MSMP Fernando, LRC Pathberiya, PLA Sudeshika (Central Bank) • Uruguay: Victoria Buscio (Ministry of Economy and Finance) • WB/Gemloc Team: Anderson Silva, Baudouin Richard, Catiana García, Thordur Jonasson, Tamuna Loladze, Indhu Raghavan, Irene Casanova Canals, Catherine Hickey, Zsofia Arvai
Discussion topic	<ul style="list-style-type: none"> • Buy Backs and Switches: Key Functions and Practices in Liability Management
Objectives:	<ul style="list-style-type: none"> • Presentation by Baudouin Richard, World Bank consultant and former Director of Treasury and Capital Markets in the Belgian Public Debt Management Agency, on key elements and practices in buy backs and switches.
Issues discussed:	<p>1. Background</p> <ul style="list-style-type: none"> • Objectives of buy backs and switches (BB&S) <ul style="list-style-type: none"> ✓ The main objectives of BB&S operations are: (i) reducing the refinancing risk; (ii) enhancing liquidity and price transparency (benchmark building and cleaning/updating the yield curve); and (iii) utilizing excess cash (for buy backs) ✓ Others include: adjusting the composition of debt portfolio, supporting the market (e.g., helping market makers unload long position), and enhancing or restoring price transparency. ✓ During the weak environment, such as a crisis, BB&S is also used to stabilize prices. For example, in Hungary, during the 2008 financial crisis, when the government bond trading faced a complete standstill, the DMO managed to revive investor confidence by buying back

securities with up to 3-year remaining maturity. In Brazil, the DMO held simultaneous auctions (reverse and standard) to improve price discovery and stabilize the market during the crisis. In general, the recent World Bank study [*Public Debt Management in Emerging Market Economies: Has This Time Been Different?*](#) found that BB&S operations were one of the key crisis response instruments of DMOs during the crisis.

- Advantages and disadvantages of a buy back vs. an exchange
 - ✓ An exchange has no refinancing risk and is best suited for bonds with similar duration and for markets with a small supply of securities.
 - ✓ Buy backs can be used for larger amounts, since they potentially generate interest among greater number of investors, can be easier to manage, and can be used as a cash management tool. Their biggest disadvantage is the refinancing risk.
 - ✓ Typically, buy backs tend to be more cost-effective than switches because they can amass a larger pool of investors, since it is easier to find investors who want to just sell bonds as opposed to investors who want to both sell bonds and simultaneously buy new issues. However, this may not be the case in markets with a large concentration of investors that tend to buy and hold bonds to maturity. In these markets, often investment opportunities are few and investors are concerned with the risk of not being able to suitably reinvest the proceeds they receive in a buy back. As such, the DMOs may be able to find greater number of investors for a switch transaction as opposed to a buy back and, hence, a switch may turn out to be more cost-effective.
- Timing of BB&S relative to remaining maturity
 - ✓ The standard practice regarding when to start retiring bonds is 12 months before the maturity date, which is the point at which the bond becomes a money market instrument.
 - ✓ It is important for the DMO to let the market know that, as a general rule, the DMO may start retiring bonds when there are X months left to maturity.

2. Key areas of concern for the country participants

- Tax on capital gains
 - ✓ After the conference call, the Gemloc team has further investigated the potential impact of the capital gains tax on BB&S transactions. The team has concluded that the rate of the capital gains tax needs to be below the rate of the tax levied on the bond coupon in order for the capital gains tax to not create a financial disadvantage. Slide 13 in the presentation has been adjusted accordingly.
- Buy-and-hold behavior of investors
 - ✓ A question was raised on how to entice institutional investors, who have large holdings of government bonds, to sell in a BB&S operation when they have a preference to buy and hold the bonds to

	<p>maturity.</p> <ul style="list-style-type: none"> ✓ In general, since the nature of the investor behavior varies from country to country, it is necessary to conduct a thorough diagnostic of existing investor practices before initiating BB&S operations. ✓ In countries where reinvestment risk is a major investor concern, the DMO would have a better chance of inducing investor participation with a switch operation rather than a buy back (as mentioned above), given that a switch would guarantee reinvestment into new issues. <ul style="list-style-type: none"> • Managing image risk <ul style="list-style-type: none"> ✓ The DMO can take certain measures to minimize and manage its image risk. For example, in general, it is not advisable for the DMO to announce the minimum amount it plans to buy back because if its effort falls short of this amount, the market may question DMO's skills and competence. ✓ If a BB&S transaction does not reach a reasonable amount, this can be viewed in a positive light, as it indicates that investors value existing debt instruments and prefer to continue holding them. The DMO could adjust its message to the market to convey this sentiment. • Concerns about legal issues <ul style="list-style-type: none"> ✓ A question was raised about potential legal risk of BB&S activities related to issues such as DMOs' discretionary power to select prices or honor bids of certain institutions as opposed to others. ✓ Similar to regular debt management activities (e.g., traditional auctions in the issuance program), the authorization and procedures to conduct BB&S activities need to be well contemplated in the legal framework for debt management. While in most cases there should be provisions in the Public Debt Law, the exact legal instrument will vary from country to country.
Documents discussed:	<ul style="list-style-type: none"> • Presentation on "Bond Buy Backs and Switches" by Baudouin Richard.
Next steps:	<ul style="list-style-type: none"> • Solicit other topics for discussion in future Peer Group meetings.