Sovereign Debt Management Forum 2014

Summary Note for Plenary Session 3

How have debt managers increased the attractiveness of local currency debt?

I. Summary of session

The session was organized in a Panel Discussion format, followed by Q&A.

After brief introductions, Mr. Silva summarized the incredible shift in the composition of EM sovereign debt towards a predominance of local currency debt that occurred especially in the first decade of the 2000's. The shift was backed by improvements in macroeconomic fundamentals, a benign global environment for EM local currency debt and proactive debt management strategies. The share of EM sovereign local currency debt reached approximately 90% of total EM sovereign debt, remaining reasonably stable in the last several years. Against this backdrop, Mr. Silva explained that the objective of the session was not limited to discuss how debt managers conducted such a strong shift of debt portfolios, but also, and more importantly, on how to: (i) keep the progress that has been achieved; (ii) how to deepen and increase liquidity of local markets; and (iii) how to deal with moments of volatility that we know will come.

- **The Brazilian Experience:** Mr. Otavio Medeiros showed the substantial transformation in Brazil's debt portfolio. Following a significant shift to domestic debt in the beginning of the century, the share of external debt over total debt continued to drop from 11.4% in Jan/07 to less than 5% in Oct/14. In the same period, foreign investors increased their participation in domestic local currency debt from 1.4% to 19.4%, representing approximately USD 167 billion (BRL 418 billion), one of the largest volumes among EMs. Strong macro-fundamentals were a major driver in the transformation, but several debt management policies were also relevant: (i) greater transparency (e.g. creation of an Investor Relations Office; regular publications; auction calendar); (ii) improvements in issuance policy – organizing monthly maturities according to type of instruments (e.g. fixed-rate instruments mature in the first month of each quarter) and concentrating issuance in benchmark instruments to stimulate liquidity. Mr. Medeiros also highlighted Brazil's policies: to mitigate refinancing risk - by keeping a cash buffer equivalent to a minimum of 3 months of redemptions; and to contain market volatility in periods of severe market distress - by adopting liability management operations (e.g. simultaneous buy-sell auctions of long-term securities)

- **The Romanian Experience**: Mr. Stefan Nanu provided a historical perspective, highlighting key milestones in the development of domestic debt markets in Romania. Prior to 2008 debt levels were low, mostly financed via multilateral debt. The first formal Government Debt Management Strategy was published in 2008, having as an explicit objective the development of the government securities market. On the supply side, a benchmark policy was introduced, incentives and obligations of Primary Dealers are being gradually improved (e.g. bidding obligations, use of non-competitive subscriptions to best performing PDs, quoting obligations); and an electronic trading system is being launched. On the demand side the implementation of the private pension system (pillars II and III) helped develop the institutional investor base, mitigating the still large predominance of banks as investors; and Romania's inclusion in global local currency indices in 2013 was a game changer allowing fast growth of foreign investor participation to reach 26% by May 2013. Mr. Nanu also highlighted the relevance of keeping a cash buffer to deal with moments of volatility caused by external events not directly related to Romania's sovereign credit.

- **Investor's views**: Ms. Simon described how investors in EM local currency debt are basically divided in two groups (EM dedicated investors and cross-over investors) and that within the EM dedicated investors there is a small group of very large fund managers, with assets under management above USD 10 billion, and some small players. Key messages from that are that holdings are increasingly concentrated in the hands of a few dedicated investors and that size of a market matters if these investors need to do portfolio reallocations. Also, a large share of the portfolio can be either in local or hard currency, which leads to a trend of more tactical allocations by fund managers. Ms. Simon highlighted the relevance of policies that enhance transparency (e.g. auction calendars), promote benchmark issues, facilitate access (e.g. easy setting of a custodian account, being able to trade FX with third parties) and a tax regime that does not inhibit access of long-term, dedicated, investors. The investor was supportive of debt management measures to control volatility in moments of market distress, but raised a word of caution that these measures do not work when the government tries to manipulate the market avoiding it from finding a new equilibrium price and causing distortions. According to the investor, depending on the nature of the shock is preferable to see the market work freely.

- **Q&A**: Questions from the audience involved, among others: details on the longest maturity of instruments issued in Brazil (10 years and 40 years for fixed and inflation linked bonds, respectively); clarification on how Brazil was able to decompose the nationality of foreign investors in one chart (data came from the local SEC and custodians); and on what has been the perceived impact for market development from the Brazilian Central Bank's policy of issuing only repos (instead of their own securities). On the latter Mr. Medeiros explained the relevance of CB repos in anchoring the short-term of the curve, using government securities as collateral. Two questions also generated some interesting inputs: (i) What happens if foreign investor participation crowds-out domestic investors?; and (ii) Whether investors consider the availability of hedging tools a big factor in the decision to invest in a local market?. On the first question Mr. Nanu stated that debt managers need to be attentive to the specific needs of domestic investors (sometimes even issuing

instruments that are high on demand by local investors). He stressed, however, the difficulty to distinguish across allocations by type of investors as it depends on a competitive process in primary markets. Mr. Medeiros complemented that in Brazil, higher participation of foreign investors led to a positive crowding-in of domestic investors to corporate bonds. On the second question Ms. Simon mentioned that derivatives helps in terms of liquidity and investors value their capacity to tactically hedge and manage their duration exposure without buying-selling the underlying bonds.

The moderator finished the session by mentioning the recent growth of frontier markets and asked Ms. Simon for her views on what are the minimum conditions that an investor looks at to start considering to invest in a particular market? Ms. Simon said that besides high yield and good fundamentals, important elements are accessibility (open local account, trade the currency and a DMO as transparent as possible). She cautioned however that the situation for smaller markets are more difficult as capital inflows can be disruptive.

II. Key insights from presentations and discussion

Common themes and lessons learned from the discussion included:

- The relevance of good macro fundamentals to attract and maintain a sustainable path of development of local markets
- The relevance of debt management practices linked to enhanced transparency, regularity and predictability of auction calendars, the use of a benchmark building policy to stimulate liquidity of domestic instruments, easy access of non-resident investors to set local accounts and trade FX, and the use of preemptive policies to manage refinancing risk, especially the use of cash buffers. Brazil's experience of buy-sell auctions during moments of volatility and Romania's reforms to improve performance of primary dealers, including quoting obligation in an electronic trading platforms, were also key themes that received wide attention from the audience.

III. Conclusion and issues for further discussion

EMs have been successful in implementing a remarkable transformation in their sovereign debt portfolios. In a different front, the international fund management industry has become much more concentrated than in the past, with a few large fund managers dominating the investment space and flows to local currency markets. These trends raise at least two issues for further discussion:

(1) The relevance of a direct investor relations strategy targeted at this concentrated group of investors; and
(2) The design of preemptive policies to deal with the increased exposure to a more concentrated base of investors. Portfolio reallocation decisions by these large investors may involve large volumes with potential consequences to market liquidity and volatility in specific segments of the yield curve.

Both aspects above call for continued policies that favors transparency and contingent actions to deal with moments of market distress. Further work and discussion is warranted on best practices for the use of cash buffers and in adopting liability management operations to contain market volatility.