

Centre for Central Banking Studies
Bank of England

**Primary Dealers in
Government Securities Markets**

Robin McConnachie

Handbooks in Central Banking
no.6

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Foreword

This series of *Handbooks in Central Banking* has grown out of the activities of the Bank of England's Centre for Central Banking Studies in arranging and delivering training courses, seminars, workshops and technical assistance for central banks and central bankers of countries across the globe.

Drawing upon that experience, the *Handbooks* are therefore targeted primarily at central bankers, or people in related agencies or ministries. The aim is to present particular topics which concern them in a concise, balanced and accessible manner, and in a practical context. This should, we hope, enable someone taking up new responsibilities within a central bank, whether at senior or junior level, and whether transferring from other duties within the bank or arriving fresh from outside, quickly to assimilate the key aspects of a subject, although the depth of treatment may vary from one *Handbook* to another. While acknowledging that a sound analytical framework must be the basis for any thorough discussion of central banking policies or operations, we have generally tried to avoid too theoretical an approach. Moreover, the *Handbooks* are not intended as a channel for new research.

We have aimed to make each *Handbook* reasonably self-contained, but recommendations for further reading may be included, for the benefit of those with a particular specialist interest. The views expressed in the *Handbooks* are those of the authors and not necessarily those of the Bank of England.

We hope that our central banking colleagues around the world will find these *Handbooks* useful. If others with an interest in central banking enjoy them too, we shall be doubly pleased.

Needless to say, we would welcome any comments on this *Handbook* or on the series more generally.

Lionel Price
Director of Central Banking Studies

Tony Latter
*Director for Technical Assistance
and Series Editor*

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Abstract

This introductory *Handbook* first describes the main functions of what are commonly called primary dealers in the government securities markets. It sets out the advantages of primary dealer systems to the authorities running these markets (usually the Ministry of Finance and the Central Bank) and explains what the authorities may have to concede to secure the benefits. It analyses which of these considerations may be most relevant in deciding whether or how to develop a system of primary dealers. The analysis would be applicable to any economy, although these questions may currently be most pressing in some of the countries in transition towards a market economy.

The *Handbook* does not specifically deal with the role of financial intermediaries in money markets, as opposed to securities markets, although, particularly in a developing market economy, there may be a fair degree of overlap between these two markets, so that some of the argumentation here could apply equally to the role of specialist financial intermediaries in money markets.

* * *

I am grateful to my colleagues in the Bank of England for comments on successive drafts of this *Handbook*. I owe a particular debt to Hans Blommestein (OECD), Éva Ladányi-Kiss (National Bank of Hungary) and Pedro Martinez Mendez for helpful comments on one particular draft and for general advice and encouragement. The views expressed in this *Handbook* should not be taken necessarily to be those of the Bank of England but the errors which remain are certainly my own. I, and colleagues at the Centre for Central Banking Studies, would be happy to respond to any enquiries arising from the *Handbook*.

PRIMARY DEALERS IN GOVERNMENT SECURITIES MARKETS

1 General

The basic objective of a government debt manager is to cover the government's borrowing needs as cheaply as possible. To accomplish this objective, both primary and secondary markets need to be broad and efficient and the secondary market, if at all possible, deep and liquid. There are several ways of trying to achieve this but many OECD countries appoint a group of highly qualified financial firms to play a role as specialist intermediaries in the government securities markets between the authorities on the one hand and the market on the other. These are generally called primary dealers - as for example in the United States - but they are sometimes referred to simply as market-makers. In the government securities market in the United Kingdom they are known as gilt-edged market-makers (or GEMMS - the term "gilt-edged" is used to describe government securities), while in France they are called specialists in Treasury securities (SVTs). In this *Handbook* the terms "primary dealer" and "market-maker" are used largely without distinction.

In return for a set of obligations, such as making continuous bid and offer prices in marketable government securities or submitting reasonable bids in the auctions, these firms receive a set of privileges in the market. The nature and content of these obligations and privileges varies greatly from country to country. In some cases there are firms which play the role of primary dealers without formal official recognition but nevertheless with a degree of official encouragement.

Of course, setting up a primary dealer system should not be undertaken in isolation from the authorities establishing a market-oriented monetary policy, developing a well-functioning money market and following a reasonably steady and predictable issuing policy, without which no-one is likely to embark on dealing in government securities or to make a regular profit out of it. And for some countries in transition at least, it should be recognised that the normal development of a primary dealer system will be out of existing banks according to the "universal

bank” model; primary dealers should not necessarily be thought of as stand-alone securities firms on the “anglo-saxon” model.

2 International practice

Primary dealers have existed for some time, for example in Canada, France, Italy, Spain, the United Kingdom and the United States of America. These countries all use official recognition as an incentive: it is granted under specific conditions and the “licence” thus created is reviewed from time to time. Ireland has recently introduced this system as appropriate to the stage of development of its market.

By contrast, in Australia, Germany, Japan, Netherlands and New Zealand there are no formally designated primary dealers, although in these countries a group of firms do collaborate in the allocation and proper development of the market in an informal way. In Germany and Japan the governments raise part of their financing needs through syndicates, although nowadays the greater part tends to be raised by systems offering more open access; the liquidity of both markets has been partly ensured by the strength of the respective currencies.

A primary dealer system can be particularly helpful in the transition from a directed to a fully market-based system for the sale, transfer and redemption of government securities. India would appear to present such an example.

3 Advantages and disadvantages of a primary dealer system

This section considers the advantages and disadvantages of a primary dealer system from the viewpoint of the authorities. (The term “the authorities” is used in this *Handbook* to refer collectively to official bodies such as the Ministry of Finance, Central Bank and supervisory agencies; the precise meaning in any context is usually clear.) They will have three main objectives.

(a) An objective in the primary market of securing *maximum participation in the auctions* of government securities which are held from time to time, so assuring the Ministry of Finance of a strong voluntary take-up of government securities at auction and/or highest possible prices.

(b) An objective in the secondary market of *improving liquidity* through a system of market-making, which should also improve the functioning of the primary market and so ultimately the terms on which the government is able to finance its deficit.

Liquidity is facilitated if there are active market-makers who will undertake to make, on demand and in any trading conditions, continuous and effective two-way prices. This market-making is the core purpose of a system of primary dealers. If the system is effective, it should allow the debt manager - eg the central bank (which in the early days of market development may itself have been the sole market-maker) - to retire progressively from that role. Market-making is not generally regarded as the function of a central bank in a developed market, in particular because of possible conflict with its key monetary policy objectives as expressed in its operations in the money market (a topic which is dealt with in more detail in *Handbook* no 10). In any case the central bank should not undermine the position and potential profitability of the primary dealers. Moreover, the central bank would not normally wish to expose itself to the risks of market-making. Another drawback of the central bank itself being a dominant market-maker is that, if it consequently tends to set the market price itself, it may become isolated from the signals which the market would otherwise convey about the true market-clearing price.

(c) A more general objective of bringing about *greater competition*. In particular, if foreign firms are allowed to operate as primary dealers, they may have the effect of both bringing more capital into the market and, through greater competition, bringing down commissions or narrowing bid/offer spreads, so cheapening the costs of dealing in the secondary market and thereby stimulating, indirectly, the primary market. The question whether to allow foreign firms access to the domestic market for government securities, either with some restrictions or with none (including the question of the extent to which they may be obliged to establish a true local presence), is discussed in more detail later.

There are, however, some arguments on the other side which the authorities need to weigh before going ahead with the introduction of a primary dealer system . The main risk is that the new arrangements actually turn out to be anti-competitive. Primary dealers hope to make money by being given an oligopoly as intermediaries between the authorities and the market; and there is a danger of collusion, particularly if only a few firms wish to be and are accepted as primary dealers. A cartel could -

- (a) force the price at auction down *against* the authorities by forming a bidding ring, with the intention to resell later at higher prices;
- (b) take too high a cut on their intermediation, so depressing demand from end-investors.

The threat of anti-competitive behaviour can pose a serious problem. And it is not always easy for the authorities to detect such practices and take effective countervailing measures, though much can be gained from closely analysing and publishing auction results and diligently monitoring the behaviour of individual firms. Nevertheless, many countries have found that the advantages of a primary dealer system do outweigh the disadvantages.

4 Selection criteria for primary dealers

Most countries operate similar criteria which applicants have to satisfy before being allowed to function as primary dealers.

(a) Sound financial capacity

This is usually expressed as a requirement for net capital or own funds; there will often be a minimum entry level and a higher amount set to reflect the firm's actual or prospective share of the market and/or the authorities' assessment of the risks implied in its business plan. Additional requirements in some countries are:

(i) the capital employed has to be dedicated to the government securities market and stated to be not available to support any other business, though this may not be necessary if other criteria are tightly set;

(ii) a separately capitalised subsidiary is often required, whether for legal or prudential reasons;

(iii) in some countries, the authorities require a guarantee or letter of comfort from any parent company - eg, from a bank owning a securities subsidiary - to the effect that they would support the activities of the primary dealer if, for example, its capital was insufficient to support its trading or failure seemed imminent.

(b) Adequate management capacity

Most countries insist on a strong management team, competent trading personnel and an efficient back-office operation. Some countries will require evidence of the personal and professional capabilities of, in particular, the directors and chief dealer of the firm before approving an application for a primary dealership.

(c) Market activity

Most countries insist on an active presence in the market but the detail varies widely. For example, the French require SVTs to maintain a minimum market share and monitor this closely, whereas in the UK the requirement is for a permanent presence in the market which is assessed qualitatively as much as quantitatively. The French also operate a formal intermediate stage under which firms wishing to enter the market have to demonstrate their overall capacity to be primary dealers and provide evidence of current market activity, even if their market share does not yet approach the stipulated minimum.

(d) Relations with authorities

Finally, sufficient information must be supplied to the authorities. This requirement also varies from country to country. In the UK it is expressed partly as the primary dealer agreeing to accept the supervision of the central bank, in particular the obligation to report activities *daily*, with additional special reports as required. These *supervisory* arrangements are discussed in more detail below. The provision of *operational* information, such as prices and dealing volume (which may have to be submitted to a different body), is equally important, especially for reasons of transparency, and is of interest to all market participants, not just the issuing authority.

There should be a close relationship, going beyond the mere provision of information, between the primary dealers and the authorities, in particular the authority responsible for supervising market behaviour and, where relevant, market share. One problem is that there may be a multiplicity of separate bodies responsible for different parts of the task: for instance, a securities commission may be responsible for prudential supervision and perhaps also for the conduct of the primary dealer in the market, while the central bank may be responsible for invigilating market share. Naturally, possible conflicts of interest may arise. If, for example, a firm says it loses money in auctions but makes profits in the secondary market, the prudential supervisors may say that it should abstain from auctions while the central bank, as issuer's agent, may insist that it stay in. Where such split supervisory arrangements exist - and this may be inevitable - the relationship should be mutually supportive, not adversarial, and conflicts will have to be resolved one way or another.

5 Obligations

Official recognition as a primary dealer entails in almost every country the observance by the firms involved of a set of commitments related both to the primary and secondary market. The main ones are as follows:

(a) Supporting the auctions

Primary dealers are usually required by the government debt manager to submit bids at auctions in order to ensure the placement of government securities. Some countries set a minimum amount of securities that primary dealers must purchase at auction during a period of time (usually a year), normally related to the size of the firm or its share of the secondary market. In other countries there is a generalised but unquantified commitment that those market-makers who stand in a dealing relationship with the central bank will take a full share of new issues, whether by tender or by auction, by bidding for an appropriate amount of stock and/or not submitting bids outside a realistic price range with the deliberate intention of being unsuccessful. Obviously, the extent to which this obligation is enforced by the central bank or debt management agency may vary from country to country and within a country over time.

(b) Market-making

The primary dealers are obliged to guarantee liquidity in the government securities market. The nature of these requirements varies from generalised and unspecified commitments to ensure liquidity by continuous presence in the market, to very precise ones defined in terms of maximum spreads for two-way prices on specific volumes and/or types of securities. The United Kingdom perhaps lies in the middle of the range in requiring GEMMs to make, on demand and in any trading conditions, continuous and effective two-way prices at which they stand committed to deal. However, it is left to the judgement of the authorities how big a gap to permit between bid and offer prices, after allowing for different sizes of deal, in assessing whether the market-makers are fulfilling their obligations. Some countries require primary dealers to deal at the prices they display; in others the displayed prices are indicative only and what matters is the actual bid/offer spread on prices. It should also be noted that, currently, the United Kingdom requires market-making across the whole range of government securities, including index-linked securities, whereas in some other countries, such as the USA and France, the obligation is to make a market in leading stocks only - a less onerous requirement. There is a case for allowing market-makers to specialise in particular sectors of the market, perhaps reflecting their client base: for

example, if they are not strong in index-linked securities, they could be allowed to opt out of market-making in those.

(c) Retail market

Some countries require evidence of commitment in the retail market, particularly for individual investors. Although retail investors may be better served by non-tradeable forms of debt (eg “national savings” instruments targeted at households, or collective investment products such as unit trusts), in some countries the authorities may desire that a significant share of the primary dealer’s business derives from this sector of the market, or require more specific obligations relating to the maintenance of a network of local offices for the convenience of the retail investor. The authorities may also impose limitations on the extent to which spreads for retail business may diverge from the dealer’s quotations in the wholesale market. Note, however, that it would be entirely reasonable for spreads on retail business to be wider than in the wholesale market because of the relatively high cost of retail market-making and distribution. (It may be noted, however, that there is not necessarily a simple relation between size and cost: for deals above a certain size in the wholesale market, spreads may widen to take account of the increased risk in acquiring a large position).

6 Privileges

In return for the obligations referred to in the previous section, primary dealers may enjoy a wide range of privileges - in the primary market, in the secondary market, or in their relationship with the central bank.

In addition to these explicit privileges, and no less important, primary dealers enjoy indirect advantages such as the prestige of their special status in the government securities market or direct access to information about the extent and context of the government’s borrowing needs.

(a) Primary market

The most important advantage in the primary market is a degree of exclusive access. This may take different forms:

- (i) exclusive rights to bid at auctions;
- (ii) exclusive rights to bid, but only at “second round” sales, which are often on a non-competitive basis; in some countries this possibility only becomes available if the whole issue is not allotted at the initial auction, while in others an amount of stock is set aside for it;
- (iii) exclusive rights to bid for certain issues, such as the “tap” issues in the United Kingdom.

There may also be more detailed (though nonetheless important) subsidiary privileges offered to the primary dealers -

- (iv) exemption from the usual requirement to submit payment at the time of bidding at auction;
- (v) exclusive access (whether for dealing only, or for both dealing and viewing) to the screens of inter-dealer brokers (IDBs), where these exist; this can help the primary dealer to assess the price at which to bid;
- (vi) the right to submit bids by telephone; in a well developed market, the consequent ability to adjust the price of bids up to the last second before the auction may confer an important commercial advantage.

Most auction regulations allow anyone to participate in the auction: financial institutions, corporate treasurers and even individuals can bid directly. Furthermore, anyone uncertain of the price at which to bid can make a “non-competitive” bid, though the right to make such bids is often restricted in various ways, particularly as to size. However, taking the UK as an example, the commercial advantage conferred on the primary dealers by the right to make telephone bids and by being excused from the

requirement to pre-pay, means that direct bids from ultimate investors - even from major financial institutions such as pension funds - are rare; the auctions are dominated by the primary dealers. They are sufficient in number to offer a good and competitive service to their customers (wholesale and retail), who do not therefore see much advantage in bidding at the auctions themselves. Major investing institutions are anyway in close contact with primary dealers up to the last minute before an auction.

Primary dealers in some countries may receive overt price advantages, or commission, in return for effectively underwriting an issue. However, in developed markets this practice has tended to disappear, since the authorities are reasonably confident that auctions will be adequately covered without conceding special terms to the primary dealers.

(b) Secondary market

The advantages here tend to be considered less important than those related to the primary market. They are as follows:

- (i) Access, which may be exclusive, to the trading system of inter-dealer brokers. Thus in the UK only GEMMs have access to the screens of the inter-dealer brokers. They may use this facility to take on or unwind their positions without disclosing them to each other.
- (ii) A wider range of permitted operations than other traders - in particular the ability to borrow stock and to take short positions, in order to help them discharge their market-making function. But in countries with generalised repo markets this relative advantage does not really exist.

(c) Relationship with central bank

The recognition by the central bank of a primary dealer as a main or even an exclusive dealing counterpart can be of considerable advantage to that firm, particularly if it is allowed to operate also in the money market, where the central bank is likely to be active in pursuit of monetary policy objectives. In some countries primary dealers have specific short-term

borrowing facilities at the central bank, either by direct credit or by discounting paper, sometimes by way of direct access to a discount window.

Generally, it is desirable that there should be a facility, although not necessarily an exclusive one, for the primary dealer to borrow stock and/or money. Thus, primary dealers might be given -

- (i) the facility to borrow money short-term from the central bank on a secured basis if normal market financing is not readily available, subject to maximum amounts related to the borrower's capital; this facility may enable the market-maker to carry a long position overnight or even for a period of a week or two;
- (ii) the facility to obtain stock on repo from the central bank (or the finance ministry), on occasions when its market-making obligation may have left the primary dealer short of stock.

It may also be necessary for the Ministry of Finance to concede certain tax exemptions to the primary dealers, if the tax regime would otherwise inhibit their market making operations. Naturally, this depends on the type of tax system in operation in each country.

More generally, as part of their close relationship with the central bank, primary dealers may obtain more timely and accurate information than other participants in the market. They may also expect to be consulted from time to time, both on structural questions relating to the market, such as regulatory procedures or rules of conduct, and on more operational aspects such as the market's likely appetite for issues of particular types of security or for particular maturities.

Finally, primary dealers may be able to draw on occasional support from the debt manager in their various day-to-day activities. This is a subject about which those concerned are naturally reticent, but there is no doubt that in many countries primary dealers are helped from time to time, for example by the central bank making available from its own portfolio securities which the primary dealer might require (for example to hedge a particular transaction) at a price not too far away from the market price.

The central bank may judge that this is desirable in order to assist market liquidity.

Overall, in most developed markets a close relationship between the primary dealers and the central bank works to their mutual benefit. At the same time it is important to ensure that such cooperation does not unfairly disadvantage any other participants or investors.

7 Assessment

In attempting to apply these primary dealer arrangements to new or emerging markets a number of considerations are particularly relevant. First, as regards *obligations* -

(a) It is important that the *secondary market should develop*. Thus the authorities should not be too zealous in requiring narrow spreads and large transaction size; in volatile markets a firm can lose money very easily, and may need to protect itself by widening the spread and reducing the size of deals. The authorities need to understand this.

(b) The obligation to *support the auctions* may turn out to be a heavy one if the market is thin. Often the auctions will be undersubscribed, and there may be pressure on the central bank to take up the balance. In these circumstances the authorities should refrain from cutting the price too soon. And, even if the auction is a success, the authorities should resist the temptation to offer an additional supply of similar stock, especially at a lower price, in the period immediately following the auction. In either of these instances those who did subscribe at the auction would face potential losses as a result of falling prices. If the authorities wish primary dealers explicitly to underwrite the auction, the dealers could reasonably expect to be paid a fee for that task.

(c) If part of the commitment of the primary dealers is to develop or support a *retail market*, the central bank should not undercut them by itself offering aggressively competitive secondary market facilities - for example through its branches..

On the *privileges* side, exclusive or preferential *access to auctions* may be of little attraction in an infant and developing market. Thus, in order to reinforce the incentives for the primary dealer actually to support the auctions, it may be necessary to exclude certain categories - eg financial institutions; corporates; wealthy individual investors; foreign residents - from direct bidding, at least during the early stages.

These end-investors, if excluded from bidding, will be obliged to obtain stock from the primary dealers; if the primary dealers have judged the market correctly, they will be able to earn a mark-up in the process. Individual investors can be allowed to make non-competitive bids at the auction, if this is deemed desirable by the authorities for reasons of public policy. (An alternative is to require primary dealers to make special arrangements for small retail investors.) What the authorities should not do is to set up a system of primary dealers and simultaneously allow unrestricted access to the auctions on the same terms to the primary dealers' likely clients, particularly wholesale ones such as financial institutions and corporates. Putting it another way, the primary dealers must be allowed to make enough money to support their market-making activities and earn a reasonable return on the capital investment which is required for authorisation.

As to the other privileges, the most important is probably the facility to *borrow stock and/or money*, normally from the central bank (but not to such an extent as might disrupt the market). It is certainly desirable that market-makers should have the facility to borrow money when they need to in order to discharge their market-making function. Where central banks have been accustomed to deal only with banks, they need to consider whether they would be willing in this particular case also to have an exposure to securities firms. This may involve central banks in some difficult decisions, and they would be entitled to impose (varying) limits on their counterparties; but if they allow both banks and securities firms to participate in the same market, logically they should not discriminate between one sector of the government securities market and another by a willingness to lend to banks but not to securities firms.

The importance of the less tangible benefits mentioned above should not be underestimated. Even in developed markets the authorities need the primary dealers just as much as the dealers are dependent upon the

authorities. If the system functions properly, the process of price discovery will be improved and the auctions should become, hopefully, less volatile. It should not be forgotten that the government's desire for a low cost of borrowing overall will not be served unless the network of primary dealers is wide enough and the firms themselves are sufficiently profitable to be able to carry out their essential function.

8 Supervision

The supervision of primary dealers is a subject in itself, meriting fuller treatment than is possible in this introductory *Handbook*. Each country must work out its own supervisory arrangements. However, a few general principles may be noted.

(a) Scope of business

The authorities will want first to identify who may be at risk from the failure of a primary dealer, and how far the different types of counterparty may require official protection. They will then need to decide exactly which types of related business, in addition to market-making in government securities, primary dealers should be allowed to undertake. For example, in the UK the ability of GEMMs to maintain "short" positions in government securities provides them with a tactical strength in the sterling debt market more generally, since it enables them, for example, to hedge a long position in corporate debt. The authorities need to balance encouragement to primary dealers to develop new instruments and new trading strategies, which may benefit financial development more generally, against the risk that their core business of market-making in government securities might be contaminated through adverse business experience in other sectors of the market.

(b) Supervisory authority

The authorities need to decide at the outset and explain very clearly who is the supervisor for the primary dealers. The main candidates are a separate Securities Commission or a department of the Central Bank. If the central bank is to undertake this role, while it also carries out money market operations using government securities or is the fiscal agent of the Ministry of Finance for issuing government securities, then the supervisory responsibility needs to be placed in a separate department with clear and rather restrictive rules about the exchange of information between it and the department responsible for market operations. Primary dealers must be confident that information which they provide for supervisory purposes will not be used to their operational disadvantage. If, on the other hand, responsibility for supervision is handed to, say, the Securities Commission, then the staff actually carrying out the supervision need to have both a deep knowledge of the market and some understanding of the policy objectives of the authorities in establishing a network of primary dealers in the first place. Policing of the market-making obligation requires particularly sensitive handling either by the central bank directly or in close co-operation with it.

(c) Supervisory regime

This needs to take account of the following policy requirements:

(i) *Measurement of capital base* for prudential purposes, plus whatever rules are thought desirable to insulate market-making entities so far as possible from potential adverse developments in other parts of any group to which the firm belongs.

(ii) *Measurement of both position risk and credit risk.* The first is usually done by breaking down the market-maker's book into separate categories, each of which attracts a different risk weighting intended to reflect the relative price volatility of the category. There is also a developing theoretical framework for assessing credit risk and setting counterparty limits, based on internationally agreed standards. In practice, credit risks demand regular monitoring, in particular by requiring details to be reported of uncompleted transactions and how they are to be settled, and of all unsettled

transactions with any individual counterparty which exceed a certain percentage of the market-maker's capital base.

In both cases the authorities need to be conscious of the cost implications for the primary dealers of whatever requirements they impose. And, of course, the importance of proper risk management by the primary dealer firms themselves cannot be underestimated.

(d) Reporting frequency

The precise contents of daily, weekly, monthly, quarterly or annual reports and the method of their transmission - paper, diskette or electronic mail, for instance - need to be settled and strictly enforced by the supervisory body.

e) Practical considerations

Some of the practical issues which arise are:

(i) In many regimes both *banks and securities firms* are allowed to undertake business in government securities, but these may be supervised by different bodies. Whatever the precise structure of institutional responsibility for supervision, the risk weightings and other regulatory calculations should broadly be the same for equivalent business, whether the business is undertaken in the name of a bank or in the name of a securities house.

(ii) The firm must keep the assets of its clients *segregated* from its own, in practice even if not required in law. It must not be allowed to use its clients' securities to support its own business, directly or indirectly.

(iii) It is sometimes asked whether the aim of supervision is *to prevent failure*. Good supervision that is competently and promptly exercised will in many cases prevent a firm from undertaking business which is dangerous or excessive, whether in terms of overall scale in relation to its capital or by virtue of the size of exposures to individual counterparties. However, in some circumstances it may be inevitable that a firm fails; in which case it should be allowed to

do so, provided that any winding-down of its business is orderly and is conducted in close co-operation with the supervisor and in such a way as to minimise damage to other market participants or to the reputation of the government in the market.

(iv) Lastly, *training*. It is essential that supervisors, to whichever institution they are attached, should properly understand the market and be adequately trained. To this end, technical discussions with supervisors in other countries may be helpful, as too may be exchanges or secondments of staff between the market institutions and the supervisory agency.

9 Foreign firms

Most developed countries have rules about the nationality of their primary dealers and the question has to be considered for developing markets also.

In favour of allowing foreign firms into the market there are the following arguments:

- (a) If the capital markets in general, and the government securities market in particular, are short of capital, the admission of foreign firms would be an obvious way of adding to it.
- (b) Since foreign firms may already have had experience of functioning as primary dealers, they will bring expertise and know-how to the market.
- (c) By adding to the number of potential primary dealers the danger of collusion against the authorities by a small inner-ring of domestic firms may be reduced.

There are, however, some arguments on the other side:

- (a) Banning foreign firms from entry into the domestic capital market can be used as a lever to negotiate entry for one's own nationals into the foreign market (although no firm can expect an application to operate in a foreign market to be seriously considered unless the firm conforms to necessary supervisory standards). The United Kingdom enforced a

reciprocity criterion when opening its market worldwide in 1986: it was only progressively that, for example, French and German firms and (later) Japanese ones were allowed into the UK government securities market. It should be acknowledged, however, that this type of negotiating tactic may be contrary to international agreements, and can provoke retaliation, possibly in unconnected areas of business.

(b) Aggressive and experienced foreign primary dealers could possibly squeeze out infant and developing domestic primary dealers, leading to resentment and perhaps political backlash, or discrediting the whole concept of a primary dealer system.

c) Supervision of foreign firms, especially if the business is, in effect, directed from abroad, may be even more difficult than that of domestic firms.

Faced with these conflicting considerations, most authorities in developed capital markets have opted for a compromise; the details vary from country to country but common features may be along the following lines:

(a) A foreign firm must have a fully professional *local presence* in the market, which can provide the focus for detailed control by the supervisory authority. This often requires a fully incorporated local subsidiary company.

(b) If the parent firm is foreign, it must undertake to support the activities of the local subsidiary.

(c) Additionally, some countries restrict the scale of activity of foreign firms, either overtly, such as by limiting their total number or their combined share of the market, or covertly. In general, such measures should be avoided, although certain rules, such as a requirement that foreign firms or joint ventures must employ a minimum percentage of local staff, appear to have won a degree of acceptance.

10 Transparency

“Transparency” refers to the public availability of full, accurate and prompt information about market prices, transactions, etc. Since there is

an inherent danger of lack of transparency in setting up an inner ring of primary dealers with an oligopoly of access to the auctions, the authorities in charge of setting up new market arrangements need to consider very carefully how they can balance this by making the operation of the market as transparent as possible, in particular to the ordinary investor.

A primary dealer system puts pressure on the debt manager to formulate and follow a well-defined issuing strategy in the primary market. Ideally, this should be accompanied by measures to ensure transparency. There are, however, some practical arguments against full transparency in the government securities market:

- (a) Even in developed markets, a market-maker with a substantial position in a particular government security which it wishes to unwind runs a serious risk that the market will move the price against him if his position becomes known.
- (b) It can be argued that transparency is more important to the smaller retail investor than to the bigger wholesale investor, who should be able to look after himself, particularly if there is sufficient competition for big wholesale business among a number of primary dealers.
- (c) In any event, primary dealers doing client business should as a matter of practice, if not of law, segregate client business from their own; thus the client should have reasonable confidence in the primary dealer.

Consequently, in most of the developed markets a compromise has been reached which contains most or all of the following elements:

- (a) The primary dealers are required to be members of the stock exchange and must follow the normal rules of reporting transactions to the stock exchange, just as they do for trading in equity shares.
- (b) However, it is recognised that in the government securities markets special arrangements may be permissible because of the importance of the market to the overall financing needs of the government and to macroeconomic policy.

(c) Primary dealers may therefore be given exclusive access to the screens of the inter-dealer brokers. They can use the inter-dealer brokers to trade among themselves without disclosing their identity or their positions.

(d) As regards other transactions, small transactions should be reported immediately to the stock exchange and larger transactions either after a delay or, if very large in amount, they need only be reported anonymously.

(e) If clients wish to trade over-the-counter because it is quicker or cheaper, they have to understand that they forfeit some of the protection conferred by a stock exchange transaction. In some countries - for example the UK - over-the-counter trading is not allowed for government securities, though this is exceptional.

11 Organisation

The organisation of responsibility for government debt varies between countries, and between the primary and secondary markets. In the *primary market* it is usual for the Ministry of Finance to take the main policy decisions because debt management is part of fiscal policy. But the Ministry of Finance may appoint the central bank as its fiscal agent; this is quite common, particularly where the central bank also has an advisory role, based on its market knowledge. In some countries the Ministry of Finance cedes all or part of its responsibilities to a separate debt management agency.

It is more common for oversight of and official operations in the *secondary market* to be the responsibility of the central bank, given the link to money-market operations which the central bank usually carries out in the context of monetary policy. The central bank may also engage in market-making itself, either as a service for the smaller retail investor or more generally.

It does not much matter who takes *prime responsibility for setting up a primary dealer system* and carrying out the detailed work on it, provided that the potential participants know clearly who is in charge. And whatever disagreements there may be between different official bodies with an interest in the matter (including a Securities Commission if this exists), these should be aired in private, not in public. Where

responsibility is shared, there needs to be a formal mechanism - such as a policy committee which meets regularly - for taking decisions and resolving disagreements.

The importance of adequate prior consultation with the market over prospective innovations and changes cannot be over-stated. The authorities need to take the market into their confidence in order to derive best advantage from any change of system. The consultation should be genuine, not perfunctory. There is much to be said for a trial period before any new system of primary dealers, or major innovation within an existing system, goes live. And it may be useful for primary dealers to form their own association, which could have regular dialogues with the authorities on matters of common interest.

12 Conclusion

It is not essential to have a primary dealer system. Many countries finance their government borrowing perfectly adequately without such intermediation. And it is noteworthy that in perhaps the most advanced government securities market, the United States, recent developments have meant that the primary dealers have lost many of their special privileges. Nevertheless there is a stage in the transition from a planned to a market economy where, in the view of the author, primary dealers can play a useful part, not least because such markets are often starved of human as well as financial capital, and it may be easier and safer for the authorities to deal with a limited (though not too limited) number of counterparties. In one or two such countries, in an advanced stage of transition, primary dealer systems have been or are about to be introduced. A number of other countries are well on the way to doing the same. We wish the firms concerned and the authorities in these markets every success.

Further reading

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