

PRIMARY DEALERS ON GOVERNMENT SECURITIES MARKET

Main role of primary dealers is to participate in the primary (issuing) government securities market, where they will ensure absorption of newly issued government securities and distribute them to the final investors, mainly to the broader market predominated by institutional investors where liquidity is especially recognized

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Darko Blazevski was born in 1976. She graduated from the Faculty of Economics in Skopje in 1998, Business Economy Department, major Financial and Accounting Management. At the moment, he attends post-graduate studies in the field of Monetary Economy at the Faculty of Economics in Skopje. He was employed in Ministry of Finance in September 2005, Public Debt Management Department as Senior Associate. Previously he worked in AD RADOBANKA Skopje, as junior officer in February 1999 in the Asset Management Department, and in 1999 he moved to the Credit Department as credit officer. He has attended trainings and seminars in the field of banking, development of small and medium enterprises, financial derivatives and public debt management. He speaks fluent English and German.

1. Introduction

Prior to beginning the general discussions on primary dealers and market makers, it is necessary to point out that these issues appear as a result of the development of the domestic financial market and the number of related achievements such as the improvement of the transparency, increased issuance of government securities, introduction of OTC, etc. In addition, an event related to this is the publication of the 2006-2008 Public Debt Management Strategy (Official Gazette of the Republic of Macedonia, no. 39/06), elaborating the future steps for the development of the domestic government securities market.

2. Definition

It is well known that the primary objective of the government manager of public

debt is to cover the needs for borrowing as cheaper as possible and with as lower risk level as possible. To achieve this objective, primary and secondary markets need to be broad and efficient (in particular the secondary market which needs to be deep and liquid).

There are many ways to achieve these objectives. One is to designate a group of highly qualified financial companies to play the role of specialized intermediaries on the market of government securities between the issuer on one side and the market



on the other. These intermediaries have obligations, as well as privileges: in return for the direct access to government auctions and for other benefits, they guarantee the issuer a sound, secure demand for its securities and development of a more efficient and more liquid secondary market. They are often called primary dealers, but sometimes the reference market makers is used, depending on whether their obligations also cover the secondary market.

3. Role of primary dealers when issuing government securities

Many governments - issuers created the group of primary dealers from specialized intermediaries, with obligations and privileges, so as to help the development of the government market of securities. Main role of primary dealers is to participate in the primary (issuing) government securities market, where they will ensure absorption of newly issued government securities and distribute them to the final investors, mainly to the broader market predominated by institutional investors where liquidity is especially recognized. Apart from the

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main role, primary dealers can appear as market makers, thus ensuring the listing of selling and buying prices of government securities so as to maintain market liquidity. It means that the investors will have greater security to buy government securities at price close to the market one. Market makers usually hold small number of government securities as a stock, or can easily find such securities, meaning that they can always deal with this type of demand. Depending on the manner on which they are set, primary dealers can bring more competition and more capital on the market.

4. Obligations and privileges of primary dealers

- Obligations

Nature and context of these obligations and privileges significantly vary from country to country. In some cases there are financial companies playing the role of primary dealers without formal authorization, however, with certain dose of official support.

Obligations of primary dealers, in addition to the participation in auctions, usually vary from country to country. Thus, somewhere dealers can recognize auction quotas; can behave as market makers or can provide the government with information on the market conditions.

1. Main obligation of the primary dealers is to support the government when selling government securities. The government creates a group of primary dealers mainly to use their distributive capacity. Most of the countries require the primary dealers to register or, at least, to offer certain portion of the government securities to auction. Many of them also stipulate a request for a quarter, a year or for a minimum per auction, which is normally a function arising from the size of the primary dealer or its share on the secondary market. Other countries do not set a quantitative amount and expect for the primary dealers to appear, as an obligation, with offers at the auctions. Level of rigidity of the arrangements depends on the market conditions and can change over time. Stipulating strict demands for submission of offers at the auctions when then market is shallow can be a burden for some of the primary dealers, and all that can be neutralized with a certain privilege, or other type of incentive.

2. Primary dealers usually appear as market makers as well. Arrangements for market makers contain an obligation to list the selling and buying prices of government securities and to monitor the specific margins along the yield curve. Especially when the markets develop and price stability is high, demands by the market makers need not be too rigid, since primary dealers can face significant loss and abandon the activity of supporting the secondary market.

One of the most difficult issues to resolve the arrangement with primary dealers is the width and volume of trading. If margins are too wide, the obligation will become meaningless and liquidity will not improve. If the margins are too narrow and instability is high, there is a risk for the market not to attract buyers due to

potential losses. Size of the margins is also in permanent ties with the volume of trading. Having the fact that market makers can cover some fixed costs (prior to earning profit) as a starting point, the larger number of transactions, the smaller the margin needed to cover them.

Development of the market and reduction of the instability can reduce the obligation to support the secondary market. Margin can be reduced and the number of government securities for which the dealer is obliged to list selling and buying prices can be increased. Even in the developing countries, some governments (such as the Czech Republic and Turkey) are the position that primary dealers should not be given certain privileges in return of the function to support the secondary market, since the margin has already provided them with a sufficient reward. In other countries as well (such as Australia and New Zealand) there is a position that, taking into account the development of the markets, different participants and volume of trading, supporting the secondary market should be in a natural way and the government should not provide any special incentives to this end.

3. Third main obligation of the primary dealers is to provide the issuer of government securities with information on the market conditions and market preferences. Information can be exchanged between the primary dealers and the government representatives. In the initial stages of the development, primary dealers can give reports to the issuer on monthly basis, and when the market matures, more rare reporting can satisfy the needs.

- Privileges

In return for the set obligations, primary dealers can receive number of privileges. They are present as most justified in the developing countries with markets characterized with instability. When the market matures, justification for the existence of privileges reduces and the issuer should be prepared to gradually abandon them. On the developed markets, the governments should avoid giving special privileges to the primary dealers, in particular to recognize their special title, i.e. status, or to be granted certain advantages arising from the information they acquire from the meetings with the

bodies in charge in the Ministry of Finance or in the Central Bank. Other privileges, discussed below, should be limited only to the early stages of the market development.

Primary dealers are given exclusive right to participate in the regular auctions of government securities, as well as the possibility to participate in the part of non-competitive offers. Sometimes, they are also given exclusive right to be primary dealers for the central banking operations of the monetary authorities.

Thus, they acquire the possibility to perform broader scope of activities in relation to the other dealers, such as the development of the foreign exchange market in the part of sale and purchase of foreign currency assets, repo operations defined through the general repo agreement and credit lines for primary dealers. Still, danger that stimulations through privileges to a group of institutions is a Damocles sword should be taken into account, whereby the government for the purpose of a single objective discourages the market participation of other institutions, thus leading to weakening of the long-term market development.¹



5. Advantages and disadvantages of primary dealers

- Advantages

Main objectives to be achieved with the introduction of primary dealers are the following:

1) Repoto i pozajuvaweto na dr' avni hartii od vredn

1. to ensure maximum participation in the auctions of government securities on the primary market;

2. to improve the liquidity of the secondary market through the system of supporting the secondary market, thus directly improving the functioning of the primary market as well, and subsequently improving the conditions under which the government can finance its deficit;

3. More general objective is the increase of competition. Especially if foreign companies are allowed to operate as primary dealers, they can have the effect of bringing more capital and, through increased competition, reduce fees or narrow down the margins, making the dealing costs on the secondary market cheaper, indirectly stimulating the primary market.

- Disadvantages

However, there are several arguments that are to be measured prior to introducing the system of primary dealers. Main risk is that the new arrangement has features of non-competitiveness. Primary dealers hope to earn with their oligopolistic position as intermediaries between the issuer and the market, so there is a danger of conspiracy, especially if there is a small number of accepted participants for primary dealers. The created cartel can:

take appropriate measures, although much can be done by close analyzing and announcing of the results from the auctions, and by thorough monitoring of the behaviour of individual companies. Still, having the experience of most of the countries as a starting point, one can conclude that the advantages of the system of primary dealers overcomes its disadvantages.

Primary dealers are just a way to distribute government securities. In fact, although many developed countries used the system of primary dealers to a certain level in the development of their government securities market, there are examples of countries that managed to develop efficient and versatile financial markets even without them. Development of e-trading and Internet can play historical role in the issuance and absorption of government securities, and to diminish the role of the primary dealers on the government securities market over time.

6. Criteria for selection of primary dealer

- Financial capacity

Criteria for selection of primary dealer usually include assessment of the financial capacity of the market participant, measured through the capital adequacy, adequacy of management skills, technical capacity, active presence on the market observed through the participation in the trading with government securities and readiness to provide information to the authorities.

Requirements for financial capacity are essential, especially when the primary dealer is obliged to list the selling and the buying prices of government securities, thus being exposed to great market risks. Therefore, in order to maintain market efficiency, criteria for selection should be revised and adapted to the needs.

There are many criteria that refer to the financial capacity, but the most important are the participation in the auctions, volume of trading and possibility to list the selling and the buying prices of the government securities. With respect to the participation in the auctions, there is a recommendation for the indicator to be measured more through the approved offers, rather than through the total volume of offers (approved and rejected). Final evaluation is based on an index created from the series of the abovementioned quantitative indicators.

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1. make downward pressure on the price of the auctioned government securities by creating supply chain, with an intention to sell the government securities later on at higher prices;

2. create higher intermediation costs, thus reducing the demand by the final investors.

The threat from the non-competitiveness can cause a serious problem. Observations point out to the fact that it is not easy to detect this practice and to under-

- Supervisory criteria

Not a single primary dealer should be approved, except if he/she meets the supervisory criteria. Thus, criteria for selection of primary dealers need to be set as more transparent as possible. Candidates can be aware of the potential obligations they have, and other market participants who meet these criteria will be taken into account when selecting the future primary dealers.

Some countries, when selecting primary dealers, have introduced quotas as a method to ensure participation of various types of institutions between the primary dealers. Justification for this procedure rests in the advantage for creation of diversified base of primary dealers from different business and consumption circles. For instance, certain percentage of licences for primary dealers is granted according to the participation of certain types of institutions (commercial banks, insurance companies, investment funds, etc.). Within each group, primary dealers are selected on the basis of the previous criterion. The remaining primary dealers, not included in this percentage, are selected exclusively on the basis of the previous criterion, regardless of the type of the institution.

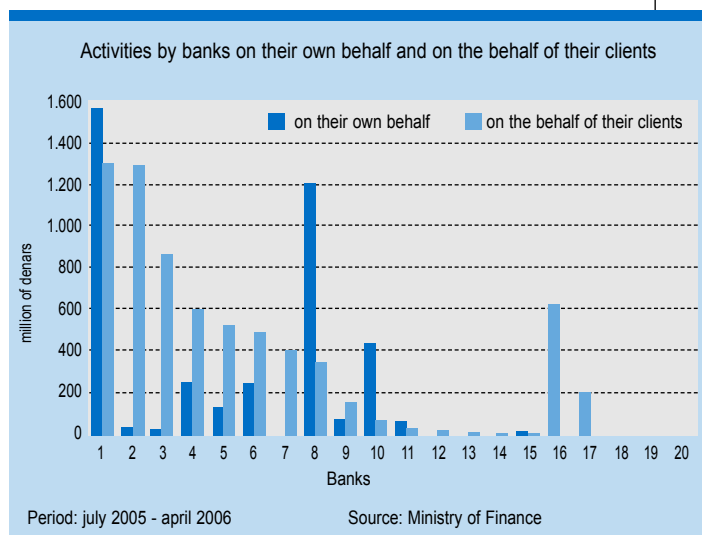
- Trial period

Important factor to maintain a competitive market of primary dealers is the entrance of new participants that will challenge the existing ones, especially if the existing participants try to use the oligopolistic advantage. Therefore, some countries use a trial period during which the interested institutions behave as primary dealers only provisionally. Following this period, those who have been active according to the previously agreed criteria are formally designated as primary dealers for a certain period of time, ranging from one to two years. Remaining institutions can continue applying for primary dealers. Following the set time period (one or two years), the list of designated primary dealers is subject to revision, thus enabling the most active outsiders that meet the selection criteria to replace the relatively inactive primary dealers.

7. Experience of the Republic of Macedonia

Macedonian government securities market has brief history of existence since 2004, with a modest portfolio and features of almost undeveloped secondary market of government securities. However, the experience so

far, the international practice and the theoretical concepts are sufficient to start the initiative for introduction of intermediaries on the government securities market who will improve its development.



The procedure for introduction of intermediaries on the government securities market primarily envisages defining the primary dealers on the primary market, followed by selection of the market makers.

Present state on the primary market of government securities includes the Agreements for participation in primary market of government securities concluded between the Ministry of Finance, NBRM and all active banks in Macedonia, whereby none of them has spe-

Until primary dealers are finally introduced (it is planned for the beginning of 2007), activities are expected from the Ministry of Finance that will take place in several stages and will cover the following monitoring of the banks on the auctions in the period from May to November 2006, broader analysis of the development of the government securities market and raising the awareness of the banks about the significance of the concept of primary dealers

cial privileges or obligations, except to respect the Rulebook on the Manner and the Procedure for Issuance and Payment of Government Securities (Official Gazette of the Republic of Macedonia, no. 99/05).

To the end of showing the effect of such type of organization of the primary market, results from the activities performed by banks on their own behalf and on the behalf of their clients is presented below.

It can be concluded that during the shown period three banks have shown no activity, and over 5% of the total activity on their behalf is present at only five banks, while over 5% of the total activity on behalf of the clients is present at only nine banks.

In addition, one can notice big discrepancies between the participating banks, and in order to have a more precise analysis so as to evaluate the right moment for introduction of primary dealers and their right number, parallel analysis is also needed of the participation of the banks on the CB bills market.

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1. monitoring of the banks on the auctions in the period from May to November 2006;
2. broader analysis of the development of the government securities market;
3. raising the awareness of the banks about the significance of the concept of primary dealers through articles, individual meetings and presentations to be organized by the Market Committee.

Last step in the series of activities is the preparation of more precise criteria to define the primary dealers by monitoring the following:

- volume of participation of the banks in the auctions;
- number of clients served;
- regular attendance when banks participate in the auctions on the primary market;
- amount of fees set for their services;
- shown interest by the participating banks;
- participation in the secondary market.

When these steps are finalized, Ministry of Finance of the Republic of Macedonia will be in a position to designate several banks to perform the function of primary dealers.

We can consider the reform of the pension system as a positive trend, since the appearance of pension companies as investors on the market will increase the interest in medium-term and long-term government securities on the primary market, and they are expected to bring greater activity on the secondary market when creating their portfolio

That is why we can point out the introduction of government securities for monetary purposes as a positive trend this year. Thus, the present segmentation of the securities market can be reduced, enabling the banks to abandon the conservative approach in the placement of the excess of liquidity, and on the other hand, longer maturity of this instrument will influence the development of the secondary market.

In addition, we can consider the reform of the pension system as a positive trend, since the appearance of

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