IGCP
Instituto de Gestão do Crédito Público

PORTUGAL - GOVERNMENT DEBT MANAGEMENT

GOVERNANCE AND INSTITUTIONAL FRAMEWORK

As a consequence of Portugal's integration in the European Monetary Union, the environment underlying the management of the Portuguese government debt has gone through very important changes in the last few years. By adopting the euro as its currency, the country now benefits from both the credibility of a monetary policy that is defined at the EU level and the fiscal discipline that EU members have to comply with. On the other hand, the constraints over the government debt management coming from the execution of the monetary policy got diminished and the country gained access to a much larger "domestic" financial market – the euro debt market. However, the privileged position as the reference issuer in the Portuguese escudo was lost and Portugal became a small borrower in a large market, where it has to compete with other sovereign issuers for the same base of investors.

In the second half of the nineties, and in anticipation of these changes, a series of important reforms took place that aimed to develop conditions for a more efficient management of public debt in this new environment. These reforms included, at the institutional level, the creation of an autonomous debt agency – the IGCP – in 1996, the publication of a new Public Debt Law approved by the Parliament in 1998 and the Government approval of formal guidelines for debt management in 1999.

Debt management objectives

The strategic objectives to be pursued in government debt management and State financing were made explicit by the new Public Debt Law, which states that these activities should aim to guarantee the financial resources required for the execution of the State budget and be conducted in such a way as to:

- Minimise the direct and indirect cost of public debt on a long term perspective
- Guarantee a balanced distribution of debt costs through the several annual budgets
- Prevent an excessive temporal concentration of redemptions
- Avoid excessive risks
- Promote an efficient and balanced functioning of financial markets.

The minimisation of debt cost was already an implicit objective of debt management before the approval of the new Law. Its publication, nevertheless, has been an important step as it formalised these objectives, clarified that the minimisation of cost should be pursued on a long-term perspective and introduced an explicit reference to risk limitation, namely in what concerns refinancing risk and the volatility of debt cost over time.

The objective of promoting an efficient and balanced functioning of the domestic financial market was particularly important before the creation of the European Monetary Union, in a context where most of the debt was denominated in Escudos and placed in the domestic market. The relevance of creating and maintaining a benchmark yield curve to support the Escudo capital market vanished as the Portuguese Escudo integrated the Euro.

The Guidelines for Debt Management, approved by the Minister of Finance in late 1998 and in force since 1999, adopted a model for risk management and translated the strategic objective of minimising the debt costs into the definition of a benchmark which, since then, has been the reference for debt management.

The risk management approach has four basic components: (1) adoption of a consistent model for the development of primary and secondary market for Portuguese public debt; (2) development and implementation of clear debt management guidelines and risk/performance evaluation (benchmark); (3) investment in IT systems, to support well informed management decisions, reduce operational risk and increase transparency, by improving availability and quality of all transaction data; (4) development and implementation of a comprehensive manual of operational procedures, to reduce operational risk and support external and internal auditing.

The scope of debt management activity

Debt management includes the issuing of debt instruments, the execution of repo transactions and the completion of other financial transactions with the purpose of adjusting the structure of the debt portfolio.

There is no limitation in the Law as to the nature of the financing instruments that can be used for the funding. However, concerns with the liquidity of the government debt led to a progressive concentration of the financing activity into the issuance of a restricted number of standard fixed rate Treasury bonds (OT) and commercial paper. The issuance of savings certificates, a retail instrument sold to individuals on a continuous basis, remains an important funding source.

The repo transactions are carried out under a window facility of last resort created in 2000 to support the market-making obligations of the primary-dealers in the secondary market of the OT.

In order to adjust the redemption profile of the government debt, the Law includes within the scope of the operations allowed to debt managers the early redemption and buy-back of existing debt and the direct exchange of securities. Since 2000 this kind of operations has been used more intensively, also with the purpose of promoting liquidity in the Treasury bond market through the concentration of existing debt into larger and more liquid issues.

The Law also includes within the scope of debt management the trading of derivatives, namely interest rate and currency swaps, forwards, futures and options. Those transactions must be hedging existing risks and hence be linked to the underlying instrument in the debt portfolio. Swaps and fx forwards have been the instruments most used for the purpose.

Contingent liabilities are followed by the Treasury Department, at the Ministry of Finance, and at this stage are not taken into account in debt management decisions, even though that is something that should be analysed in the future, with a view to include it in the risk management framework. IGCP is only responsible for the management of the direct public debt of the central government, even though it is required to appraise the financial terms of guaranteed debt and debt issued by (public sector) services and funds with administrative and financial autonomy[1].

The scope of IGCP's activity does not include, for the time being, the investment of surpluses that may exist in the State central cash accounts, which is also under the responsibility of the Treasury Department[2]. The exchange of information on policies and forecasted treasury flows between the two entities is carried out on a permanent basis in order to coordinate funding and surplus investment in an effective way.

Legal framework

The legal framework that regulates the issuance of central government debt and the management of public debt includes, as main legal instruments, the Public Debt Law, the annual Budget Law and the Decree-Law that regulates the activity of the IGCP. According to these, it is IGCP's responsibility to negotiate and to execute all financial transactions related to the issuing of central government debt and to the management of the portfolio in compliance with the guidelines approved by the Minister of Finance.

The Public Debt Law states that the State financing has to be authorized by the Parliament. The annual Budget Law establishes limits for the amounts that the Government is authorized to borrow during the year (in terms of net borrowing) and may also define maximum terms for the debt to be issued and limits to the currency exposure and to the floating rate debt.

The decisions on the debt instruments to be used in State financing each year and their respective gross borrowing limits are approved by the Government through a Council of Ministers' Resolution.

The Minister of Finance is empowered to define specific guidelines to be followed by the IGCP in the execution of the financing policy approved by the Government and in the completion of other transactions concerning the buy-back of securities and the active management of the debt portfolio.

Permanent guidelines from the Minister of Finance were formalised through the adoption of a long-term benchmark structure for the composition of the debt portfolio, which

[1] Above a certain threshold, set yearly.

reflects selected targets concerning the duration and the profile of redemptions and refixings. This benchmark was set as the reference for the evaluation of the cost/performance of the actual debt portfolio and for the definition of limits to the interest rate risk, currency risk and refinancing risk that it may undertake.

On a yearly basis, specific MoF guidelines are formalised through the approval of a financing programme for the year, which includes broad lines for the issuing strategy, namely in terms of instruments, maturities, timing and placement procedures and also measures to be taken regarding the marketing of the debt and the relationship with the primary dealers and other financial intermediaries. The Minister of Finance also approves specific guidelines to be followed during the year, e.g. as to the buy-back of debt (debt instruments, procedures amounts) and repo transactions.

Organisational issues

The operational activities associated with the central government debt management including the servicing of the debt are, since 1997, centralised in the IGCP. Previously, two departments inside the Ministry of Finance were in charge of these activities: the Treasury Department, responsible for the external debt and the issuance of Treasury bills and the Public Credit Department, responsible for domestic debt (excluding T-bills).

Nowadays, the IGCP is empowered to negotiate and carry out all financial transactions related to the issuing of central government debt and to the active portfolio management, in compliance with the guidelines approved by the Minister of Finance.

It is governed by a Board of 3 Directors, appointed by the Council of Ministers for a term of 3 years, that reports to the Minister of Finance.

An Advisory Board, composed by the Chairman of the Board of Directors, a member of the Board of Directors of the central bank and four experts in economic and financial matters, appointed by the Council of Ministers, plays an advisory role in strategic matters.

An Audit Committee composed of a chairman, nominated by the Inspectorate-General of Finances, and two permanent members (one being an official chartered accountant) appointed by the Minister of Finance, is responsible for following up and controlling the financial management of IGCP as well as supervising its accounting procedures.

The IGCP is organized in a structure intended to allow the use of its resources in a flexible way, namely with recourse to project teams. After some initial adjustments, this structure has been stabilised since 1998. The organisational structure comprises the Board of Directors, 2 departments and 5 technical and 4 operational units, with a total staff of 65 people.

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[2] The Decree-Law that created the IGCP recognized the importance of further integration between the treasury management and the debt management. Formal integration is under consideration.

The Debt Management Department is responsible for all the aspects related to the definition of the issuing and portfolio management policies, the follow-up of the secondary market, the relationship with the primary-dealers and other financial intermediaries, the negotiation and placement of non-retail debt and the active management trading. It comprises two technical units: a trading room and a markets unit.

The Operations Department is responsible for the matters related with the confirmation and settlement of the wholesale transactions executed by the trading room, debt accounting and procedures related with withholding tax over the debt interests. It is also responsible for the issuance and amortisation of savings certificates and the debt service of other retail instruments, as well as controlling the activity of the Post Office, which acts as an agent for the selling and redemption of the savings certificates. It comprises 3 operational units: a documentation and settlements unit, a debt accounting and budgeting unit and a retail debt unit.

Four other units report directly to the Board: the Financial Control unit, which is responsible for all aspects related with risk and performance evaluation, internal control, procedures definition and internal auditing; the Research and Statistics unit, which produces economic analysis, definition of scenarios and external reporting; the IT Systems unit, responsible for the operation and maintenance of IT systems; and the Administration unit, which is in charge of all internal matters - personnel, acquisitions, premises, etc.

There is a Markets' Committee, composed by the Directors, the heads of the Debt and Operations Departments and of the Financial Control, Research, Trading-room and Markets units, that meets once a week to analyse market developments, treasury forecasts, the position of the real debt portfolio against the benchmark and to define guidelines for the activity during the week.

In order to allow the IGCP to hire and retain qualified staff, some aspects were legally provided for: the possibility of hiring people not as civil servants but under the general labour law; a high degree of administrative and financial autonomy, within an annual budget approved by the Minister of Finance. The guidelines for personnel compensation approved by the Minister of Finance are based on the need to maintain competitiveness when compared with the banking sector. Budgeting was also adequate in providing the financial resources necessary to acquire and update the information systems.

There has been a strong concern with transparency since the IGCP began to operate in 1997. Key functions are now covered by written internal procedures, which include delegation of powers and the role of each unit inside the organisational structure.

A detailed quarterly report is submitted to the Minister of Finance, portraying all the transactions executed during the period and presenting the figures for cost and risk of the debt portfolio relative to the benchmark. A report describing the activities carried out throughout the year and presenting the financial accounts of the debt is published annually.

The Audit Court (public sector audit body) is responsible for checking the activity of the IGCP, covering the financial accounts of the debt and the compliance with the guidelines and limits established by the Parliament and the Government. This audit has been recently extended to the internal procedures and to the quarterly report presented to the Minister of Finance.

RISK MANAGEMENT FRAMEWORK

Main Risk Variables

Since the inception of IGCP, a significant effort was developed to formulate (and, whenever possible, quantify) the types of risk relevant for public debt management[3].

First and above all else, IGCP has the mission to guarantee the fulfilment of the yearly borrowing requirements of the State. In order to minimise, as a debt manager, the risk of not being able to guarantee that, there are 2 main areas of action: (1) Developing an efficient market for public debt; (2) Smoothing the redemption profile of the debt portfolio.

Therefore, and in what concerns the risk management framework, a high priority was given to the minimisation of refinancing risk[4], in spite of all the "comfort" that derives from the depth and liquidity of the euro capital market. The constraints imposed at this level are increasingly important, given the market's constant demand for liquid bonds (meaning large volumes). The reconciliation between these two conflicting requirements has been partially achieved by investing both on the efficiency of the primary and secondary markets (basically trying to compensate lack of size with extra efficiency) and on the set up of other methods of managing the redemption profile (besides issuance), namely buy-back programs.

Subject to that, the debt manager has the overall objective of minimising the long-term cost of debt, without incurring in *excessive* risks.

In this context, the major risk for a (public) debt manager was assessed by IGCP as being the extent to which financial variables' volatility affect budget volatility (through debt servicing costs changes), thus reducing the range of manoeuvre of the fiscal policy maker. Therefore, risk is better measured on a cash-flow basis, rather than on the "value-at-risk" basis commonly used by asset managers.

Like several other sovereigns, the IGCP is working on the development and implementation of an integrated budget-at-risk (BaR) indicator for the debt portfolio. Until

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[3] And, for that purpose, all the learning process associated with the modelling of a benchmark portfolio had a critical contribution, making that project, *per se*, a worthwhile investment.

[4] I.e., the risk of not being able to roll over the maturing debt close to previous market prices, or, in the extreme, at any price.

that process is finished and tested, cash flow risk is measured through a combination of indicators, namely duration, refixing profile and currency exposure. Duration has the advantage of being a standard market measure, and works as a proxy for the degree of cash flow cost immunisation to interest rate movements. It is complemented with the refixing profile, which portrays the portfolio exposure to the different yield curve segments, giving a more comprehensive picture of total interest rate risk than the single duration figure. Finally, foreign exchange risk: since 1999 and the introduction of the euro, it has been significantly reduced - nowadays being almost negligible - and it is measured by the percentage of debt denominated in foreign currency.

Credit risk is not necessarily inherent to a debt portfolio and results from the eventual necessity of obtaining a portfolio structure that is not achievable (by whatever reason) through funding transactions. In a pure liability management framework[5], only with the use of derivatives is credit risk incurred. IGCP measures this type of risk with an adapted version of the BIS model, and controls it through tight procedures for counterparty approval (including credit scoring, limits attribution and ISDA agreement negotiation). The use of collateral as a means of partially covering credit risk has been approved and should be implemented during 2002.

Finally, in its debt management activities, IGCP incurs in operational risk. This last type of risk is not measured explicitly, but underlies several policy measures. It was first addressed when IGCP was created, leading to the choice of an organisational structure based on the financial industry standard of front-, middle- and back-office areas, with clearly segregated functions and responsibilities; and it has since been a focus of attention by means of 3 main initiatives, namely: a significant investment in IT (including the purchase of a management information system), followed by the development of a manual of internal operating procedures, and finally the investment in specialised human resources. In the future these measures will be complemented with internal auditing, besides the external auditing that is already done by the Audit Court.

Management Guidelines and Benchmark Portfolio

The (debt) portfolio management mandate given by the Minister of Finance to IGCP was further formalised in 1998, with the approval of management guidelines and a reference portfolio (benchmark).

The benchmark is deemed to incorporate the long-term objectives of the portfolio owner[6] in terms of risk profile and expected level of cost, embodied in a financing strategy and the resulting portfolio structure.

The main purpose behind the adoption of a benchmark by IGCP was to have a measurable reference of the long-term target portfolio structure, based on the conviction that this type

[5] Not considering the cash management function or the “credit” component of settlement risk.

[6] I.e., the Government (Minister of Finance), acting on behalf of the tax payers.

of guidance would improve consistency between day-to-day debt management decisions and long-term goals.

On the other hand, the fact that IGCP was created as an independent entity raised the need for a tool that allowed an objective evaluation of management results (accountability). This influenced the decision to adopt the benchmark also for performance measurement purposes.

This, it should be stressed, was only possible given the specific context in which IGCP operates since 1999, with the first stage of the European Monetary Union. Since then, the euro capital market became the relevant "domestic" market, where Portugal is a sufficiently small player for its transactions to have no major impact, and be subject to no other interpretation from market participants than pure portfolio management decisions. In this context, funding and market development decisions can be separated from portfolio management decisions through the use of derivatives, providing conditions for the usefulness and fairness of a performance benchmark.

The determination of this benchmark portfolio was based on a mixed simulation/optimisation model, where the key decision variables were cash flow cost and risk, with a restriction to address explicitly refinancing risk (the other risk components were analysed for every possible solution, but no limits were imposed on them in the model). The model's solutions were then short listed not only in terms of efficiency, but also in terms of robustness to changes in the model's main assumptions (macroeconomic and interest rate scenarios[7]).

The final choice of a solution, amongst the subset of efficient and robust possibilities, was determined by the conjunction of 3 factors:

- Cash-flow risk/return trade-off;
- Comparison of the resulting risk figures (especially interest rate risk) with the equivalent values for other euro zone sovereigns;
- Market restrictions (the funding strategy associated to the benchmark portfolio had to be a feasible strategy for an euro-market sovereign issuer – duplicability attribute).

In this type of framework, debt management decisions performed through the combination of financing and derivative transactions aim at a certain relative positioning versus this benchmark, in terms of both interest rate and foreign exchange risk, being (implicitly) expected from the debt managers to outperform the benchmark.

The maximum divergence that the debt portfolio can show relative to the benchmark for the relevant risk variables (i.e. the maximum level of additional risk the debt manager can take) is established in the guidelines.

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[7] Given the context in which Portuguese debt management is performed, this reference portfolio was built so as not to have any net foreign exchange risk.

The management guidelines therefore aim to: describe the main types of risks associated with the debt portfolio; specify whether they are measured on an absolute (e.g. refinancing and credit risk) or relative[8] basis (cash flow risk); and, where appropriate, impose limits on the risk variables.

Formally, the management guidelines approved by the Minister of Finance are divided in 5 parts, containing: (1) list of relevant definitions (of scope and risk/cost variables); (2) set of authorised instruments and transactions; (3) limits for the key risk variables (namely: refinancing profile, modified duration, refixing profile and currency exposure) and reporting requirements (timing and content); (4) composition and dynamics of the benchmark portfolio; (5) credit risk. Of all these, the first 3 items were published. The theoretical model behind the definition of the benchmark was also published in the IGCP's Annual Report 1999, even though the approved benchmark portfolio is not publicly disclosed (neither are the credit risk guidelines).

The benchmarking process in IGCP had an experimental year in 1999, and has since been in place formally. And even though the overall assessment about its usefulness is positive, it has to be said that it is, in a liability management context, a less straightforward process than for asset management, for several reasons. First of all, not only is it very difficult to quantify all the restrictions and objectives of a sovereign debt manager, but also these change in time, which leads to either the non-duplicability of the benchmark (making it unfair as a performance measurement tool) or the need of frequent changes in the benchmark itself, which also goes against the desired nature of such a tool. Another specific problem is that, even in a small player/big market situation like Portugal's in the euro market, the funding policy adopted by IGCP has an influence in the credit spreads of Portuguese government bonds, which however is very difficult to quantify. This makes it even harder to estimate the cost levels associated with different funding policies (e.g. the cost of the benchmark simulated financing strategy), turning the operational maintenance of that reference portfolio into a relatively complex exercise.

Therefore, a performance benchmark in sovereign liability management should always be taken with a high degree of pragmatism and discernment, from both the portfolio manager and the portfolio "owner" (MoF/Government).

Management information systems

In the end of 1999 an off-the-shelf, straight-through processing treasury system was bought to support the debt management transactions (Finance Kit, from Trema).

The choice of a user-friendly front-to-back office integrated system[9] was made not only in order to mitigate operational risk, but also because of the conviction that, by increasing the use and share of information across IGCP, it would lead to better data quality – in fact,

[8] "Relative" – measured as a deviation from the benchmark portfolio equivalent figures.

[9] In detriment of a more specialised risk management software

having a robust database of all debt transactions was one of the selection process' main priorities.

This system was initially designed for corporates and has a strong cash-flow focus, having revealed a good fit to the risk management policy at IGCP.

Additionally, a system was developed to handle the retail debt transactions, which are registered in the treasury system only in aggregate form, on a monthly basis, for position keeping, accounting and reporting purposes.

Operational procedures manual

The implementation of these two systems had a considerable impact on the internal processes at IGCP, increasing the need for the development of a written manual of operating procedures, including the new tools for operational control.

Given its scope, this is a relatively ambitious project, which started in 2001 and aims not only to optimise the internal processing circuits at IGCP, but also, and in that process, to develop a new culture regarding operational risk matters and associated control procedures (including internal auditing).

DEBT MANAGEMENT STRATEGY AND GOVERNMENT SECURITIES MARKETS

Debt Management Strategy

The Portuguese debt management follows a market-oriented funding strategy. It acknowledges the importance of issuing marketable instruments at market prices building up a government yield curve with liquid bonds along the different maturities. The new Euro environment did not change this target; however, this goal is now conducted in a different context. The former role of strategically issuing a benchmark yield curve to help develop a domestic capital market disappeared; the new competitive environment in which government debt is managed has been driving it since then. A much larger domestic market, - the Euro - where twelve sovereign issuers compete, replaced the "protected" Portuguese Escudo market, and market participants now demand much more liquid and efficient markets.

Liquidity became, in fact, one of the most important factors behind the spreads displayed by sovereign debt in the Euro zone. An outstanding amount of no less than € 5 billion is commonly accepted as a first criterion of liquidity and the target size for Portuguese Treasury bonds was increased to this new threshold[10]. Due to the relatively low level of

[10] The € 5 billion standard corresponds to almost twice the average size of the Treasury bond lines issued before 1999.

the Portuguese gross annual borrowing needs, a gradual approach to achieving this goal has been followed. Since 1999, every year priority is given, firstly, to the launch of a new ten-year issue and, secondly, to a new five-year issue. These two maturities, backed by efficient derivatives markets, reflect the market's preference. In support of this strategy, most of the funding through marketable instruments has been channelled to the euro-denominated Treasury bond market (*Obrigações do Tesouro* – OT). To speed up this strategy, since 2001, the IGCP is also relying on an active buyback program aiming to refinance old issues (with small outstanding sizes and coupons not in line with current market yields) with on-the-run issues.

Feeding liquidity into the OT market[11] reduced the variety of instruments used to standard and plain vanilla fixed-rate bonds. The issuance of floating-rate bonds has been suspended and index-linked securities have been ruled out so far.

In the meantime, the access to the Eurobond market, which was regular before 1999, has been excluded. A Global Medium-Term Notes Program, in place since 1994, now plays the role of a *safety net* funding alternative and no new issue was placed after September 1999.

Although not always cost efficient on a short-term perspective, the priority given to the issuance of medium and long-term bonds, putting aside "opportunistic" funding alternatives, is conceived as a medium term strategy to reduce country vulnerability. Simultaneously, priority has been given to the development of efficient primary and secondary Treasury debt markets, making use of the most advanced technical infrastructures. Foreign and domestic financial intermediaries and final investors were all granted equal access conditions to these markets. This strategy is being rewarded by the increasingly widespread geographical distribution of the OT in the euro area and by its dispersion between buy-and-hold investors and active traders.

Government Securities Issuance and Primary Market Structure

Credibility is perceived to be a decisive feature whenever a market-driven funding strategy is followed. Transparency and predictability are, therefore, important pillars of the Portuguese debt management.

The strategic guidelines were not changed since 1999 and they are regularly explained to market participants, financial intermediaries and institutional investors in particular.

At the beginning of the year the components of the annual funding program are publicly announced, with particular emphasis on the issuance of medium and long-term tradable debt securities. The market is informed on the estimate of the annual gross borrowing requirements and the amount to be funded through the issuance of Portuguese Treasury bonds (OT). The amounts to be placed, the maturity and final size of the new lines, the mechanisms for placing the OT - syndication and auction – and the financial intermediaries

[11] Since 1999, the final size of each new OT line has on average been twice that of those issued up to that date.

to be involved are also announced. On a quarterly basis, a more precise calendar is published. The auctions have been kept fixed at the second Wednesday of each month, whenever there is room for such a placement.

About 75-80% of the gross borrowing requirements are funded through the placement of Portuguese Treasury bonds[12]. Short-term market instruments and non-tradable debt (savings certificates), issued on demand from private investors, account for the remaining 20%. The issuance of Euro-commercial paper is a backup alternative supporting the implementation of the Treasury bond program.

For liquidity reasons, the initial size of a new Treasury bond line corresponds to around 40% of the targeted final amount. Therefore the IGCP is using syndication when launching a new OT line. This option aims to achieve better control of the issue price and, at the same time, to further diversify the investors' base. The preference given to the placement of the initial tranche through syndication is due to the belief that it is the most effective way to simultaneously achieve significant size (more than 10 times the indicative amount of auctions held in 1998) and efficient and controlled pricing. Moreover, it also helps to achieve a wide and diversified investors' distribution, particularly within the Euro zone, and increases the visibility of the issuer's name and of its debt instruments. Furthermore, a syndicated structure makes it possible to target specific groups of investors and countries. New syndicated structures have been developed, giving increasing importance to the book-building process.

Leaving behind the traditional Eurobond placement, the IGCP has been closely monitoring the book-building process in all syndicated issues, demanding the investors' identity disclosure from the underwriters. More recently, the pot system approach was studied and has already been used.

Only the primary dealers (13 banks) can be invited to be underwriters of the syndicated issues. This is a privilege that not only rewards their commitment to the OT market, but also recognises that they are the financial intermediaries that know best the OT base of investors.

The OT initial tranche is increased through auctions thereafter[13]. Multiple-price electronic auctions are tentatively conducted once a month (and not every month). In 2000, the technical support to the auctions was radically changed. The fax system previously used for bidding was replaced by an electronic system: the Bloomberg Auction System (BAS). The BAS allows the auction participants to introduce and update bids until the cut-off time (strictly controlled) and have faster access to auction results, thus incurring in fewer risks. The possibility of monitoring the reception of bids in real time enables the issuer to reduce

[12] The features of the Portuguese Treasury bonds have been kept stable and the conventions used are in line with the standards of the euro debt market.

[13] The 1999 auctions were already three times larger in size than the previous ones; in 2000 the average size increased fivefold when compared with 1998 and between 1998 and 2001 the increase was sixfold.

the time needed for a decision on the allotment of each auction. Nowadays, the average time span from the bid cut-off time to the release of the auction results to the participants is less than 5 minutes[14].

The settlement of primary market transactions is carried out through efficient and internationally recognized CSDs (Euroclear and Clearstream), thus making the fulfilment of standard settlement cycles possible both for domestic and foreign investors.

Secondary Market for Government Securities

The development of an efficient primary market for Treasury bonds has to be supported by an efficient secondary market. In 1999, a special market for public debt was created, the MEDIP (the Portuguese acronym for "Special Market for Public Debt"), designed to be a regulated market under the Investment Services Directive. To create a highly efficient and competitive environment, an electronic trading platform was chosen. MEDIP operates under an MTS platform (MTS-Portugal), which went live on July 24, 2000, placing MEDIP in line with the most efficient European Treasury debt markets. This was a very important step in the reform of the Portuguese Treasury debt market.

As a result, three different segments now coexist in the secondary market : the exchange market, whose trading structure is mainly directed at the retail segment and the trading of small lots (this segment is traded in the Euronext Lisbon Stock Exchange and participants are those who have access to this market); the over-the-counter (OTC) market, which should offer maximum flexibility in terms of trading and registration of transactions; and the MEDIP, which aims to centralise wholesale trading by offering the most efficient conditions for this type of transactions, and where the most important players are the primary dealers.

The creation of the MEDIP and the adoption of the MTS model were decisions that fostered financial integration while preserving the national “location” of the wholesale Treasury debt market. The setting-up of MEDIP/MTS-Portugal therefore marked an important and decisive step in the modernisation of the Portuguese government debt market, a step promoting its efficient integration in the Euro financial market and, more broadly, in the

[14] Portuguese OT auctions include a competitive phase (whose participation is open to all primary dealers and other auction participants) as well as a non-competitive phase. Before every quarter, the IGCP releases an indicative calendar of the auctions, although the indicative amount of the auction is only confirmed slightly before it takes place. A predefined day of the month tends to be used. Each institution can make up to five bids, whose total value may never exceed the amount announced for the competitive phase of the auction. Participating institutions are informed of the bids that were accepted and of the overall results immediately after the close of the auction (on average 2/3 minutes after the cut-off time). The overall results of the auction are also immediately announced to all market participants via the IGCP pages in REUTERS (IGCP04) and Bloomberg (IGCP). The subscription for the non-competitive phase of the auction is made at the highest yield accepted in the competitive phase. The maximum amount each primary dealer can subscribe in the non-competitive phase corresponds to the percentage of its participation in the competitive phase of the previous three bond auctions, considering only the amount placed through primary dealers.

vast global market. This step, taken by the issuer and the primary dealers together, was the culminating point of a strategy that took almost three years to unfold. This ongoing dialogue, acknowledging the critical role of the primary dealers in developing the secondary market, was an outstanding feature of this process, namely leading to the selection of the most adequate electronic trading platform to be used.

Being a regulated market, MEDIP' s access and listing conditions, its governing rules and its code of conduct are non-discriminatory and subject to the approval of the Portuguese Securities Market Commission (CMVM). Prices formed on MEDIP are used as a reference for marked-to-market purposes. This market aims at wholesale proprietary trading among specialists. It uses a blind trading platform based on the electronic platform *MTS-Telemático*. It is managed by MTS Portugal, SMGR SA, a joint-stock company incorporated under Portuguese law and supervised by CMVM, with the following shareholders: IGCP 15%, MTS S.p.A. 15% and the primary dealers 70% (13 x 5.4%).

This market is driven by market-making obligations, settles with Euroclear/Clearstream and has access to repo trading facilities in EuroMTS/MTS Italy. Real-time prices are disclosed to non-participants in Reuters and a daily market bulletin is published via the Internet. The market-makers have the obligation to quote firm bid and ask prices for a set of liquid securities according to maximum spreads and minimum lot sizes. The market dealers can only take prices from market makers. The primary dealers must participate as market makers, while other participants can act either as market makers or market dealers.

The Primary Dealers Strategic Role

The Portuguese debt management relies on the critical role of the Primary Dealers. The primary dealership system was introduced in Portugal in 1993 but only in 1998 did the role of the Primary Dealers gain a new strategic dimension. By then, new selection rules were defined in order to limit the participation of each major domestic banking group to only one institution, thus inducing the development of critical mass on the domestic operators. Also in 1998, this status was first granted to non-resident banks. After 1999, the Primary Dealers were defined as the principal channel for distributing Portuguese debt and a network for the regular distribution of debt within the Euro zone was created.

The "primary dealer" status is granted for periods coinciding with calendar years and may be renewed annually, depending on the fulfilment of several duties. In order to be granted the primary dealer status, a bank has to fulfil a certain group of obligations *vis-à-vis* the market and the issuer[15], namely minimum quotas in primary and secondary market have

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[15] Duties of primary dealers

- Participate actively in bond auctions by bidding and subscribing a share no less than 2% of the amount placed at the competitive phase of the auctions;
- Participate actively on the secondary market for Portuguese Government debt securities, ensuring the liquidity of these instruments;

to be attained. Besides being invited to underwriters of syndicated issues, Primary Dealers are also granted exclusive access to non-competitive auctions[16]. The increasingly important direct contact between the issuer and final investors is also conducted in articulation with the Primary Dealers.

Counting with a credible and relatively stable group of Primary Dealers, with a recognised distribution capability (both within the Euro zone and worldwide) and committed in the long run to the development of the Portuguese debt market, the IGCP established an ongoing partnership for the continuous distribution of the Portuguese debt and for creating a liquid and efficient wholesale secondary market.

- Participate in the wholesale electronic market (MEDIP/ MTS Portugal) as market maker, maintaining a share not lower than 2% of this market's turnover in the previous two years;
- Participate as shareholder in the managing company of MEDIP/MTS Portugal;
- Operate as privileged consultants to the issuer in the monitoring of financial markets;

Rights of the primary dealers

- Participation in the competitive phase of the bond auctions and exclusive access to the non-competitive phase;
- Preference in the formation of syndicates;
- Access to the facilities created by IGCP to support the market, namely the "last resort" repo window facility;
- Preferential counterpart in the active management of the public debt;
- Privilege hearing in matters of common interest.

[16] Another group of banks can also have access to the auctions - the Other Market Participants (OMP) - but they are not allowed to participate in the non-competitive auctions.