Debt market development: challenges for the central bank in Poland

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1. The Polish Treasury securities market

The debt instruments issued by the Polish government to cover the budget deficit can be divided into two groups. The first consists of Treasury bills, short-term papers with maturities of up to 52 weeks in denominations of PLN 10,000. They are offered for sale on the domestic primary market at a discount in the American-style auction system every Monday. Secondary trading takes place in an unregulated OTC market. About 15 banks offer quotes. It is a well developed segment of the financial market in Poland, although its liquidity is declining due to the decreasing issuance of T-bills and the growing involvement of non-banking institutions that hold them to maturity.

The second group of debt instruments comprises Treasury bonds, long-term papers with maturity of up to 10 years, which come in various types (Table 1). They are issued through monthly American-style auctions. Only the entities having the status of a "direct participant" can bid in the auctions for Treasury bonds. Other market participants wishing to bid must do so through these intermediaries. Both T-bills and T-bonds are issued in dematerialised form.

Table 1

Classification of Treasury bonds

	Marketable	Non-marketable
Wholesale	2- ,5- and 10-year fixed rate bonds 10-year floating rate bonds	restructuring bonds
Retail	3-year floating rate bonds 5-year fixed rate bonds	2-year fixed rate savings bonds 4-year CPI-indexed savings bonds

At the end of 2000, the majority of Treasury securities outstanding were fixed rate marketable bonds. The liquidity of the T-bond market improved markedly in recent years, with gross turnover almost doubling since the mid-1990s. The most liquid T-bonds were those with a five-year maturity. The ten-year bonds were mainly bought by pension funds, which tended to hold rather than trade them.

2. Registration and the cost of trading Treasury bonds

Whereas T-bills are registered with the National Bank of Poland (NBP), T-bonds are registered with the National Depository System (NDS). T-bonds are traded on the Warsaw Stock Exchange, over the counter, and on a non-regulated interbank market. Transaction costs are much higher on the regulated market; as a result, 98% of the volume of transactions is carried out on the non-regulated interbank market. This has the following consequences:

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- the volume of T-bonds issued is much higher than their turnover;
- the costs imposed by the NDS discourage the use of repos and the system for outright trades. A double fee (sale and purchase) is charged on repos, making short-term repos prohibitively expensive;
- transactions made via the NDS, in theory, are on a DvP T+2 basis (net settlement in cash and gross settlement in securities); and
- some trades are cash-settled outside the NDS. Banks send the NDS an order to shift securities while transactions are settled separately through the banks' accounts with the central bank.

The NBP has purchased about 30% of the NDS. The NBP's representatives on the supervisory board of the NDS are pushing for appropriate action to promote market liquidity.

3. Legal and institutional aspects

Repo agreements have become the major instrument for liquidity management by financial market participants. However, T-bonds are not used for repo transactions, even though this is legally possible. This effectively reduces the amount of collateral available in the interbank market, and may increase marginally the cost of T-bond issue by increasing the liquidity premium. As the central bank has regulatory responsibility for the money market, it is supporting proper legislation contributing to the safety and transparency of financial markets. In particular, the NBP has worked with the Polish Banking Union to prepare a repo framework agreement so that market participants do not enter into repo transactions without sound legal documentation.

Another concern for the NBP is that there are as yet no regulations concerning securities lending agreements. The Civil Code in Poland does not recognise such a form of transaction. The law on the public trading of securities only allows for securities trading under the following conditions:

- the NDS may use securities lending in order to ensure the liquidity of transactions; and
- on the regulated market, only brokerage houses and banks conducting brokerage activities may conclude securities lending agreements for the purpose of short selling.

These legal circumstances make it difficult for the central bank to further stimulate development of the T-bond market.

4. Role of the central bank

The NBP influences the financial system and market liquidity not only by means of monetary instruments – credit and open market operations, obligatory reserves – but also through the payment system and supplementary instruments. For example, the NBP rates commercial banks for their activity in the Treasury securities market, and on this basis selects counterparties for its transactions.

With the ongoing globalisation of financial markets, maintenance of stability, liquidity and transparency in the financial system has become a vital function for the NBP. To fulfil this function, the NBP is actively cooperating with the Ministry of Finance in a number of areas. For example, the Ministry of Finance plans to introduce a primary dealer system in 2002, which is expected to help improve liquidity of the T-bill market by encouraging banks to carry out transactions on an electronic platform. The primary dealer system should also help boost market transparency by providing more information on quoted prices and making it easier for pension funds to value T-bonds.

5. Reform of the National Depository System

The NDS is concerned that introducing a primary dealer system may boost turnover to such an extent that settling transactions in seven cycles a day, as at present, would no longer be sufficient to meet the demand for settlement services. The introduction of multibatching has increased significantly the number of transactions settled in T+0. To support future demand for faster settlement, the NDS plans to implement a clearing and settlement system similar to RTGS in 2003. A separate “real-time” bond settlement module is expected to become operational by mid-2002. When implemented, this settlement module could make the existing net cash settlement method less attractive. During 2002 principles and procedures will be drawn up for the introduction of repo transactions in the depository-settlement system.