

The development of debt markets in emerging economies: the Saudi Arabian experience

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1. Background

Saudi Arabia has a short history of deficit financing. From 1983 to 1988 the budget deficit, resulting from falling oil revenues, was financed out of state reserves. Since mid-1988, government securities have been issued in the domestic market to fund fiscal deficits. The policy option has been to mobilise domestic savings with a view to developing a capital market. Saudi Arabia has not so far tapped the eurocurrency market for issuing its sovereign paper, but raised syndicated US dollar loans on two occasions during the 1990s. There are no restrictions on foreigners buying government securities through domestic banks, nor are there withholding taxes on coupon payments.

Government Development Bonds (GDBs), issued since mid-1988, carry fixed coupons payable semiannually. GDBs are offered to financial institutions every month in two-, three-, five-, seven- and 10-year maturities. Banks view GDBs as a hedge for their earnings against a decline in short-term interest rates, as a complementary asset to their loan portfolio, and as a means of meeting the liquid reserve requirement. Until December 1998, GDBs were priced off US Treasuries. Thereafter they were priced off the one-year Riyal Interbank Bid Rate (SIBID) to reflect domestic money market conditions. Faced with the yield curve inversion in the late 1990s and the fact that the banks use US dollar interest rate swaps as an alternative to GDBs, the pricing benchmark for GDBs was changed to these swaps (plus a discretionary spread) in November 2000.

In November 1991, Bankers Security Deposit Accounts (BSDAs – ie Central Bank Bills) were replaced by treasury bills, which are offered every week in various short-term maturities (one, four, 13, 26 and 52 weeks). T-bills are used for short-term cash flow management. BSDAs were identical to T-bills but their availability remained restricted to the banks, and the proceeds were not available for deficit financing.

Riyal Floating Rate Notes (FRNs) were introduced in late December 1996 to broaden the universe of available instruments and diversify the price risk. In developing countries where banks play an important role in mobilising domestic savings, FRNs suit the banks' balance sheet structure, particularly in a rising interest rate environment. For the issuer, FRNs are financing tools attracting longer maturities at short-term funding cost. FRNs are offered every month in five- and seven-year maturities at a variable coupon of 3-month Saudi Interbank Offered Rate (SIBOR) plus a spread.

Government debt securities are issued in book entry form in SAR 1 million denomination. For retail buyers, the minimum purchase is SAR 50,000. Holders can enter into a repo agreement with the debt manager (the Saudi Arabian Monetary Agency, or SAMA) for up to 75% of their gross holdings. The interbank repo market is expected to be operative shortly upon completion of relevant repo agreements between the banks. Domestic banks display GDB prices on their Reuters pages.

2. Debt management policy objectives and techniques

The main objectives of debt management are listed below.

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Broadening the range and the distribution of government debt instruments

This objective deals with covering the government's gross borrowing requirements and ensuring its continued access to financial markets. Gross borrowing requirements may consist of financing a gap between expenditure and revenue in a given period and/or needs for refunding maturing debt. Saudi Arabia's borrowing requirements have remained confined to financing budget deficit and/or refunding maturing debt from domestic sources. There is a fair amount of diversity in debt instruments offered to the market in the form of T-bills, GDBs and FRNs. Debt management has not been used to support monetary policy, such as by issuing more debt to mop up excess liquidity. Nor has foreign currency borrowing been used to strengthen the country's foreign exchange reserves.

Effective management of selling operations

One important aspect of this complex question is that debt managers generally attempt to reconcile the following objectives:

- to realise quantitative borrowing targets; and
- to obtain the lowest possible issue cost under given circumstances.

Achieving these objectives may often imply that government debt operations should not disrupt the smooth functioning of financial markets. A relatively wide range of debt instruments and timing of issues are helpful in maintaining orderly market conditions and minimising borrowing costs. Saudi Arabia offers floating and fixed rate instruments with different maturities to satisfy investor preference in terms of product and maturity. The product composition has been instrumental in raising the required amount of funding from the captive sources in the domestic market. Government debt instruments are issued at relatively short intervals. Given sharp fluctuations in the level of subscription, SAMA chose to raise the issue size to accommodate sporadic oversubscriptions, but lately the issue amount has been left open, as this is effectively determined by the market. In the event of undersubscription or weak investor interest, there would be no devolution on SAMA.

Minimising borrowing cost

This objective is of special significance to countries where interest payments on outstanding debt have become an important item in the government's budget. In Saudi Arabia, attention has remained focused on raising the required funding from captive sources at coupons/yields set by the debt manager. The justification for price fixing was the concern that a small group of banks acting in concert could manipulate the market. An argument in favour of applying an auction technique is that the debt manager does not have to take a decision vis-à-vis the market on the issue yield. In the absence of an auction/tender system, it would be difficult to judge the appropriateness of the cost of borrowing, though the availability of fixed and floating rate instruments gives the issuer flexibility to use them over the interest rate cycle.

Borrowing costs can be reduced by applying "privileged circuits" either in the form of mandatory investment regulations or in the form of offering tax privileges on income from government securities. There could thus be short-term cost savings to the government but long-term efficiency losses for the economy as a whole (as part of the borrowing cost burden would be shifted to other borrowers). Saudi Arabia has preferred to stay away from mandatory direction of investment. In the absence of formal underwriting and distribution commitments by market-makers, the obvious saving to the issuer is the incentive fee but the hidden cost is an illiquid secondary market.

Maturity structure

This objective calls for avoidance of a heavy bunching of maturing debt, redemption payments and refunding operations in particular periods during the year. The longer the average life of debt, and the more balanced the distribution of maturity and amounts, the smaller the refunding needs in a particular year. Saudi Arabia has endeavoured to spread its debt across the curve by accommodating the longer maturity profile of autonomous government institutions in a bid to avoid the bunching effect and subsequent crowding for refunding.

Secondary market

The existence of efficient secondary markets for government securities facilitates the successful launching of new issues. Other objectives of debt management, such as smoothing bond price movements and minimising the impact of redemption payments, may also be facilitated if open market operations/interventions can be conducted in well functioning secondary markets. Saudi Arabia suffers from a weak secondary market. In our experience, the inefficiency of the secondary market is a reflection of a narrow investor base, a short-term investment culture and the absence of investment banks. The growth in Saudi Arabia's primary market size is not a reflection of a liquid secondary market but has to do with the availability of adequate captive sources of funds.

SAMA has so far addressed the "product" (the instrument design) by improving the issuance mechanism, such as tap issues to create size, a full maturity spectrum for duration management, fixed and floating coupons to diversify price risk, and the availability of a repo facility for day-to-day liquidity management. On the "distribution" side, much has to be done. This subject is currently being discussed with the banks, particularly the issue of primary dealership and incentives against their underwriting and distribution commitment. A detailed discussion on product distribution is given in section 4 below.

3. Interaction between debt markets and banks

Banks continue to have a unique place within the financial system. They operate with a wide variety of assets and liabilities. Recently, financial intermediation has undergone a profound transformation in developed markets due to changes in the global financial system. In developing countries, banks still play a preponderant role in financial intermediation.

A system in which capital markets are the principal means of corporate finance is very different from one in which loans or credits predominate. In well developed markets, high-quality borrowers often raise funds by approaching investors directly (disintermediating the banks). Where there is less institutional specialisation and a limited secondary market, as is the case in emerging debt markets, a loan-based system of corporate finance remains pronounced.

In Saudi Arabia, money market operations are confined to bank deposits, repos and foreign exchange swaps. Bank-guaranteed commercial paper, first issued in 2000, has yet to gain popularity with both investors and borrowers. Banks are now focusing on fee-generating business. As far as bank balance sheets are concerned, there was a major shift in the asset composition of Saudi banks during the 1990s. For instance, banks' aggregate loans accounted for 34% of total assets in June 2001, compared with 39% at end-1996; investments rose to 43% from 29% and interbank deposits declined to 12% from 23%. Almost 30% of banks' assets are in the form of government securities. It may be noted here that the banks are not coerced into investing in government debt instruments. While recognising the developmental role that banks can play in relation to the debt market, it is also important to note that greater involvement of commercial banks in the secondary market can expose them to risks which may not be prudent. It is for this reason that in many countries there is a strict separation of commercial banking functions from market-related activities.

Saudi banks tend to run unhedged interest rate exposures as their holdings of government securities are largely booked in investment accounts, which are marked to cost. Occasionally, the banks hedge their trading account portfolios using the US dollar futures market and/or fixed versus floating interest rate swaps, given the limitations of riyal hedging instruments. Since the underlying instrument and the hedge are in different currencies, this is not a perfect hedge. Indeed, the basis risk in such cross-hedgings could be substantial.

4. Liquidity of government bond markets: an ongoing challenge

Secondary markets play an important role in providing liquidity in times of a "cash crunch" by broadening the investor base. Efficient secondary markets are important for ensuring in the long run a successful marketing and distribution of government securities. A major condition for the development of secondary markets for government securities is a sufficient volume of outstanding government debt

and its wider distribution. A second major condition for secondary markets is the existence of private financial intermediaries prepared to quote two-way prices and deal in specified amounts in both rising and falling markets.

The distribution of government debt instruments is largely reactive in developing countries, and Saudi Arabia is no exception. In the Saudi context the main constraints on secondary market activity are:

- *Banks' market-making role.* Banks and selected financial institutions, which are regular investors in government bonds, generally prefer to "hold to maturity". This is understandable for financial institutions, which are end investors. But the banks, despite the diversity of their business, are still overwhelmed by the commercial banking philosophy – ie size of deposits, balance sheet growth and asset quality. These considerations result in a conflict of interest between retaining deposits and marketing GDBs at the expense of their deposit base. This pattern is quite in contrast with the investment banking approach. In the absence of monetary incentives, banks are reluctant to undertake investment banking functions such as underwriting and distribution commitments. SAMA is currently reviewing this issue. Logically speaking, it is essential that brokerage firms/security houses (whether subsidiaries of commercial banks or independent firms) be allowed to operate in the domestic market for dealing in GDBs and conducting investment banking business. With professional market-makers, the secondary market will be able to fulfil the role assigned to it.
- *Investor base.* Saudi Arabia has a narrow investor base. Apart from the banks and a few financial institutions, retail investors and corporations prefer short-term money market instruments. This attitude has to do with their short-termist investment culture and lack of awareness about the product risk/reward relationship.

A few suggestions have been floated for improving liquidity in the secondary market. One is to market GDBs to retail investors through SAMA branches, with a provision to buy them back after expiration of a specified initial waiting period. This might encourage the banks to speed up their marketing efforts and over time take over from SAMA branches. But the banks, which are already complaining about autonomous government institutions' direct GDB dealings with SAMA (as it takes a major source of secondary market activity away from them), might consider this approach as a further encroachment on their market-making commitment. Retail distribution may be important from a public policy point of view, but its contribution to developing a secondary market may prove to be a non-event. In the grand scheme of things, it is imperative to focus on institutional flows, as these matter the most in creating liquidity in the secondary market.

Another suggestion is to direct financial institutions to invest in GDBs. In some emerging economies, banks and other financial institutions are required to invest up to a quarter of their assets in government debt instruments. In the interest of free market workings, Saudi Arabia has refrained from imposing direction of investment on domestic financial institutions. There is, however, a substantial pool of money in the form of end of service benefits (ESBs) which remains untapped for the lack of regulatory framework. ESBs, which are deferred liabilities of employers, are not funded. Any social security reform should take into account the treatment of ESBs so that they are fully funded and the pool so created is available for long-term investment.

Finally, the setup of mutual funds in Saudi Arabia largely caters to investor interest in foreign markets. Mutual funds, which are well suited to retail investors, should have a home bias in terms of design and marketing in order to mobilise domestic savings into the fledgling debt market. The ratio of GDB mutual funds to Government debt is a meagre 0.7%.

- *SAMA as market-maker.* In emerging markets, central banks also play a defined market-making role in government debt instruments. They undertake open market operations as a tool of public debt management, particularly in facilitating switch/swap programmes of banks and other financial institutions. SAMA has stayed away from this role to avoid being caught up in buying huge volumes of outstanding GDBs, particularly in a rising market when the banks would seek to realise profits. SAMA's reactive role has remained confined to meeting day-to-day liquidity needs of the banks through repos or draining excess liquidity through reverse repos. According to the memorandum of understanding (MOU) between SAMA and banks, SAMA would, at its discretion, swap issues with the banks provided the maturity differential did not exceed three months. Swap maturity mismatch restrictions and SAMA's discretion rendered the MOU largely ineffective in its application. SAMA may revisit its role

- and revise its strategy in terms of open market operations, without hampering its monetary policy.
- *Monetary policy versus debt market.* In Saudi Arabia, monetary policy revolves around the stability of the dollar/rial exchange rate. Exchange rate targeting necessitates tracking dollar interest rates closely regardless of the inflation differential (of about 1½%), which is supportive to the riyal. In a disinflationary environment, the investor focus remains on the shape of the yield curve rather than the level of interest rates. Lately, the steepness of the curve resulting from aggressive global monetary easing has enhanced the attraction of longer maturities. SAMA, as the central bank and debt manager, has a delicate balance to strike between the cost of borrowing to the issuer and its other roles. SAMA conducts government debt operations within a given overall financing task in such a way that undesirable liquidity effects are avoided. SAMA refrains from conducting monetary policy to support the government debt market, but this policy consideration should not be confused with open market operations in the context of public debt management.
 - *Infrastructure.* Saudi Arabia has an efficient clearing and settlement infrastructure. Saudi Arabian Interbank Express is an advanced payment system based on real-time gross settlement. Shares are traded via an electronic trading system, called Tadawul, which provides a continuous, order-driven market. Bonds, which are currently traded via telephone, are expected to be included in the electronic trading system next year. Unlike the sophisticated technical infrastructure, the regulatory and operational framework is fragmented. Capital market laws are being finalised, and this should be a welcome development in terms of rendering credibility to the securities market in Saudi Arabia. With regard to the central issue of distribution, there is a pressing need to overhaul the existing market-making structure by introducing investment banking operations in Saudi Arabia and expanding SAMA's role in open market operations.

5. Concluding remarks

The Saudi Arabian government debt market shares the shortcomings of many emerging markets in terms of debt distribution and secondary market liquidity. During the last decade, SAMA and banks jointly worked to identify factors needing to be addressed. Initially, the focus was on broadening the range of instruments in terms of coupon characteristics and maturities, followed by creating a sizeable volume of outstanding debt in a single issue through “tap issues”. Pricing of issues went through evolutionary changes to reflect the market dynamics. As it stands, the instrument design appears to have the features required for secondary market trading. However, the distribution conundrum stands in the way of secondary market liquidity. Obviously, the narrow investor base, poor publicity, the absence of investment banks and SAMA's passive role in open market operations have not been helpful to secondary market trading. Any discussion of corporate bonds at this juncture may be premature before the relevant concerns/constraints affecting government bonds are adequately addressed.