

DANMARKS NATIONALBANK

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New primary dealer model continues in 2018

- The central government's primary dealer model with enhanced requirements and payments has strengthened the market for Danish government securities. That is the background for maintaining the model with payments in 2018.
- The model has contributed to a more liquid market for government securities and hence to lower financing costs for the central government.
- Liquidity has been increased through narrower bid-ask spreads and a higher number of banks actively trading Danish government securities.

The new primary dealer model that was introduced in 2017 has contributed to a more liquid market for government securities and hence to lower financing costs for the central government. Therefore, the model continues in 2018 with the adoption of the Finance Act with total payments to the central government's 11 primary dealers not exceeding kr. 25 million. The amount is unchanged relative to 2017.

The primary dealer model has been a success

Experience with the new primary dealer model is good. Liquidity in the market for Danish government securities has improved, which has contributed to lower financing costs for the central government. This is reflected in e.g. the narrowing of the 10-year yield spread to Germany since the model was announced in early 2017. The spread at end-November was lower than the equivalent spread in the Netherlands, cf. Chart 1. The Netherlands usually has the lowest spread to Germany among countries in the euro area.

Narrowing of 10-year yield spread to Germany

Chart 1



Note: Par yield spreads.
Source: Nordea Analytics.

The narrowing of the yield spread can be attributed to several factors, but is partially assessed to reflect a better-functioning market for government bonds with enhanced price transparency and lower transaction costs for the investors. If the model is assumed to have reduced financing costs by just 1 basis point, this corresponds to a saving of around kr. 50 million on government bond issuance in 2017¹. This should be viewed in the light of the total annual appropriation to primary dealers of kr. 25 million in 2017. Add to this the positive response from market participants and the most important investors, who report that the market is better-functioning and that more banks are trading actively. Moreover, a liquid market for government securities has a positive contagion effect on the rest of the Danish bond market, which uses the government yield curve as a price reference.

Enhanced price transparency and higher turnover

In the interdealer market, where the primary dealers quote prices to each other, the bid-ask spread has narrowed markedly. Since the model was announced, the spread for 10-year government securities has decreased from around 0.3 price points to less than 0.1 price points, cf. Chart 2. This matches the most liquid markets for government securities in Europe. A similar narrowing has been observed for the other Danish government securities. This enhances price transparency and makes trading in Danish government securities cheaper.

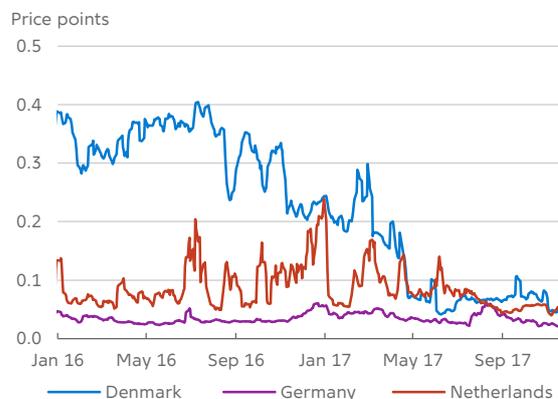
At the same time, turnover in the interdealer market has increased, cf. Chart 3. One reason is that it has become considerably cheaper to hedge customer transactions in the interdealer market due to sharper price quotation.

More banks are actively trading government securities

The purpose of the primary dealer model is to increase the banks' involvement in trading Danish securities, especially in the middle group of banks. Over a number of years, turnover in Danish government securities had increasingly become concentrated on a few active primary dealers. Since the model was introduced, turnover has been distrib-

Narrowing of bid-ask spreads for 10-year Danish government bonds

Chart 2

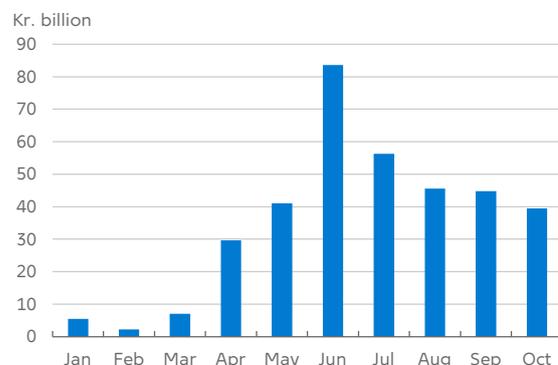


Note: 5-day moving averages of bid-ask spreads for 10-year government bonds.

Source: MTS (Denmark and the Netherlands) and TradeWeb Germany.

Increased turnover in the interdealer market

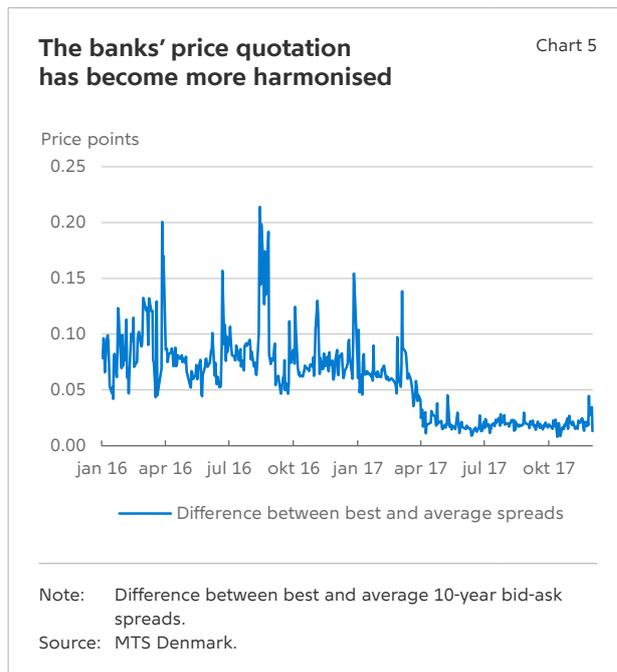
Chart 3



Note: Turnover in the interdealer market for Danish government bonds.

Source: MTS Denmark.

¹ The central government has issued kr. 66 billion in 2017 with an average maturity of 7.5 years. A 0.01 per cent decrease in financing rates yields a saving of kr. 50 million (kr. 66 billion * 7.5 years * 0.01 per cent).



uted on more primary dealers, cf. Chart 4. This may reflect, inter alia, that more banks quote narrow prices and that price quotation among the banks has become more harmonised, cf. Chart 5. A broad group of actively trading banks contributes to intensifying competition for servicing investors and ensuring a robust distribution channel for the central government.

Adjustment of the model in 2018

It is positive that the element of differentiated remuneration according to the banks' price quotation has generated competition for quoting tight prices. However, price quotation has become so sharp that several banks have found it difficult to meet the model's minimum requirements for price quotation. Today, they are set on the basis of prices from the three banks that quote the narrowest bid-ask spreads. It is considered expedient to ease the requirements a little by setting lower limits for the bid-ask spreads that the banks must quote to meet the requirements in 2018, cf. Box 1. The aim is for the central government to continue to have a broad group of primary dealers. The price quotation requirements will still be stricter than before the introduction of the new primary dealer model and at a level not seen since the financial crisis in 2008. At the same time, the share of remuneration for meeting the minimum requirements is reduced from 20 to 10 per cent. The banks will still have an incentive to compete for quoting tight prices, as 40 per cent

Payments to the central government's primary dealers

Box 1

The central government has concluded agreements with 11 primary dealers in Danish government bonds on market making and distribution and marketing of Danish government bonds. The remuneration has been set at maximum kr. 25 million for 2018. In order to receive payment, the primary dealers must meet minimum requirements for price quotation (prices, amounts and time) on a monthly basis. The bid-ask spread must not exceed 1.5 times the average of the three best primary dealers' bid-ask spreads, but with a lower limit. Remuneration is based on the following criteria:

Fulfilment of minimum requirements for price quotation (same for everyone):
10 per cent (kr. 2.5 million annually)

Ranking according to price quotation (distributed according to position):
40 per cent (kr. 10 million annually)

Customer turnover (distributed by share):
50 per cent (kr. 12.5 million annually)

of the remuneration is distributed on the basis of ranking the price quotation beyond the minimum requirement.

The model has had a substantial impact on price transparency and turnover in the interdealer market, but the same effect has not yet been seen on turnover with end-investors in the market for government securities. Against that background, the model's share of remuneration for customer turnover will be increased from 40 to 50 per cent in 2018, cf. Box 1. The total appropriation to the primary dealers is unchanged.

ABOUT ANALYSIS



As a consequence of Danmarks Nationalbank's role in society we conduct analyses of economic and financial conditions.

Analyses are published continuously and include e.g. assessments of the current cyclical position and the financial stability.

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BANKING AND MARKETS



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