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Enhanced Requirements and Payments are to strengthen the Danish Government Securities Market

- For a trial period, the central government is introducing annual payments of up to kr. 25 million to banks that quote prices on a current basis and act as distribution channels for Danish government bonds. At the same time, requirements for the banks are enhanced.
- This is expected to contribute to a more liquid market for government securities and hence to lower funding costs for the central government.
- Liquidity is to be increased through narrower bid-ask spreads and more banks trading actively in Danish government securities.

From 1 April 2017, the central government is introducing payments to banks that quote prices on a current basis and act as distribution channels for Danish government bonds, i.e. function as primary dealers, cf. Box 1. Total payments will amount to a maximum of kr. 25 million p.a. The banks making the greatest efforts will receive the largest payments.

The aim is to improve liquidity in the market for Danish government securities. When liquidity is high,

Primary dealers help to sell Danish government bonds

Box 1

The central government financing requirement is met by selling bonds via 11 Danish and international banks – the “primary dealers”. The banks use their sales networks to resell the bonds to Danish and foreign investors. In this way, the central government gains access to a broad distribution network.

The banks and the government have a mutual interest in ensuring that the market for Danish government securities functions as well as possible. In a highly liquid market, it is easier for the banks to sell bonds to investors, and the central government can obtain the most inexpensive financing. To ensure liquidity, the primary dealers have an obligation to quote bid and ask prices for Danish government securities on a current basis.

it is easier for investors to sell the assets again. This reduces the return required by investors. Therefore higher liquidity contributes to lower yields and hence to lower funding costs for the central government.

The total annual payments of up to kr. 25 million will be distributed among the primary dealers according to two main criteria: price quotation in the interdealer market and turnover with customers, cf. Box 2. At the same time, the requirements for primary dealers will be enhanced.

Primary dealers are influenced by global tendencies

Trade in the international financial markets is changing. Following the financial crisis, many banks have adjusted their business models in response to new financial regulation, technological advances, etc. A major change is that the banks have become more selective when it comes to using their balance sheets. This is also seen in the market for Danish government securities, where several primary dealers have reduced their turnover.

In Denmark, liquidity deteriorated in 2015, when the government temporarily suspended sales of government securities in order to support the fixed exchange rate policy. Since sales of government bonds were resumed, liquidity has gradually improved, but remained lower in 2016 than before the suspension of issuance.

Payments to primary dealers

In other countries, primary dealers typically receive compensation for quoting prices for government bonds on a current basis and acting as distribution channels. For example, payment may be received in the form of fees in connection with issuance (syndicated loans), or primary dealers who buy bonds at auctions may be granted options to buy more bonds on the following days on the same terms as at the auctions (non-comp options). In Sweden, primary dealers are also compensated directly under agreements resembling the new Danish primary dealer agreements.

In Denmark, banks have previously received compensation, but only in connection with the issuance of foreign loans. In the period 2008-14, the central government paid out fees averaging kr. 25 million p.a. In 2015 and 2016 the central government did not need to raise foreign loans to support the foreign exchange reserve, and hence the primary dealers did not receive any payment.

Distribution of payments to primary dealers

Box 2

The rights and obligations of primary dealers are specified in agreements with the Danish government. On 1 April, the agreements will be updated to include the terms and conditions for payments. Payments of up to kr. 25 million will be distributed among the central government's 11 primary dealers according to the following criteria:

- Fulfilment of a number of minimum requirements for price quotation.
- Ranking according to price quotation.
- Turnover with customers.

In the new agreements, requirements will be tightened so that each primary dealer is to a larger extent measured relative to the best price quoters. At the same time, the best price quoters are rewarded, which provides a stronger incentive to quote the sharpest possible prices. The primary dealers will receive payment on the basis of their turnover with customers so that those who are able to attract investors are rewarded.

Intended effects of the new payment agreements

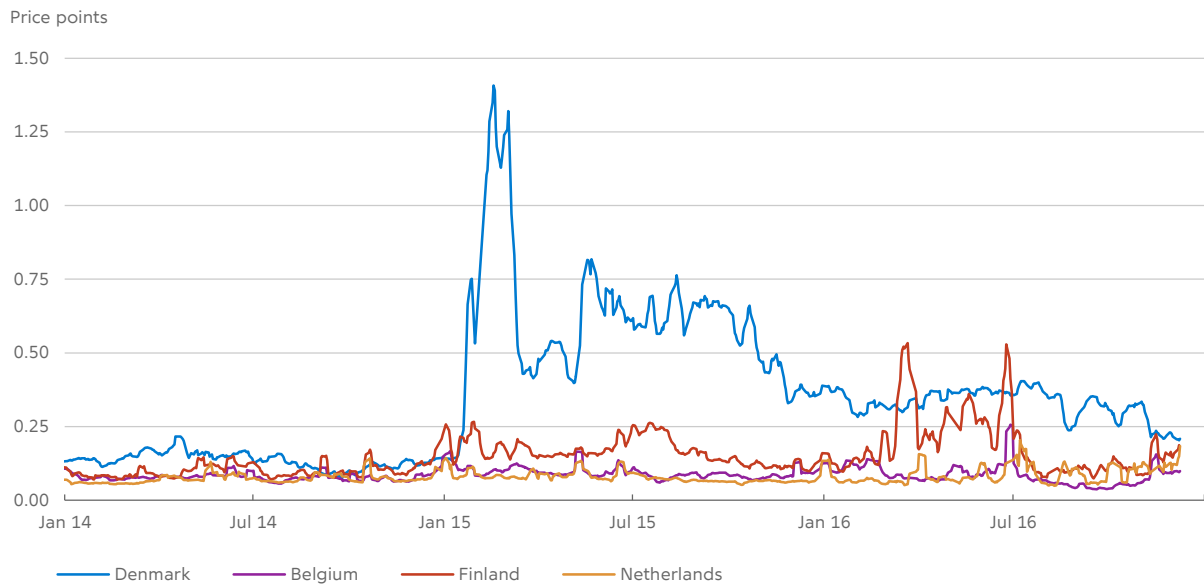
Danish government securities are primarily attractive to investors because the credit rating of the Danish government is very high. But it is also important to investors that the securities are so liquid that they can rapidly be purchased or sold without any substantial costs. This is generally the case in the market for Danish government securities, but there is room for improvement. The new agreements aim to improve liquidity in three areas: Narrowing the bid-ask spread, faster market recovery after episodes of market turmoil and more active primary dealers.

Narrowing the bid-ask spread

On the electronic trading platform where banks trade Danish government securities with each other, a number of indicators point to price transparency and market liquidity being lower than what has previously been observed. For example, the spread between bid and ask prices remains wider than in comparable countries, cf. Chart 1. This leads to increased uncertainty about the current market price and higher costs for purchasing and selling Danish government securities. The new agreements provide a financial incentive to quote the closest bid-ask prices so that uncertainty about the market price is reduced. Increased price transparency will contribute

The bid-ask spread was wider than in comparable countries in 2015-16

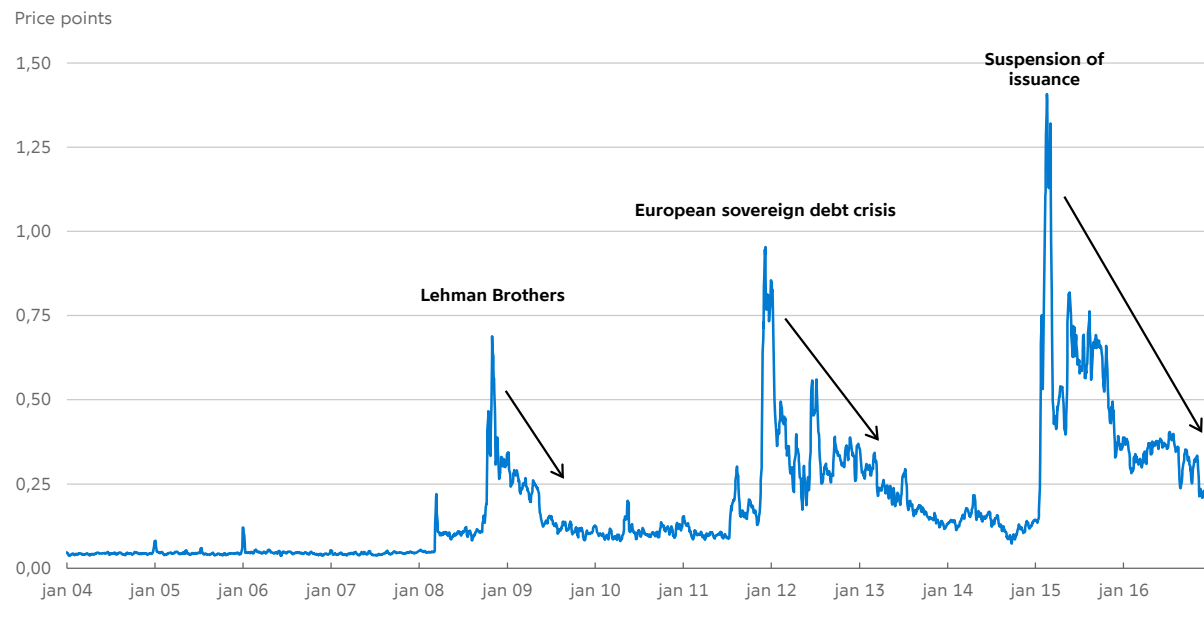
Chart 1



Note: Bid-ask spreads for 10-year government bonds in the interdealer market. 5-day moving averages.
 Source: MTS Denmark.

The bid-ask spread adjusts slowly after periods of market turmoil

Chart 2



Note: Bid-ask spread for 10-year government bond in the Danish interdealer market, MTS Denmark. 5-day moving average.
 Source: MTS Denmark.

to making it less risky for individual primary dealers to quote current prices and be a temporary counterpart vis-à-vis other primary dealers or investors. Sharper prices make it easier and cheaper to trade, reduce the return required by investors and contribute to lower funding costs for the central government.

Faster recovery after episodes of turmoil

When the financial markets are hit by turmoil, the spread between bid and ask prices widens rapidly and substantially, while it takes much longer to return to a normal level, cf. Chart 2.

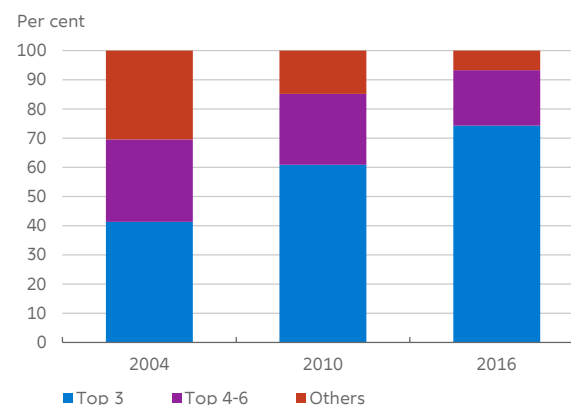
In order to boost the dynamics, the requirements for current price quotation have been tightened in the new agreements. The limit for the maximum bid-ask spread is calculated on the basis of the best three price quoters, whereas the previous model was based on the average for all price quoters. This should help to ensure that the other banks to a larger extent follow suit when one or more banks lead the way and reduce the bid-ask spread.

More active primary dealers

Turnover in Danish government securities is increasingly been concentrated on a few active primary dealers, cf. Chart 3. This development has unintended consequences for the government and investors, which become dependent on a few banks. The new agreements focus mainly on increasing the level of activity among the top 4-6 banks. Hence, the agreements have been structured so as to give banks in this particular group a clear financial incentive to increase their activity. This will sharpen competition to service investors, ensure a broader distribution channel for Danish government securities and contribute to giving end-investors the best possible terms.

Concentration on primary dealers has increased

Chart 3



Note: Share of aggregate turnover in the Danish interdealer market.

Source: MTS Denmark.

An evaluation will determine whether the new agreements will continue

The new primary dealer agreements will be evaluated on the basis of whether the bid-ask spread has narrowed, whether more banks trade actively in Danish government securities and whether the market recovers more rapidly after episodes of turmoil. This should result in improved liquidity for end-investors. For this reason, the evaluation will also take into account whether investors experience an improvement of the market for government securities. On the basis of the evaluation, it will be decided whether the new primary dealer agreements are to continue or to be adjusted after 2017.



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