

## Offering debt securities

*Q 7-04. What are the key issues in state debt securities distribution?*

The essential concerns of sovereign debt management involve choosing which securities are offered, to whom they are offered, and what type of transaction will be used to distribute them.

The choices for securities and customers are closely related. The state may choose to offer retail-level certificates that are sold in small denominations chiefly to individuals or it may offer securities designed for fixed income markets. This decision will have a significant impact on the scale of financing and the denominations of the instruments.

In either case, the state may opt to use agents or intermediaries to distribute or place the securities rather than undertaking the work itself. These agents may assist in the sale outright of the securities, in underwriting a distribution, or in managing a private placement of the debt. Each method has its own advantages and strategies.

*Q 7-04.01. What are the principal types of market securities for debt?*

The most common debt instruments issued by sovereign governments can be classified into a small number of categories. Debt instruments can be nominal securities, with their value only dependent upon market interest rates and term to maturity, and linked securities, with their value dependent upon market rates, term to maturity, and the value of some other reference index or rate. For the former, their value if held to maturity is known at the time of issue; this is not true for the latter.

Nominal securities that offer no periodic coupon payment are sold at issuance at a discount to their par value that is paid at maturity. Short-term, usually one-year or less, discount securities are referred to as treasury bills. Longer-term discount securities are referred to as zero-coupon bonds.

Nominal securities that offer a periodic coupon payment are coupon debt. They may be referred to as notes or as bonds. The distinction usually is tied to the term to maturity with bonds having maturities beyond ten years from the date of issue. Whether the debt is sold at a discount, a premium, or at its par value at issuance depends on whether the coupon rate is less than, exceeds, or equals the market interest rate for a security of this quality and term.

Linked securities are frequently tied to some index of prices or inflation.<sup>1</sup> This is done by adjusting the principal by the relative increase in the price index since issuance. These securities use a fixed rate for coupon payments; the amount of the payment varies with the inflation-linked increases in principal.

While linked securities, especially the inflation-linked debt, protect the buyer from losses due to purchasing power erosion, floating rate notes protect the buyer from interest rate movements that would erode relative earnings or the market value of the asset. The coupon rate on floating rate debt is tied to another rate such as, an interbank lending rate or the rate on shorter-term money market instruments, with, in many cases, a fixed spread, or differential. The floating rate is revised at set intervals to re-establish the relationship with the reference rate.

*Q 7-04.02. Are there risk considerations in the selection of debt instruments?*

For nominal securities, the risk of loss caused by changes in the market value of the instrument is borne by the buyer of the instrument. With linked securities and floating rate notes, the government issuing the security retains some risk. In the case of the former, the stream of interest payments and principal payments may be greater than anticipated. For the latter, the financing cost in interest will be less predictable.

*Q 7-04.03. How might benchmark issues be chosen?*

There are several theories about the factors that shape the yield curve. Two of these are the market segmentation theory and the related preferred habitat theory. In each, it is argued that different populations and markets exist at points along the yield curve. The term of the security, the size of the market for that term, and the volume of demand for that security (sometimes with near substitution of similar tenors) characterizes how much debt can be sold at each point on the yield curve. In this case, the relative size of each market should guide the selection of benchmarks and allocation of offering amounts across the portfolio. Because of the need to understand the demand at points along the curve, it is good practice to consult with various parties in the market, including dealers, banks, and the central bank, for assessments of the market at these points.

*Q 7-04.04. What additional information should guide benchmark choices?*

In selecting benchmarks, it is important to balance the size of the market at each point with the size needed to maintain liquidity. If too many benchmarks are chosen given the amount that needs to be borrowed, the individual benchmark issues may be spread too thinly along the curve. The resulting securities may lack

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<sup>1</sup> Other types of linkages have surfaced occasionally. One such example is the linking of bond principal to GDP as a means of tying bond repayment to ability to pay.

the requisite volume to provide liquidity to the market. The resulting illiquidity will hamper trading and development of a robust market. It may be wiser to maintain liquid sizes by using fewer benchmarks with more market depth than too many of them.

*Q 7-04.05. How can yield curve information mislead decisions?*

The generally upward slope of the yield curve can tempt sovereign issuers to focus on issuing debt at shorter maturities because the rates are lower; this is not a sufficient reason for concentrating on the short end. The lower financing cost must be balanced against the risk of a failure to rollover the debt. Shorter-term securities will require a return to the market more frequently.

*Q 7-04.06. Can a favorable bond issue point on the yield curve be reused?*

Individual issues of a benchmark can be brought to the market more than once by issuing additional amounts of a previously issued bond. To do this, the original documentation for the bond issue should state that the issuer might borrow additional sums later by issuing further bonds on the same terms -- the same face value, maturity date, and coupon rate -- as the initial issue, but at the current market price. This procedure is referred to as a bond reopening or a bond tap.

Although the maturity date, security identifier, and coupon rate are unchanged, a reopened bond has a different issue date and usually a different purchase price that reflects current market yields. The buyer of a reopened bond must pay the accrued interest that the bond earns from the original issue date.

Issuing debt in this manner has advantages. Tap issues allow a borrower to avoid some transaction or legal costs associated with a new bond issue and expedite fund raising by sale or auction of the new securities. Issuing on tap is often suited for smaller fund-raising attempts, where the cost of a new issue is too high compared to the amount borrowed.

These methods increase the size of an outstanding issue. This might be done to make the issue more liquid when the size of an issue needed to achieve liquidity is larger than the amount that can be absorbed by the market in one distribution.

One caution is needed. The market should be prepared at the original issue with a good sense of how much additional supply of a debt issue will follow in subsequent actions. Uncertainty about the total supply or a market unprepared for additional supply may lead to balking by lenders for future issues. This may express itself as additional price concessions required by the buyers or in an inability to cover an issue.

*Q 7-04.07. Should debt be issued for specific asset acquisition?*

The principle of asset-liability management is to avoid mismatches between the durations of assets and liabilities and their respective flows of income and expenditure. The problem has often arisen when an entity lends long-term or acquires a long-term asset while using short-term borrowing to finance it. Solutions to the problem have included matching the assets and liabilities according to the maturity pattern or the matching the duration, by hedging and by securitization.

In the question of state debt, it might seem fair to assume that when borrowing is undertaken to finance specific assets, the liabilities should match to the expected asset life. This may not be a valid conclusion because of the discussion above, especially in consideration of liquidity issues. It is not advisable to issue special debt simply to finance a particular asset. Such an issue is likely to have a decreasingly liquid market over time. Special issues also suggest that there may be incomplete fungibility between different debt issues from the same sovereign. Instead, a state should develop its series of benchmarks to fill out the yield curve as practical within the constraints of liquidity of issues as discussed above.

*Q 7-04.08. What are the considerations for a state issuing retail debt?*

Retail debt instruments often involve higher cost of operations relative to the money received for the instrument. They are often issued as registered definitive issues rather than as bearer certificates or in book-entry form. Their operational inefficiencies, however, should be weighed against their social benefits. Retail debt provides a savings option for citizens when the banking system or other entities are not available to encourage the habit of saving and investment. Retail debt of the state also may provide a focus for national unity or identification. Finally, retail debt may offer a rudimentary basis for the development of a domestic market.

