European Stability Mechanism

Accessing sovereign markets – the recent experiences of Ireland, Portugal, Spain, and Cyprus

This discussion paper collects the experiences of former EFSF/ESM programme countries in rebuilding investor trust and returning to normal market access.

Coordination by ESM with contributions from heads of Debt Management Offices of Ireland, Portugal, Spain, and Cyprus

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Foreword

Every European government needs market access. It needs to be able to finance itself at affordable prices on financial markets. To most, market access seems unproblematic and is normally taken for granted. The daily work of Debt Management Offices (DMOs) rarely becomes front-page news. During the euro crisis, this critical market access broke down or was restricted in Ireland, Portugal, Spain, Cyprus, and Greece.

Euro area countries granted each of these countries financial assistance to enable them to re-establish or consolidate that market access. A key role of the temporary rescue fund, the European Financial Stability Facility, and later the permanent rescue fund, the European Stability Mechanism, is to facilitate that process. The rescue funds' financial package entails economic adjustment programmes that overcome structural weaknesses or imbalances and loans at favourable conditions to rebuild investors' trust and overcome restrictions to market access.

This discussion paper shares the experiences of several of these euro area countries as they sought, successfully, to re-establish or consolidate full, affordable market access. The first section sets the stage for the subsequent country sections. It presents an overview of the European sovereign debt crisis and market access of peripheral countries. The country sections are written by the heads of the DMOs and therefore present a first-hand practical account of the respective country's debt management strategy. They substantiate key market conditions, issuance profiles, interaction with primary dealers and investor relations.

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Executive summary

During the crisis, some countries were not able to cover all their financing needs in financial markets or do so at a sustainable cost.

A defining feature of the euro crisis, which we experienced over the past few years, is that market access broke down for some countries or was impaired. Some countries could not find sufficient investors to cover their needs or could not do so entirely at a sustainable cost. In the past crisis, this happened to Greece, Ireland, Portugal, Spain, Cyprus. This discussion paper collects the experiences of several of these euro area countries as they developed strategies to regain access to affordable financial market financing.

The ability of DMOs to secure market access towards the end of the EFSF/ESM progamme is a necessary condition for a successful exit.

Euro area governments created a crisis resolution framework that included the European Financial Stability Facility (EFSF), and European Stability Mechanism (ESM), to help countries regain market access. Governments undergo adjustment programmes or undertake measures to repair the banking sector – that is, to "bring their house in order" and regain investors' trust. For the programme period, a country's financing gap is covered by the EFSF/ESM. During this period, DMOs managed to keep to different degrees some limited market financing and importantly had to launch a strategy to regain full market access.

This paper looks at how these countries approached market financing during this difficult period.

By now, four of the five countries that underwent an EFSF or ESM programme have successfully exited. The objective of this discussion paper is to document the steps which DMOs in Ireland, Portugal, Spain, and Cyprus took to structure their financing during the programme period, where possible, and the strategy they launched in approaching domestic and international bond markets.

There were similarities and differences in the DMO strategies, with all countries ramping up investor relations and embarking on innovations.

Approaches to regaining market access in Ireland, Portugal, and Cyprus show similar phases. It starts with a renewed ramping up of communication and investor contacts, opportunistic issuances and then more broad-based bill and bond issuance. Spain maintained broader market access over the programme period and therefore deviates in this respect. However, interestingly, all countries embarked on some innovation in their investor relations, products or issuance technologies, when comparing the pre- and post-programme period. The differences reflect both each country's specific market conditions and common factors. An important commonality seems to be the reliance on a sizeable cash buffer as an assurance for investors if a country re-enters markets at a sub-investment grade rating.

Market access strategies are not deployed in isolation, but their success hinges on domestic and European policies. First, firm and credible programme implementation is a key condition for gaining investors' trust and successfully accessing markets. Second, the EFSF and ESM terms of lending at concessional rates and very long maturities facilitate private sector engagement in the programme and post-programme period. Third, monetary policy crucially determines market conditions. The impact of low interest rates and the European Central Bank's quantitative easing programme can hardly be over-emphasised in explaining investor demand and yields for former programme countries.

Credible programme implementation is key to regaining investor trust and market access.

The DMOs from Ireland, Portugal, Spain, and Cyprus contributed their experiences to this paper. They explain and put in context their strategies to regaining full market access. Presenting the DMOs' account on market access of former programme countries fills a gap in the narrative of the country experiences through the crisis. It also offers lessons to better understand market reactions and DMOs' capabilities which may be helpful in the future.

This discussion paper offers an overview of DMO experiences and provides lessons for in the future.

The European sovereign crisis and market access of peripheral countries – an overview

Juan Rojas, European Stability Mechanism

The creation of the European Monetary Union (EMU) aimed at establishing a macroeconomic framework in which member states would benefit from higher nominal stability in their economies, and improved coordination and governance of their economic policies. This macroeconomic environment would promote deeper integration of markets and improvements in growth, employment creation, and the well-being of its citizens.

The creation of EMU and the benefits of financial market integration

The single currency brought new strengths and opportunities arising from the integration and scale of the euro area economy, making the single market more efficient. Before the introduction of the euro in 1999, the need to exchange currencies meant extra costs, risks, and a lack of transparency in cross-border transactions. Hence, the single currency was a key step towards the creation of the single financial market. Its introduction removed obstacles to free capital flows. The euro also resulted in a rapid expansion and integration of European bond and money markets. The process of higher financial integration triggered a trend towards an increasing standardisation of instruments and issuance policies which materialised in the increased use of benchmark bonds at 10-year tenor which, among other developments, increased the average maturity of public debt. In addition, issuers in the euro area became more transparent and predictable by announcing debt management strategies and issuance calendars.

Since the introduction of the euro, cross-border bank deposits have increased, the yields on government bonds and the interest rates on retail loans have converged. The enhanced availability of credit brought many economic benefits and for those who were from the outset strong believers in the positive effects of the euro's introduction, it was rewarding to see the period of prosperity that followed from 1999 to 2008.

The emergence of imbalances causing the crisis

Growth momentum and improvement in incomes occurred in tandem with the generation of huge imbalances. Peripheral countries, which had lower initial per capita GDP, enjoyed higher GDP growth rates than the core, driven by a relatively higher contribution from domestic demand. That was financed by huge credit flows to the real economy, particularly to the real estate sector, which also facilitated the accumulation of large stocks of debt in the private sector. Demand-driven growth created important current account deficits (mostly due to the deterioration of the trade balances) that were in part financed by the current account surpluses from the core. The underlying rigidities in peripheral economies implied that the rebound of domestic demand translated into important inflation differentials and a wage growth pattern that was not in line with productivity, with the implied further deterioration of competitiveness. All this process was accentuated by the weakness of spending and containment of costs and prices in the core, which initially had a higher GDP per capita. The integration of financial markets eased the flow of funds from surplus to deficit countries and, until 2008, interest rate spreads narrowed and resulted more from differences in liquidity of bond markets than a risk differentiation among sovereigns.

Weak surveillance together with easy and cheap deficit financing in the weaker economies, meant that the appropriate incentives for the promotion of the needed structural reforms were lacking as was a sufficient sense of urgency in correcting the imbalances. The combination of the global financial shock with the underlying imbalances and vulnerabilities resulted in a cross-border funding shock. This resulted in financial re-fragmentation and exposed the accumulated imbalances which were reflected in an abrupt change in markets' assessment and pricing of risk. Market participants began to differentiate among euro area countries as never before, with these changing views mirrored in the evolution of the spreads on the 10-year sovereign bond yields. All these developments led to higher funding costs and roll-over risk for sovereigns and financial institutions, which had to face increasing difficulties to pledge sovereign securities as collateral. Hence, debt managers adjusted their issuance procedures and techniques so as to cope with volatile and highly uncertain issuance conditions, increased competition in raising funds due to the increasing need to borrow, at times unexpectedly (due to, for instance, the execution of guarantees) and, as reflected by decreasing bid-to-cover ratios, lack of demand. These conditions obliged issuers to adapt their funding strategies and triggered a downward trend in the average maturity of public debt with the associated increase in roll-over risk. Eventually, these developments resulted in some issuers losing market access to medium- and long-term bonds (Ireland, Portugal, Cyprus, and Greece).

Ireland

The first country that received financial assistance from the EFSF, which was founded in June 2010 as temporary crisis resolution mechanism, was Ireland. Following the adoption of the euro, Ireland experienced a massive credit-driven housing boom and housing prices increased sharply. When the housing bubble burst, general government revenues fell and the public deficit escalated. More importantly, the banking system started suffering liquidity problems and Irish banks were shut off from international capital markets. In this context, in September 2008 the Irish government provided public guarantees to protect financial sector creditors in an attempt to mitigate the impact of the liquidity challenges.

Two years later, in September 2010 (anniversary of the blanket guarantee to financial institutions), a further deterioration in liquidity conditions and economic fundamentals, including the housing sector, ultimately cast doubt on the solvency not only of the banking system but also of the sovereign, as demonstrated by a sharp increase in 10-year Irish bond yields to almost 7% in September from 4% in March 2010. The process culminated in November 2010 when the government requested financial assistance from the IMF, EFSF, and EFSM. Ireland agreed a financial package of €85 billion, made up of €17.5 billion in own resources and €67.5 billion in external resources. The EFSF provided €17.7 billion. Originally, the EFSF loan to Ireland carried a margin of 247 basis points over the EFSF's funding costs with a maximum average maturity of 7.5 years.

Portugal

In contrast to the Irish case, Portuguese banks managed to handle the initial stages of the crisis relatively well given their low exposure to toxic assets and the absence of a housing bust. Before the crisis, however, Portugal had suffered from a prolonged period of low GDP growth and loss of competitiveness which also triggered a sharp deterioration in external indebtedness. In addition, government debt that was at 62% of GDP in 2004 climbed to levels above 90% of GDP in 2010. In this context, 10-year government yields started to increase in early 2010, and by April 2011 they were hovering at around 9%, a level hardly consistent with debt sustainability.

Given the increasing funding pressures and the downgrade of the sovereign to BBB- by S&P, Portugal had to suspend the issuance of medium- and long-term debt and requested financial assistance from the EFSF/EFSM and the IMF in May 2011. The size of the financial assistance package was €78 billion, of which the EFSF contributed €26 billion. At the programme's outset, it was agreed that Portugal would pay a margin of 208 basis points over the EFSF cost of funding, with a maximum average maturity of 7.5 years.

Initial monetary policy reaction

At the onset of the crisis in October 2008, with the aim of dissipating concerns about the ability of financial institutions to obtain liquidity, the ECB moved from variable rate tenders, minimum bid rates, and fixed allotments towards a procedure characterised by a fixed rate with full allotment. In terms of interest rate policy, the ECB also cut the rate of the Main Refinancing Operations from 4.25% at end 2008 to 1% in early 2009 and repeatedly changed the interest rate corridor. In November 2008, the central bank also changed the terms of lending to financial institutions by implementing three- and six-month Long-Term Refinancing Operations (LTROs) with full allotment.

The monetary conditions under which Portugal entered the programme were then characterised by a hesitant ECB reaction as demonstrated by the stability of the balance sheet over the same period of time. In fact, the ECB hiked interest rates to 1.25% in April 2011 from 1%.

As crisis sentiment spread, EFSF/EFSM lending terms adjusted

To facilitate the strategy of regaining market access and given the continued financial market pressures on peripheral countries in which 10-year bond yields had jumped above 13% in Ireland and Portugal, the lending terms of the EFSF and EFSM loans to both countries were adjusted in July 2011: the maturity was extended to 15 years and the loan's margin reduced to 0 basis points. Developments in sovereign bond markets during the summer of 2011 reflected financial contagion as several euro area countries were affected by market turmoil, including a repricing of counter-party risk among financial intermediaries. The increasing stress among sovereign and banks was reflected in upward pressure on funding costs and roll-over risk as well as in higher levels of market volatility.

Subsequently, on 4 August 2011 the ECB Governing Council announced that the provision of liquidity to banks by means of full allotment at fixed rates would be extended until at least early 2012. It also announced a further longer-term refinancing operation with a maturity of six months. These measures were aimed at supporting bank funding, which should have enabled banks to continue lending to households and non-financial corporations. In addition, on 7 August it was announced that the ECB would again begin actively implementing the Securities Markets Programme (SMP). This programme had been introduced in May 2010 to support the transmission of monetary policy decisions given impaired functioning in some segments of the financial markets, with a view to ensuring price stability for the euro area as a whole. In fact, no purchases had been made under the programme since end-March 2011. The decision to start buying bonds again was taken in view of the significant risk of some government debt securities markets becoming dysfunctional and tensions spreading to other markets.

Between August 2011 and the beginning of November 2011, the debates about private sector involvement and the second adjustment programme for Greece pushed contagion also to Italy and Spain and triggered another wave of financial market jitters. These last two countries were also facing an uncertain political climate. On 8 November, the Italian Prime Minister said that he would resign his office after budget reforms were passed, and the results of the general elections in Spain on 20 November 2011 triggered a pause in the escalation of yields as more technocratic governments took over. The Spanish 10-year bond was at 6.72% on 25 November 2011, but receded to 5.19% on 5 December 2011. In this context, the ECB made available two three-year LTROs, the first in December 2011 and the second in February 2012. In addition, it also triggered a new wave of interest rates cuts. These developments eased funding constraints of financial intermediaries. They were being impacted by rapidly reversing cross-border private capital flows, demonstrated by growing divergence in target II balances within the Euro-system, and somehow moderated sovereign risk. In February 2012, the Eurogroup agreed on the second bailout package for Greece with private holders of Greek government bonds accepting a haircut.

Spain

The uncertain result of the Greek election in May 2012 in which no party gained a decisive majority and the increasing concerns about the break-up of the euro area paved the way to renewed peripheral bonds jitters. These culminated in the summer of 2012 when the Spanish 10-year bond yields reached historical highs, at 7.58% on 24 July 2012. These developments resulted in Spain and Cyprus requesting financial assistance on 25 June 2012. In the case of Spain, the financial support materialised in a Financial Assistance for the Recapitalisation of Financial Institutions by the European Financial Stability Facility (EFSF). The Heads of State and Government at the Euro Area Summit of 29 June 2012 specified that the assistance would subsequently be taken over by the European Stability Mechanism (ESM), once this institution was fully operational, without gaining seniority status. The Memorandum of Understanding (MoU) was signed on 23 July 2012.

The housing and construction bubble that built up until 2008 was fueled and accommodated by rapid lending of the Spanish banking sector. After this bubble burst, many Spanish banks came under severe stress and higher scrutiny from domestic and international financial markets. Large accumulated stocks of problematic real-estate assets as well as the relatively low capitalisation of some banks, especially the savings banks, have given rise to concerns. Despite a series of reforms and measures adopted by the authorities to restructure and recapitalise the Spanish banking sector, the severity of the challenges facing Spanish banks and market pressure remained elevated. It became evident that to deal effectively with the impaired assets of banks linked to the real estate bubble and to more broadly restore the viability of the Spanish banking sector, sufficiently large and credible external assistance was necessary.

Cyprus

In Cyprus, large imbalances also accumulated over time. In this case, an oversized banking sector far exceeding the needs of the domestic economy was a distinct feature. The financial sector accumulated excessive risks by extending loans to an overheating domestic real estate sector and to Greek residents, and by investing in domestic and Greek government bonds. This investment flow was financed by large and volatile foreign deposits. When the housing boom in Cyprus came to a halt and the Greek recession deepened, profitability weakened. The Greek debt restructuring dealt another heavy blow to banks' balance sheets.

By mid-2012, the Cypriot banks had become severely undercapitalised. A due diligence analysis of the banks' balance sheets finalised in early 2013 revealed capital needs of close to 60% of GDP needed to cover existing and future losses and a buffer for shocks. Given the already vulnerable fiscal position of the sovereign, with public debt over GDP around 80% at end 2012, and market access lost since mid-2011, it became apparent that financial assistance would be needed. The European Institutions and the IMF agreed on an economic adjustment programme with the Cypriot authorities on 2 April 2013.The euro area Member States approved the programme on 24 April 2013. The Programme aimed at addressing the financial, fiscal and structural challenges facing the economy that would allow Cyprus to return to a sustainable growth path and to regain market access. In line with the EFSF/ESM concessional lending terms, the amortisation of the ESM loan was scheduled to start only in 2025.

Euro break-up fears and policies facilitating sovereign market access

The requests for external financial assistance from Spain and Cyprus, and the pressures on Italian yields, fueled fears of a possible euro breakup. To dissipate the concerns about such a possibility, the ECB first announced on 2 August 2012 the possibility of implementing unlimited interventions in government debt markets. The technical features of such interventions were further approved by the ECB's Governing Council on 6 September 2012. The objective was to safeguard appropriate monetary policy transmission and the singleness of monetary policy. The possibility of the ESM intervening directly in the primary market (PMP) underpinned these steps.

A necessary condition for Outright Monetary Transactions (OMT) was strict and effective conditionality attached to an appropriate EFSF/ESM programme. The modalities considered were a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they included the possibility of EFSF/ESM primary market purchases. It was also specified that OMT would not only be considered for future cases of these types of EFSF/ESM programmes, but also for Member States under an existing macroeconomic adjustment programme as long as they had regained bond market access. Transactions were announced to be focused on the shorter part of the yield curve, on sovereign bonds with a maturity of between one and three years, with no ex ante quantitative limits. Following the specification of the technical details, the Securities Markets Programme (SMP) was terminated and the existing securities in the SMP portfolio would be held to maturity.

Despite the fact that the OMT was never activated, Draghi's "whatever it takes" pledge abated convertibility risks and led to a sharp downward correction of 10-year peripheral sovereign yields. These developments were accompanied and further reinforced because the results of reform efforts in programme countries became more apparent. By March/April 2013, euro area Member States agreed to further lengthen the weighted average maturity of the EFSF loans to Ireland and Portugal, to up to 22 years from 15. These measures were instrumental in supporting the process to regain full market access given the induced changes in the size of gross financing needs in the years ahead. Together with a strong track record of implementation of the reform agenda as agreed in the MoUs of the four countries under consideration, support from the ESM/EFSF's beneficial lending conditions in the form of very low lending rates and long maturities further supported the sustainability of public debt and created the fiscal space needed to start regaining market confidence.

Country experiences in regaining full market access

Despite the different time frames in which the four countries under consideration had to face the challenges of regaining either market access (Ireland, Portugal, and Cyprus) or broader investor confidence (Spain), the support of the ECB, the concessional features of EFSF/ESM lending agreements, and a strong record in programme implementation, are the key common factors that triggered the normalisation of sovereign issuance activity in the medium- and long-term segments. There are also commonalities in the specific strategies countries followed in the process of regaining market access (Ireland, Portugal, and Cyprus).

The first step involved transparent communication with market participants on programme implementation to regain the confidence of investors who had sold their positions in medium- and long-term bonds due in part to their exclusion from the relevant market indexes. This was followed by an effort to re-activate or resume the issuance of T-bills through auctions at increasingly higher maturities, opportunistic transactions of longer tenors or switches aimed at smoothing the maturity profile in the years following the programme exit, and efforts to lower refinancing risks. The initial attempts to issue medium- and long-term debt were usually implemented through syndicated bonds at 5-year tenor and more diversified products (like amortising bonds aimed at better targeting of investor preferences). The final stage sees a return to a regular schedule of bond auctions. During this process, the role of a cash buffer to avoid issuance pressure at times of market volatility is a key feature in countries downgraded to sub-investment grade. Efforts to increase the efficiency of the system of primary dealers is also important. Cyprus is an exception to the latter, as it does not yet have such a system although the authorities plan to introduce one as soon as possible. The role of primary dealers appears of paramount importance to provide liquidity in secondary markets, regain the confidence of investors, and better target investor demand.

That was also the case in Spain, although it never lost market access. Between 2009 and 2012, as is usually the case in crisis episodes, the Spanish Treasury's issuance profile weighed towards the short and medium part of the term structure. The crisis-driven reliance on short-tenor issuance reduced the average life of the portfolio and increased annual redemptions. However, the timing of primary-market issuance did not change significantly during the crisis. The Treasury continued to adhere to an auction calendar announced at the beginning of each year. As in the other countries, economic policy produced its desired outcome and more stable financing conditions allowed for a gradual normalisation of the funding programme allowing for the issuance to shift towards longer tenors. At this later stage, the monetary conditions have been instrumental in normalising sovereign markets in the euro area following the ECB decision on 22 January 2015 to expand the asset purchase programme to include secondary market eligible public sector securities.

The strategies in all countries managed to increase public debt's average maturity, a process facilitated by the long maturity of EFSF/ESM loans, as no country has to start repaying principal before 2022.

Country experiences: Ireland, Portugal, Spain, and Cyprus

Ireland

Frank O'Connor, National Treasury Management Agency

Introduction

Ireland made a full return to bond markets in 2014, following the end of its three-year EU/IMF Programme. It completed a number of important steps on the way.

There were three distinct stages in Ireland's market access strategy: preparatory work, phased re-entry and normalised market access. The first step involved intensive communication with market participants. It was important that the Irish Government could show credible adherence to its fiscal consolidation plans. A recapitalisation and overhaul of the Irish banking system was also necessary. This was followed by short-term issuance, opportunistic switches and product diversification. The final stage saw a return to a regular schedule of bond auctions.

Ireland's debt dynamics are now sustainable. The National Treasury Management Agency (NTMA) has completely returned to sovereign markets and is focused on funding at sustainable rates while managing market liquidity.

Historical context – from low debt levels to banking crisis

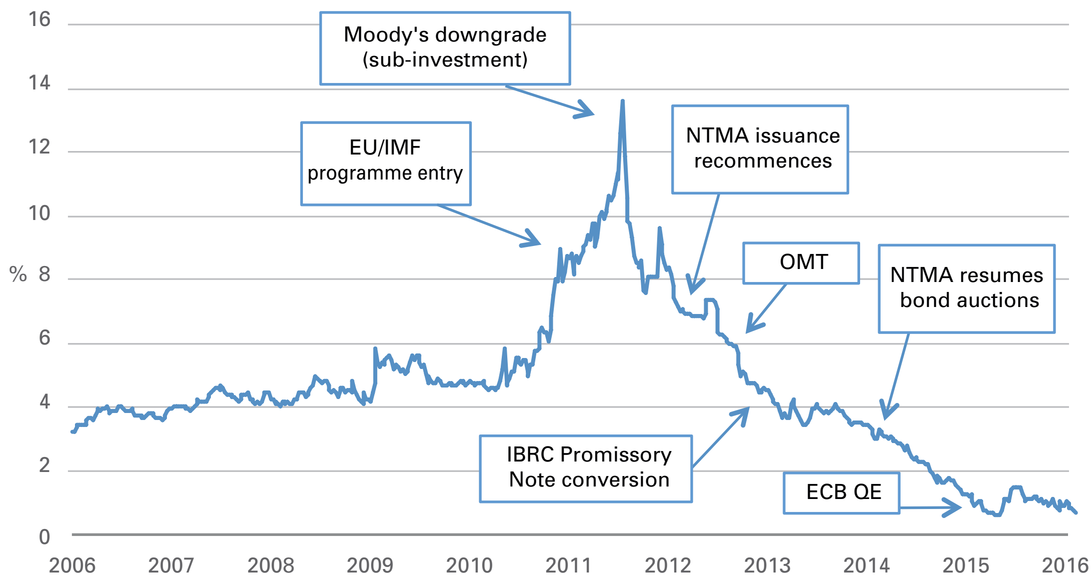
The size and composition of Ireland's General Government Debt (GGD) has changed significantly since the early 2000s. For example, in 2006 GGD amounted to only 25% of GDP. This debt was largely comprised of fixed-rate bonds and retail debt products. While economic growth was close to 6%, this growth was credit-fuelled and unsustainable.

Ireland's property bubble burst in 2007 and then it was hit by the 2008 global financial crisis. Its domestic banking system nearly collapsed. The Government was ultimately forced to recapitalise the pillar banks, following the blanket guarantee of September 2008. It provided up to €64 billion to the banks to restore their capital base.

Economic conditions were stressed: Nominal GDP contracted by 10% in 2009, while unemployment rose to close to 15% of the labour force at the peak. Many considered the Government debt to be on a dangerous trajectory, given the sheer scale of banking-related contingent liabilities.

Liquidity conditions in the banking system deteriorated and Ireland's Government bond market came under severe pressure. Ten-year bond yields began to increase rapidly towards 9%. The State had no option other than to withdraw from financial markets and ultimately enter a financial assistance programme in November 2010. This programme was designed to cover the State's financing needs until end-2013.

Figure 1: Irish 10-year government bond yields (2006–2016)



Source: Bloomberg

EU/IMF Programme

The Government agreed, on 28 November 2010, to a three-year financial support programme for Ireland by the EU and IMF. The programme amounted to €85 billion, with €17.5 billion of this coming from Ireland's own resources – its National Pension Reserve Fund.

External support amounted to €67.5 billion, which comprised:

- €22.5 billion from the IMF Extended Fund Facility;
- €22.5 billion from the European Financial Stabilisation Mechanism;
- €22.5 billion from the European Financial Stability Facility (€17.7 billion) and bilateral loans from the United Kingdom (€3.8 billion), Sweden (€0.6 billion) and Denmark (€0.4 billion).

Table 1 shows the financing needs and the funding sources from 2011 to 2015. In previous years Ireland's small funding requirements were largely met through the issuance of government bonds. However this was covered by official programme funding during the 2011–2013 period. Once normal market access was restored, the NTMA was once again able to finance its borrowing requirements through a combination of bonds, short-term paper and retail funding.

Table 1: Funding requirements and sources (2011–2015, € millions)

	2011	2012	2013	2014	2015
Opening "free" cash balance	12,308	12,961	19,275	18,432	11,148
Funding requirements:					
EBR	-18,363	-13,341	-11,497	-8,183	-62
Bonds and other MLT debt maturities	-4,789	-6,045	-9,828	-7,106	-5,632
Banks capitalisation – Exchequer and NPRF	-16,550	-1,550			
IMF			-11	-8,957	-9,138
Bilateral			-2	14	81
EFSM					-10
STP (including T-bills)	-4,046	-2,251	-8,987	-9,295	-11,201
Promissory note settlement		-3,060			
Other	-1,542	-943	-555	1,414	677
Funding sources:					
IMF	12,574	6,436	3,477		
EFSF	7,597	4,559	5,667		
EFSM	13,854	7,768		797	
Bilateral	482	2,473	1,916		
NPRF	10,000				
Government bonds & other MLT	0	8,124	8,167	12,412	13,930
Retail funding	1,436	2,120	1,864	859	364
STP (including T-bills)		2,023	8,946	10,760	9,470
Other					952
Closing "free" cash balance	12,961	19,275	18,432	11,148	10,579

Source: NTMA

The Programme of assistance gave Ireland breathing space, yet it faced huge challenges. For the NTMA the technical difficulties included reduced credit lines from market counterparts and requirements for daily collateral margining.

The steps undertaken by Ireland to regain sustainable market access are outlined below. This is divided into three stages – preparatory work, phased re-entry and normalised access.

Phase I: Preparatory work – communication, fiscal and banking overhaul

During the preparatory work phase, communication with investors and wider market participants was key. Despite being locked out from private debt markets, the NTMA led Ireland's re-engagement with investors and rating agencies. Ireland's story had become complicated and needed to be explained.

The NTMA analysed its potential investor base and identified investors who were more willing to bear risk, such as credit and emerging market investors. In time, these potential buyers would prove to be vital for Ireland's initial market return. Maintaining strong relationships with primary dealers was also an important part of the strategy. This was difficult in an environment when Ireland was not issuing debt. Primary dealers were important for their market knowledge, secondary trading role and significant investor connections. By maintaining close relations with them, they remained engaged and were prepared when bond issuance restarted.

The NTMA completed its first non-deal roadshow in May and June 2011, despite the reservations of some of its primary dealers. This trip unearthed some critical investors that sparked the market recovery from the bottom in July 2011. After that, the NTMA covered each main investor centre in Europe and North America twice annually and visited Asia and the Middle East at least once. The aim was to deliver a consistent and realistic message, and to outline the path to recovery. The NTMA adopted the mantra of "under-promise" and looked to the Government to "over-deliver". The quarterly targets of the Troika Programme lent themselves ideally to such a strategy.

Internal communication with other official institutions was also imperative, to continue meeting the EU/IMF programme targets and deliver on the fiscal reforms as promised. The Government put in place the necessary policies to address the banking crisis and the widening budget deficit. Fiscal consolidation was based on a four-year plan (The National Recovery Plan 2011-2014).

In March 2011, the Government introduced a large recapitalisation of the pillar banks – Bank of Ireland, Allied Irish Bank and Permanent TSB. A restructuring of the banking sector was also undertaken. This finally helped Ireland to deal with investor concerns about contingent liabilities.

Debt sustainability had now become a major problem, given further banking costs. The Government's four-year plan outlined the path towards a primary budget surplus, which would stabilise debt as a percentage of GDP. Remarkably, this was achieved by 2014: quite a turnaround from the primary deficit of 10% in 2009.

Ireland's Government bonds remained under pressure until the low of July 2011. Ten-year bond yields peaked at 14%, while spreads over Germany were 11 percentage points. Other European countries were facing similar crises – including Greece and Portugal, which had also entered programmes of financial assistance.

Rating agencies had significantly downgraded Ireland's sovereign rating. Moody's reduced the rating by five notches in December 2010. The rating was further cut to sub-investment grade in July 2011. Many investors panicked during this period, in anticipation of the fall to sub-investment grade. They were concerned that there would be a haircut applied to Irish government bonds, if further financial bailouts were necessary.

A return to full market access was not achievable in 2011, yet the NTMA maintained a presence in the Euro Commercial Paper (ECP) market. This enabled the NTMA to raise short term money and to stay in contact with both primary dealers and market participants. Retail debt also remained an important funding source during this period, with an outstanding balance of €14.1 billion at end 2011. This represented over 7% of the General Government Debt.

The late summer of 2011 marked the watershed. The European lenders cut lending rates on their loans to Ireland, and the EFSF and EFSM extended the duration of their loans This further helped debt sustainability. Secondary markets were also assisted, as US investors bought Ireland's Government bonds in large size. Many of these were investors the NTMA had met as part of its roadshows. They believed they were being well rewarded, given the probability of Ireland repaying its debt obligations in full.

Phase II: Phased re-entry – short-term debt and opportunistic issuance

By 2012, Ireland had built a track record under the EU/IMF programme. The banking reforms and fiscal consolidation of 2011 were increasingly recognised by the market. The NTMA communicated this progress to market participants in a systematic way through non-deal roadshows, conference calls and email updates. Market prices began to recover. This allowed Ireland to start its phased re-entry into the debt market.

During this stage, the NTMA looked for opportunities to undertake strategic issuance and switching activity, gradually moving to longer term instruments. This started with a switch in January 2012. Ireland exchanged €3.53 billion, or 30% of the outstanding 2014 bond, for a new 2015 bond. This was an opportunistic transaction. The timing was favourable and was linked to the introduction of a three year LTRO facility by the ECB. This helped to address the challenging funding cliff in January 2014, where almost €12 billion of debt was due to mature one month after the slated end of the Troika Programme.

Interaction with primary dealers was an important aspect of this phased market access. A meeting was held with all primary dealers to discuss Ireland's issuance strategy. Their expertise was requested, to interact with investors and help prepare the market for short-term issuance by Ireland. The reaction from investors was strong. Many restored credit lines and showed keen interest in investing in Ireland. There was an increasing faith in the fundamentals of the economy.

In July 2012, the NTMA resumed auctions under its short term Treasury bill programme. The first T-bill auction saw three-month money issued at 1.8%. These auctions continued throughout 2012 and 2013, with rates falling quickly as market presence was re-established and the recovery took hold.

Table 2: Treasury bill auctions 2012

Date of Auction	Maturity	Amount (€ million)	Yield (%, annualised)
5 Jul 2012	3 months	500	1.80
13 Sep 2012	3 months	500	0.70
18 Oct 2012	3 months	500	0.70
15 Nov 2012	3 months	500	0.55

Source: NTMA

Further switching activity was undertaken in July 2012. Investors were given the opportunity to switch their holdings of shorter-dated 2013 and 2014 bonds into a new 5-year bond (October 2017), or an existing bond maturing in October 2020. New money of €4.19 billion was raised on an outright sale basis, while a further €1.04 billion was accounted for by switches.

Diversification

Another aspect of the road-map for market access was to diversify sources of funding. The issuance of amortising bonds was undertaken to achieve this. These bonds pay an equal amount each year comprising of interest and principal. They were primarily aimed at the domestic pension industry, which had a preference for long-dated bonds and a steady income stream. A total of €1.02 billion was issued in 2012. The maturities ranged from 15 to 35 years. The average yield was 5.91%.

Ireland updated its EMTN programme documentation, in order to be "issuance ready" for any other opportunities. Options considered under the EMTN programme included inflation-linked bonds and US dollar issuance. Ultimately, these alternative options were not exercised, as the core market recovered and other funding options became available.

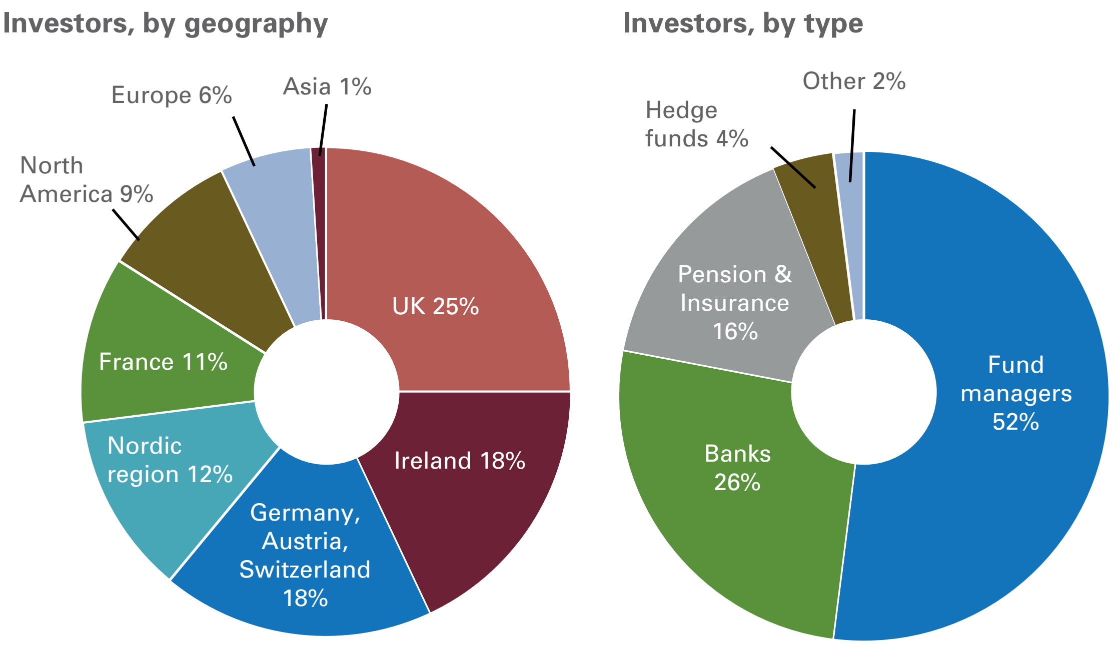
Improved market environment

Increased investor interest and success in meeting fiscal targets helped the overall market environment from 2012 onwards. A number of supportive developments at a European level further assisted Ireland’s efforts with market re-engagement. One of the most significant was the ECB announcement on Outright Monetary Transactions (OMT) in August 2012. This allowed the possibility of ECB buying sovereign bonds in secondary markets, for countries undergoing financial assistance programmes. While not used, the resulting improvement in market sentiment assisted the Irish bond market. Term extensions on Ireland's official borrowings were also seen as a positive development, which lowered borrowing costs.

Significant landmarks were reached in 2013, with the first new syndications since losing market access. The first of these was a syndicated tap of the existing 5-year bond in January. A total of €2.5 billion was issued at a yield of 3.32%.

This was followed by a new 10-year bond in March 2013, the first new 10-year issuance since January 2010. A total of €5 billion was issued of this bond, maturing in March 2023. The yield was 4.15%. There was broad investor interest, with over 400 investors submitting bids. The total order book was €13 billion.

Figure 2: New 10-year 2023 bond



Source: NTMA

These transactions attracted strong international interest and confirmed Ireland’s ability to access long-term market funding on sustainable terms.

Despite these early successes, the NTMA did not yet believe that it had restored normal access to the market. Ireland had not undertaken any auctions since 2010, and issuance to date was largely opportunistic. A number of further actions were taken or supported by the NTMA, to both improve debt sustainability and prudently manage the large debt stock. This included the second extension of EU loan maturities (EFSF and EFSM), the conversion of the IBRC Promissory Note to long-term Floating Rate Notes, and the build-up of prudential cash balances. Throughout this period, the NTMA visited each of the major investor centres.

These measures, along with Ireland's continued progress on fiscal consolidation and banking repair, laid the path for normalised market access.

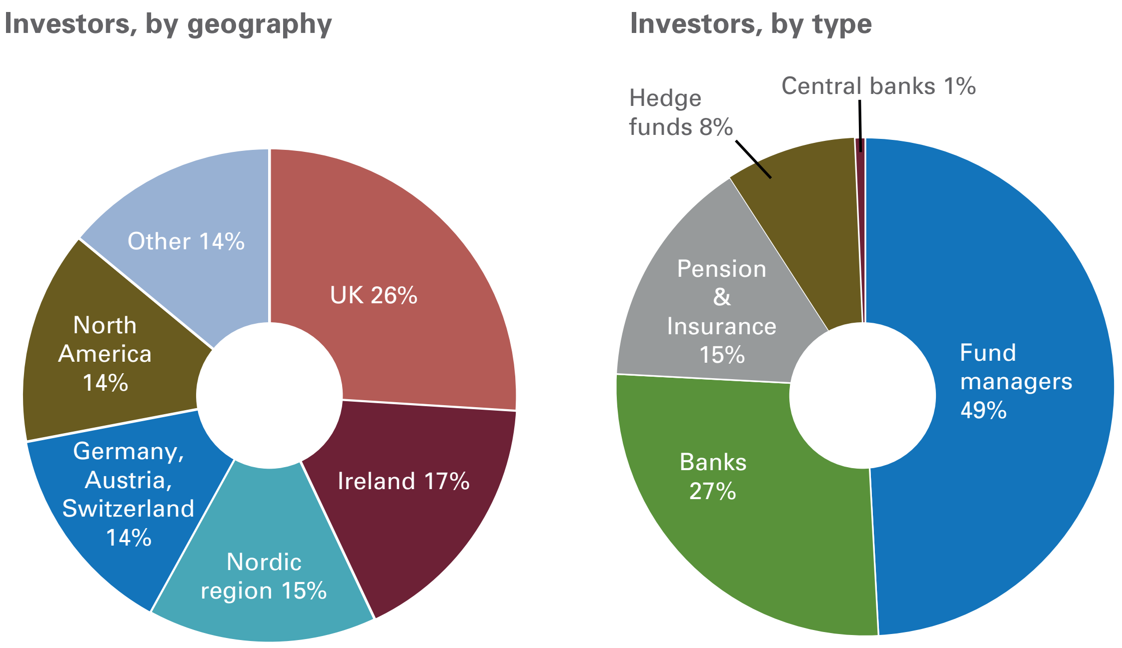
Phase III: Normalised market access – regular schedule of bond auctions

At end-2013, Ireland was well positioned to exit from the EU/IMF programme on schedule. The NTMA had undertaken pre-funding, building up prudential cash balances of 12–15 months funding. This strategy allowed Ireland to exit the Programme without the need for a precautionary credit line.

The aim at this stage was to reinforce the reputation of Ireland as a stable and sustainable participant in debt markets. There were several targets: to announce an annual funding plan, to hold regular bond auctions, to issue at rates consistent with debt sustainability and to achieve a broader composition of investors in syndications.

During 2014, the NTMA successfully raised €11.75 billion in long-term funding. This consisted of two syndications and a regular schedule of auctions. The first syndication of the year was a new 10-year bond in January 2014. A total of €3.75 billion was raised at 3.54%. The investor profile was strong, with a diversified geographic spread.

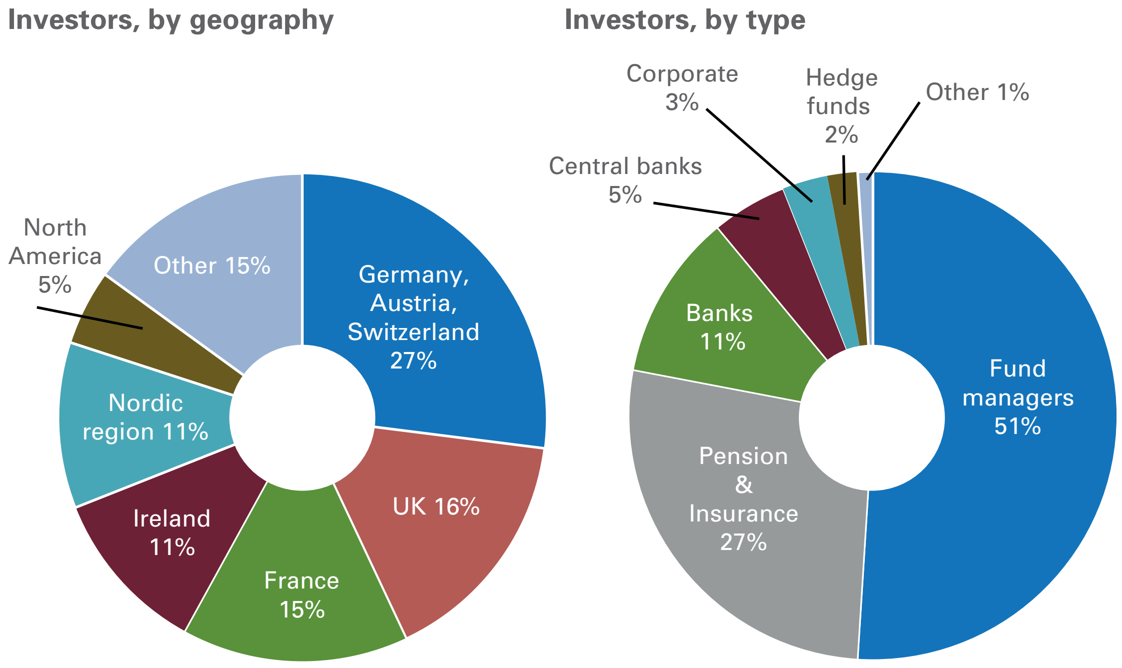
Figure 3: New 10-year 2024 Bond



Source: NTMA

In November of the same year a new 15-year bond was syndicated. The NTMA issued €3.75 billion to investors in Europe, the UK, the Nordic region and North America. The issue yield was 2.49%.

Figure 4: New 15-year 2030 bond



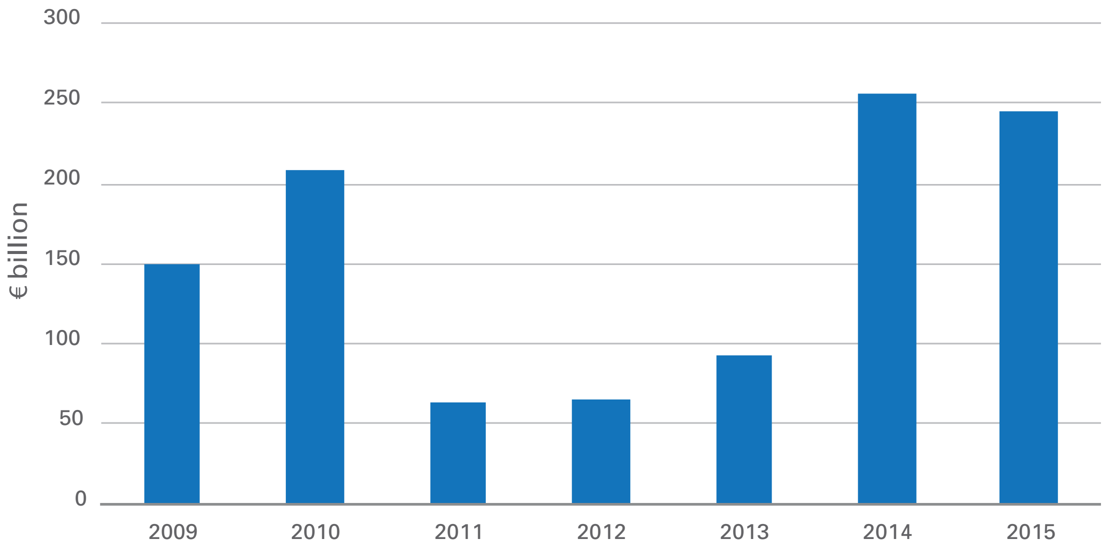
Source: NTMA

A return to a regular schedule of auctions was important, to allow greater liquidity in Irish government bonds. The model changed to a single-price auction, at the recommendation of primary dealers. This was to prevent over-bidding and make the auctions more accessible to clients. Five auctions were held during 2014, and these have continued since, with at least one auction per quarter. A regular and predictable schedule assists investors and primary dealers in liquidity planning.

During 2014, the NTMA also undertook a liability management exercise in the form of a bond buyback and switch of the bond maturing in April 2016. This assisted in further extending the weighted average life of the outstanding debt profile.

Turnover in 2014 reached a high of almost €260 billion. Bond yields continued their decline, as ECB rates were cut further. Ireland was now viewed by investors as a strong and stable investment.

Figure 5: Irish Government bond turnover



Source: Irish Stock Exchange

Credit rating changes, including an important upgrade by Moody's to investment grade, finally reflected these emerging trends. Therefore, 2014 was deemed to be the year in which full market access was restored.

Table 3: Credit rating changes (2011–2016)

	End 2011	End 2014	Current
Moody's	Ba1	Baa1	A3
S&P	BBB+	A	A+
Fitch	BBB+	A-	A

Source: NTMA

IMF early repayment and current market environment

A marquee transaction for Ireland was the early repayment to the IMF, during end-2014 and early-2015. In total, just over €18 billion, or 81% of the original €22.5 billion IMF loan facility, was repaid early and replaced with lower cost market funding. This generates interest savings in excess of €1.5 billion over the original lifetime of the loans.

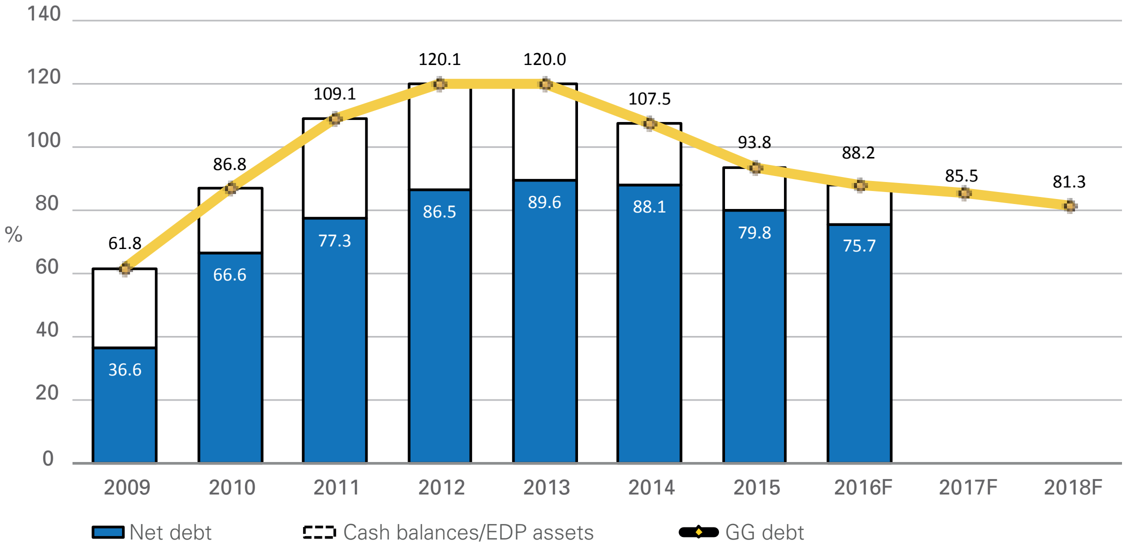
Favourable current conditions have cemented Ireland's market return. This has been assisted in part by the introduction of a quantitative easing programme by the ECB, keeping interest rates low and driving investor appetite for long-dated bonds.

The NTMA issued Ireland's first ever benchmark 30-year bond during 2015. A total of €4 billion was sold at 2.08% in February. This complemented the full-year funding of €13 billion, including a regular schedule of auctions.

These transactions helped to improve debt sustainability, locking in lower interest rates and longer maturities. The estimated weighted average maturity of Ireland's long-term marketable and official debt was 12.3 years at end-2015. This compares to 7.3 years at end-2012.

The Government debt ratio peaked at 120% in 2012 and fell to 94% in 2015 (see Figure 6). The Government is consistently generating a primary budget surplus and nominal growth is above the interest rate on the stock of debt. As a result, the debt ratio is declining quickly.

Figure 6: General Government debt forecasts



Source: Department of Finance, Stability Programme Update, April 2016
Note: Figures for 2016, 2017 and 2018 are forecasts

In the context of the current low yield environment, it is important to remain engaged with investors and increase efforts to diversity both the investor base and sources of funding.

The investor base for Irish government bonds has changed since the traditionally domestic base. At end 1999, less than 30% of bonds were held by foreign investors. Following the introduction of the euro, this percentage rose sharply. By 2006, 85% of Irish government bonds were held by foreign investors. At end 2015, the figure was lower at close to 60%. However, this is influenced in part by the Floating Rate Notes held by the Central Bank of Ireland. Excluding these, foreign investors comprise over 70% of holders. The trend back towards a larger proportion of foreign ownership is also evident in our recent syndications. The average participation by foreign investors over the last seven syndications is over 85%.

The NTMA continues with its investor relations programme, undertaking regular visits to the UK, US, Asia and continental Europe. Bespoke issuance, such as the recent 100-year private placement (€100 million at a yield of 2.35%), is also an important signal of diversification.

Despite diversification efforts, the main focus remains on providing a liquid market for investors. Government bonds comprised 62% of the General Government Debt at end-2015. Retail debt was almost 10%.

Ireland recognises the still elevated levels of public and private debt and high percentage of NPLs in Irish banks. The NTMA continues to monitor liquidity, regulation changes and the trends in primary dealer markets. However, market access is considered to be stable despite these challenges. The downward trajectory of Ireland's debt should further assist funding efforts.

Conclusion

Ireland's return to the primary debt markets was slow and challenging. It involved a concentrated effort on investor engagement, short term issuance, opportunistic transactions, and finally the return to regular auctions.

There were three distinct stages undertaken – preparatory work, phased re-entry and normalised market access. The first step involved transparent communication with market participants, significant investor engagement and a credible recovery plan outlined by the State. This was followed by short-term issuance, opportunistic switches and product diversification. The final stage saw a return to a regular schedule of bond auctions.

Some of the key steps were:

- Decisive action with a focus on debt sustainability,
- Communication with government and internal stakeholders on the needs of market participants,
- Dialogue through all phases with external investors and rating agencies; remaining realistic and informative,
- Avoiding complacency – continue to contribute as debt managers by limiting vulnerabilities in the structure of debt.

There has been a strong turnaround in Ireland's debt dynamics. This is due to the measures taken by the Government to improve the public finances, the return of economic growth and the measures taken at a European level to calm the wider euro crisis. Ireland is now on a sustainable and improving path.

The NTMA remains focused on the task of funding at sustainable rates, managing market liquidity and reducing the cost of Government debt.

Portugal

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Introduction

The Portuguese economy was subject to two very significant shocks in the late 1990s, which together were probably at the root of the macroeconomic imbalances that emerged in the late 2000s. On the one hand, the global economic integration of emerging economies, from the Eastern European countries to the Far East Asian countries (not least since China joined the WTO), implied a very significant increase in the competition faced by Portugal's most traditional exporting sectors, such as textiles, footwear, or electric material. On the other hand, the run-up to the euro area implied an abrupt reduction of nominal interest rates (e.g. the 3-month money market rate declined from 18% in 1991 to close to 4% in 1998), which boosted domestic demand and significantly reduced savings.

In the subsequent decade, the current account posted consecutive deficits in excess of 5% of GDP, which were perceived at the time to be at the core of a new investment cycle that would enhance productivity, but were actually coupled with poor economic performance, as GDP growth averaged little more than 1%, diverging from the euro area. This implied a significant increase of external debt (the international investment position deteriorated from -10% of GDP in 1996 to about -100% in 2008), which left the Portuguese economy highly vulnerable to the shocks that hit the global economy, and in particular the euro area since late 2009.

Following Greece and Ireland in 2010, Portugal requested economic and financial assistance from the IMF, EC, and ECB (henceforth EU–IMF institutions) in April 2011. The 3-year programme involved a financing package amounting to €78 billion, which was defined to cover the State's borrowing needs until September 2013:

Table 1: State's borrowing needs and sources during the EU–IMF programme

(€ billion)	Jun-Dec 2011	2012	2013	Jan-Jun 2014	Total
Planned					
Net financing needs (incl BSSF)	16	9	5	2	32
MLT debt redemptions	6	15	10	6	37
EU-IMF disbursements	38	25	10	5	78
MLT debt issuance	0	0	9	6	15
T-bill net issuance	-9	0	0	0	-9
Retail debt net issuance	-1	-1	0	0	-2
Other flows	-3	0	0	0	-3
Change in deposits	**3**	**0**	**4**	**3**	**10**
Actual					
Net financing needs (incl BSSF)	9	19	11	7	45
MLT debt redemptions (incl exchange)	5	17	13	7	42
EU-IMF disbursements	34	27	10	5	76
MLT debt issuance (incl exchange)	0	4	12	9	24
T-bill net issuance	-6	5	1	0	0
Retail debt net issuance	-2	-2	1	2	-1
Other flows	-3	3	0	1	2
Change in deposits	**9**	**3**	**0**	**2**	**14**

Source: IGCP

As the market risk perception on Portuguese sovereign debt mounted in 2011, the issuance of MLT bonds was suspended and the stock of T-bills was cut by almost 40%, with a sole focus on 3- and 6-month maturities. The outstanding retail instruments also dropped significantly. Hence, at the end of 2011 the debt composition changed substantially, with the most common components declining, while EU–IMF loans already accounted for roughly 20% of the total.

Since mid-2012, IGCP carried a strategy based on a close relationship with the investor community, a reduction of the refinancing risk, an increase of the average maturity, and a relatively high cash buffer, which allowed the country to regain full market access before the end of the programme, as seen in Table 1.

The aim of this brief note is to describe the different stages of this process from a DMO perspective, highlighting the main features that allowed for a relatively smooth transition, from a financing plan completely dependent on the financial assistance of international institutions in 2011–12, to a return to full market access in 2014.

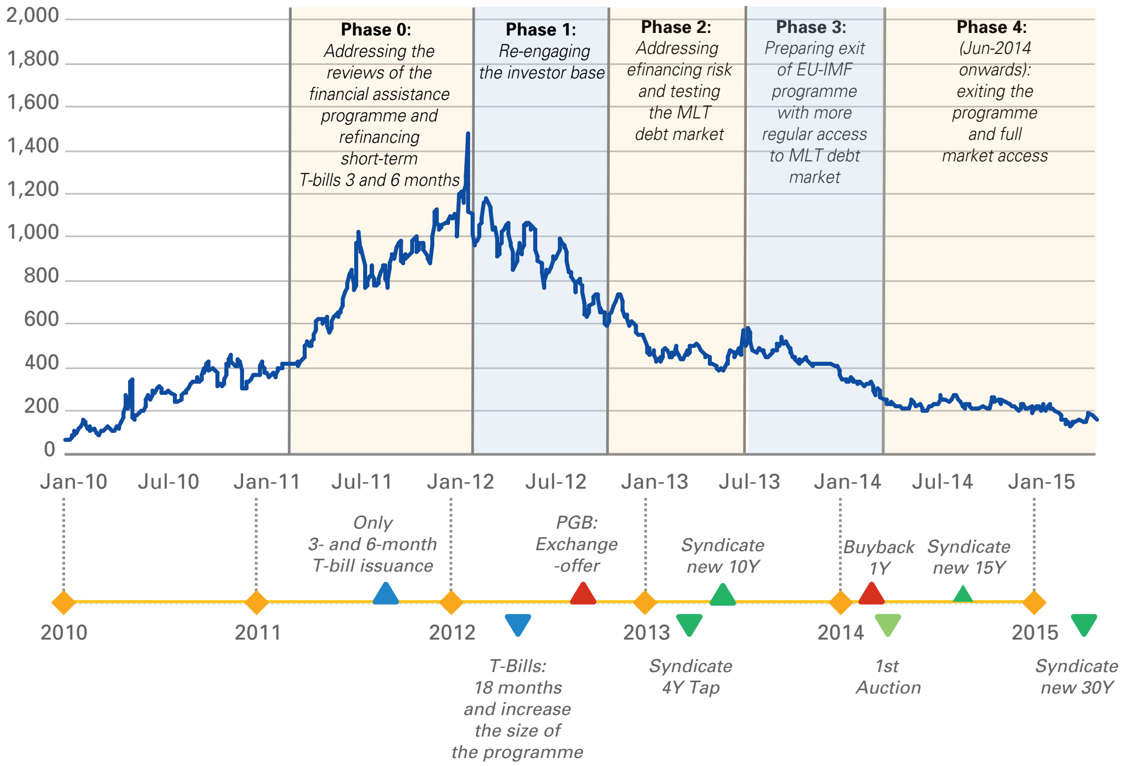
Debt management strategy between 2012 and 2014

The main objective of the exit strategy was to secure stable access to international financial markets at affordable rates. The strategy was developed under three pillars:

- Close contacts with investors, providing a comprehensive understanding of the Portuguese economy performance and of the debt management strategy, in order to regain the confidence of the investor community and broaden the investor base.
- Smoothening the redemption profile and extending duration, in order to mitigate the refinancing risk.
- Pre-financing and securing a relatively large cash buffer, to avoid issuance pressure in times of market volatility, reinforcing the credibility of IGCP's financing programme and allowing for the execution of buybacks designed to reduce the refinancing risk.

The following chart summarises the different stages of execution of this strategy, together with the evolution of the PGB-Bund 10-year spread and an identification of the main milestones that made the process move forward. These will be discussed in more detail hereafter.

Figure 1: 10-year PGB-Bund spread



Sources: Bloomberg and IGCP

Phase 0 (April 2011 to January 2012): addressing the reviews of the EU–IMF Programme and refinancing short-term T-bills

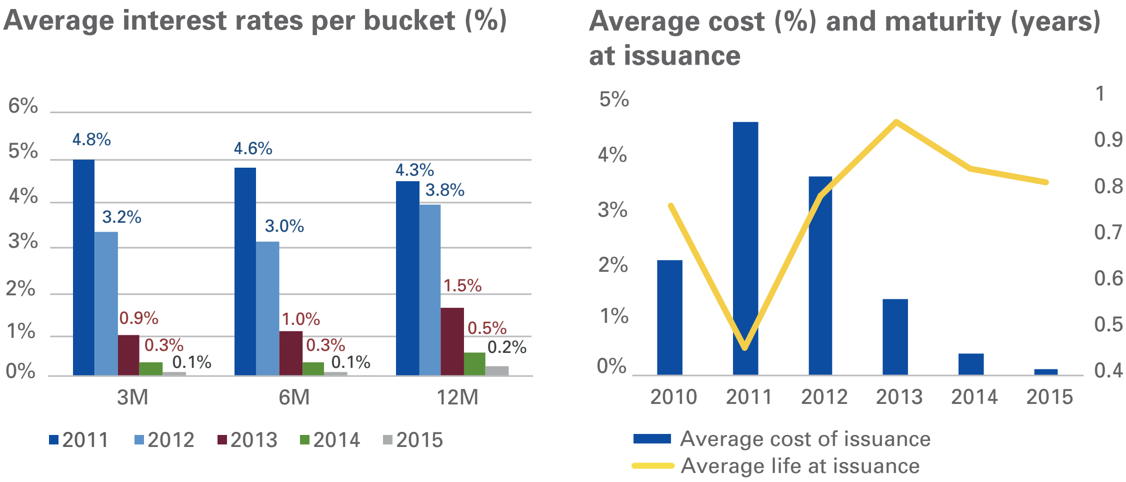
The early stages of the EU–IMF programme were marked by a continued deterioration of market conditions, as the Portuguese rating was downgraded below Investment Grade. The last of the three major credit rating agencies to take such a decision was S&P, on 13 January 2012, a decision that forced some investors to sell their positions in PGBs at short notice, as these dropped out of relevant market indices. This event actually coincided with the peak of the PGB-Bund spread (observed at the end of January 2012). In the period that followed, as Portugal was able to conclude successfully the quarterly reviews of the Programme, it slowly regained market credibility.

Until the end of 2011, Portugal was out of the MLT debt market, but it maintained the T-bill programme active, albeit with smaller volumes and focused on shorter maturities.

Hence, the financing needs over this period were solely covered by EU–IMF loans, which were front-loaded to cover the redemption of MLT debt, the reduction of the T-bill and retail debt stocks, and still allowed for a substantial increase of the cash position (see Table 1).

T-bill programme: Before the request for financial assistance, T-bills were seen as a pure money market instrument, mostly bought by European central banks and bank treasuries that wanted a safe and liquid money market application for their cash. During 2010/2011, as Portugal was being downgraded by the rating agencies, most of the traditional buyers of Portuguese T-bills started to pull out and stopped rolling over positions. In this process, the market changed completely, becoming mainly domestic driven, as international accounts were leaving the country, and for a period of nine months (until December 2011) it was only possible to issue 3- and 6-month maturities. The T-bill auctions that took place in this period always showed a comfortable bid-to-cover ratio, but average rates were close to 5%, which clearly indicates distressed conditions. Due to the fact that only 3- and 6-month T-bills were issued the average maturity at year-end 2011 was close to 45 days and the total size of the programme decreased to €11 billion.

Figure 2: Average cost and maturity of T-bills in primary market



Source: IGCP

Phase 1 (February 2012 to September 2012): increasing maturity of T-bill programme and re-engaging with the investor base

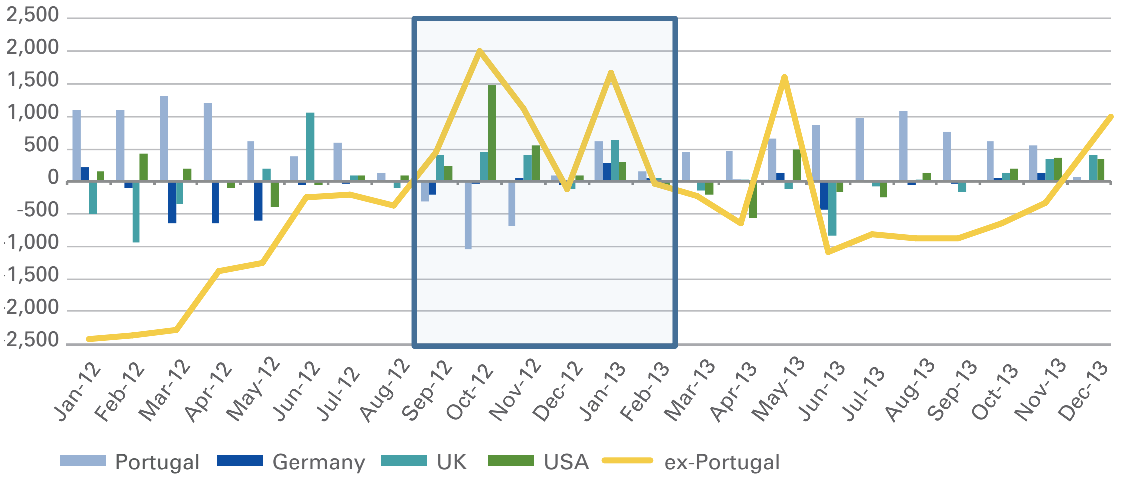
The first stage of the process to regain market access can be placed at the beginning of 2012, as some early signs of market stabilization emerged, allowing IGCP to extend the maturities of new T-bills, first to 12 months, and then to 18 months (in April 2012). Soon after, IGCP started preparing the stage for a return to the MLT debt market, re-engaging with the investor community and taking advantage of the interest of new entrants in the Portuguese debt market.

T-bill programme: The first months of 2012 marked a turning point in the T-bill programme. Although Portugal lost its last Investment Grade status by the three major rating agencies in January, the T-bill market started to improve. IGCP restarted issuing 12-month bills regularly during 2012 and introduced the 18-month bill in April (with maturity in October 2013), issuing for the first time a security with a maturity beyond September 2013, the maturity of the first PGB that was not fully covered by EU-IMF funding. IGCP kept issuing 18-month T-bills on a regular basis (seven times in total), until September 2013 when it was discontinued. During this period, the average maturity of the T-bill programme was extended, smoothening the maturity profile, and the programme's size was increased. By year-end 2012, the average maturity was 6 months and the total size of the programme was €17 billion (almost €6 billion more than the bottom in end-2011). This was all possible given a steady decline in rates.

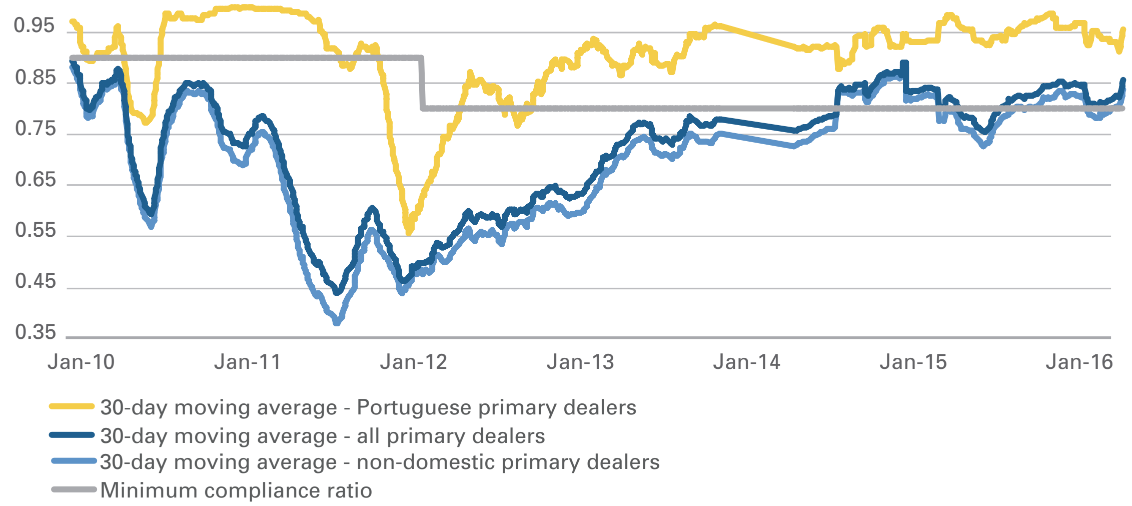
PGB market: In the run-up to the exit of the Programme that was scheduled for the 2nd quarter of 2014, Portugal started to prepare for regaining full market access. The investor base had shifted significantly, as a consequence of the change in credit risk perception, decisively determined by the sub-Investment Grade rating status. While more traditional "buy and hold" investors, such as pension funds and insurance companies, left the PGB market, newcomers, such as hedge funds, notably from the US, participated more actively. In the 2nd half of 2012, there was some evidence of market stabilization, as secondary market flows from non-residents turned positive (namely from the UK and US) and primary dealers' quoting compliance resurfaced (in particular from domestic banks). As a consequence, yields started to come down from their heights, a movement that was certainly related to the relevant role played by domestic banks and hedge funds.

Figure 3: PGB net flows by geography and compliance ratio

Net flows by geography (€ million)



Primary dealers compliance ratio



More than a year into the programme, the Government could showcase the reduction of most macroeconomic imbalances. Supported by some structural improvements illustrated by hard data, since September 2012 Portuguese authorities have embarked on a number of marketing actions directed at the traditional European investors, but perhaps more interestingly, directed at UK and US investment communities. As some of these investors were more familiar with adjustment processes in other jurisdictions outside the euro area, they were in a more favourable position to assess the success of the Portuguese Programme. These marketing actions, together with the liability management operation conducted in October that was aimed at reducing 2013's refinancing needs, proved to be crucial for the first syndicated deals of MLT debt conducted in early 2013.

Retail instruments: In an attempt to counteract the net negative issuance of retail instruments observed in the previous couple of years, IGCP also decided to adopt higher remuneration conditions for Saving Certificates (CA) in September 2012: an additional fixed premium was added (1% in the B-series and 2.75% in the C-series, in place until end-2016), which implied a gross remuneration of around 3% for these instruments. Since then, the monthly net subscriptions stopped diminishing and staunched the outflow that had been observed since 2008 (and in particular since early 2011).

Phase 2 (October 2012 to June 2013): addressing refinancing risk and testing the MLT debt market

As the Programme unfolded, Portugal progressed in correcting macroeconomic imbalances that had grown until 2011: the current account balance turned positive in 2013 for the first time in more than 40 years, improving about 13pp of GDP since the bottom in 2008; fiscal consolidation brought down the structural deficit by about 7pp of potential GDP between 2009 and 2013; and a broad array of structural reforms were implemented, ranging from the labour market to the rental market, from the judicial system to public administration. This was crucial to support the first MLT debt operations conducted in late 2012 and during the 1st half of 2013.

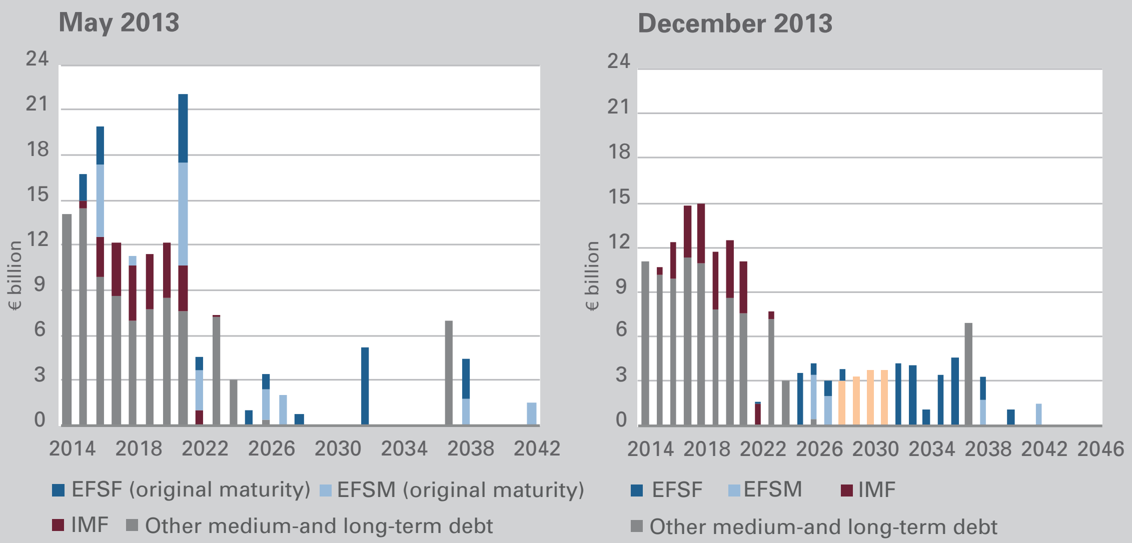
Box 1: Extension of maturities of EFSM/EFSF loans (June 2013)

One of the main challenges of the transition period was posed by the large borrowing requirements in the near future, which made Portugal more prone to unanticipated external shocks. Despite the fact that 2014 was fully funded by 2013, Portugal had a heavy calendar of financing needs in the following years that would require a pre-emptive refinancing strategy and the stockpiling of considerable cash reserves. The average financing requirements through 2017 amounted to about €15 billion/year, which was well above the average of MLT debt issuance in the pre-crisis period (less than €11 billion in 1998-2009).

With this in mind, Portugal and Ireland requested an extension of the maturity of EFSM/EFSF loans, to give more time to sustainably rebuild the investor base and to recover a more favourable status with rating agencies. On 12 April 2013, the Eurogroup and ECOFIN reached an agreement in principle for the extension of the weighted average maturity of these loans for a period of 7 years.

Taking into account the new dates of already approved EFSF loans and a simulation of the new maturities of EFSF loans to be agreed, the redemptions of medium- and long-term debt at the end of 2013 presented the following profile:

Figure 4: Redemption profile of MLT debt before and after extension of EFSM/EFSF



Note: (*)The final maturity of the EFSM loans marked with orange bars has not been defined yet (extension of maturity will be implemented close to the respective date of original amortisation), but it is not expected that Portugal will have to refinance any EFSM loan before 2026.

Source: IGCP

PGB market: From October 2012 onwards, after several positive reviews of the EU-IMF Programme, combined with supportive statements by ECB officials (namely Mr Draghi's "whatever it takes" comments in August 2012 and the OMT announcement in September), and immediately after the first feedback received from roadshows and meetings with investors, Portugal was able to test the MLT bond market. As preparation for the first syndicated deal, an exchange offer was conducted on 3 October, where a 1-year bond (maturing in September 2013) was bought, in exchange for a 3-year PGB (October 2015), thus minimising the refinancing needs for upcoming years.

Table 2: Liability management operations in 2012-2015

(€ billion)	2012	2013	2014	2015
PGB exchange offers	3.8	6.6	1.7	4.5
PGB buybacks (excl debt maturing in the year)	0.2	0.6	3.4	1.7
IMF early repurchases	0.0	0.0	0.0	8.4

Source: IGCP

The exchange offer was well received by the investor base and, in January 2013, after visiting important US investors, Portugal executed the first syndicated deal, printing €2.5 billion of the existing 5-year benchmark. It was the very first time IGCP launched a syndicated tap. A few months later, in May 2013, a new 10-year benchmark amounting to €3 billion was priced at an interest rate (5.67%) lower than the last PGB auction (a 17-month line) conducted before the EU-IMF Programme.

The success of these two operations can be assessed by both the diversified investor participation, especially in the 10-year issue, as well as by the positive performance in secondary market.

T-bill programme: In 2013, the T-bill programme stabilized, as issuance became more regular with a combination of short- and long-term maturities at each auction, rates came down towards levels closer to other European countries, and international participation started to broaden. As long-term issuance became increasingly available, the focus of IGCP funding efforts shifted from T-bills to the PGB market.

Phase 3 (June 2013 to May 2014): preparing exit of EU-IMF programme with more regular access to MLT debt market

One year before the end of the programme, Portugal was already able to access the market via syndicated benchmarks. It was also able to use exchange offers to reduce the following year(s) refinancing needs and simultaneously give liquidity to longer bonds with lower outstanding amounts. The regular issuance in the market through auctions started to be contemplated, triggering discussions with the group of primary dealers regarding the auction type (see Box 2.3. on the single-price auction).

Despite maintaining the sub-Investment grade status, the three major credit rating agencies also took the first positive steps in this period: Moody's upgraded the rating by two notches (from Ba3 to Ba1, in May and July 2014), while Fitch (BB+, positive outlook in April 2014) and S&P (BB, stable outlook in May 2014) improved the outlook, on the back of evidence of a macroeconomic recovery and some stabilization of the public debt stock.

Following these developments, Portugal exited the EU-IMF programme in April 2014, according to schedule, without drawing down the final tranche.

Box 2: New instrument targeted to broaden the retail investor base (October 2013)

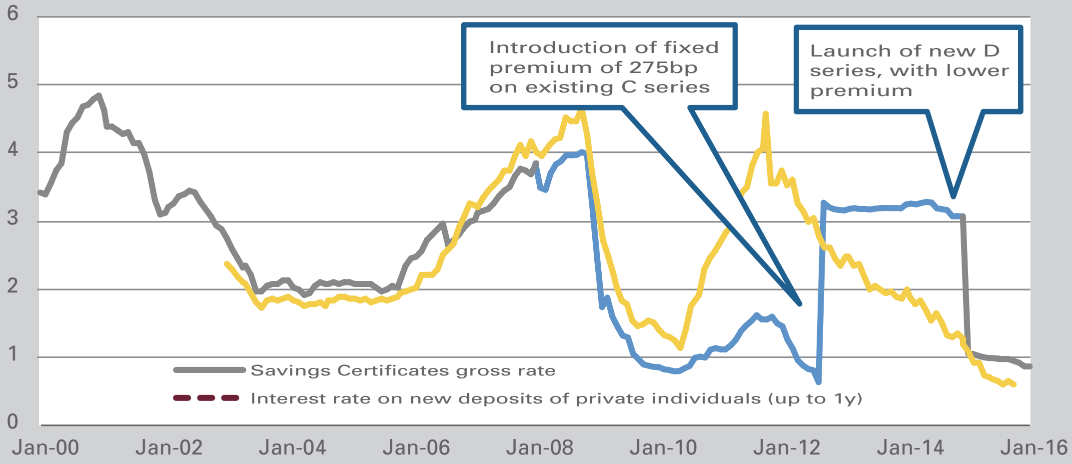
On 31 October 2013, IGCP launched a new debt instrument (CTPM) designed for investors with less need for liquidity, promoting the medium-term savings of households and hence widening the domestic investor base.

CTPM are issued with a 5-year term and a guaranteed fixed rate on the subscription date. In the 4th and 5th year, a premium equal to 80% of the average real GDP growth, if positive, will be added to this rate.

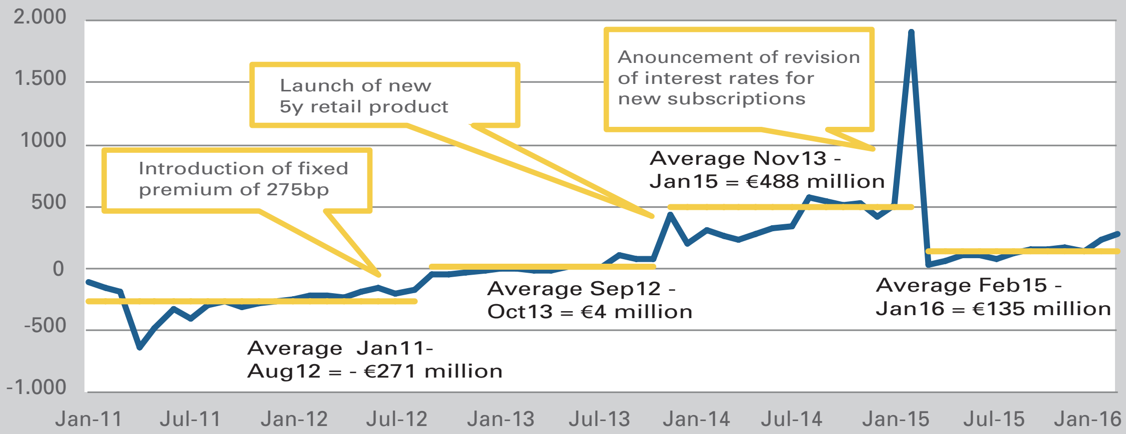
The launch of this new product, along with the adoption of more competitive remuneration conditions in CA already introduced in September 2012, contributed to reverse the downward trend of the stock of retail instruments observed since 2008. Indeed, from 2013 onwards, the net subscription of the debt instruments specifically designed for the retail market was very positive, reaching a total of more than €9.5 billion between 2013 and 2015:

Figure 5: Retail debt market indicators

Retail debt and bank deposits interest rates (%)



Retail net monthly issuance (€ million)



Sources: Banco de Portugal and IGCP

PGB market: Early 2014 was marked by strong improvement in the PGB credit risk, as the 10-year PGB-Bund spread in the secondary market declined from more than 400 bp to around 200 bp, reaching the lowest level since early 2010, i.e. before Greece had requested financial assistance for the first time.

Under this favourable environment, IGCP tapped the 5- and 10-year bonds in January and February, for a total amount of €6.25 billion. The successful execution of the funding plan early in the year allowed Portugal to anticipate the repayment of debt securities maturing in forthcoming years, namely through a €1.0 billion reverse auction of the PGB maturing in 2015, in February 2014, which was important to smooth the redemption profile, extend duration and convey a positive message to the market.

The next logical step was to resume PGB auctions, which occurred in April, with a €750 million tap of the 10-year benchmark.

The primary dealership appraisal was also adapted to privilege primary market participation (it weighted up to 30% of the total evaluation of 2014, after being removed from 2012 to 2013), as another important step in resuming a regular financing programme of MLT debt.

Box 3. Introducing single-price auctions (April 2014)

Before reintroducing auctions as a form MLT debt issuance, the auction type was re-addressed at the end of 2013, beginning of 2014.

Several in-depth analyses suggested that the single-price or Dutch auction method is more adequate to clear markets that observe higher volatility, as it is perceived as a more defensive approach for both primary dealers and investors. The main arguments in support of this method are: (i) avoid paying above the market price ("winner's curse"); (ii) higher transparency since every order is allotted at the same price; and finally (iii) it incentivises participation by investors who may be less informed than qualified investors.

Regarding the risk of overbidding that this price method may involve, IGCP adopted some monitoring indicators, which were included in the primary dealers' regular performance appraisal scoreboard.

T-bill programme: In 2014, the T-bill market was running smoothly and had a stable issuance pattern along the year. Rates steadily approached 0% and there was no longer the need to issue 18-month bills, so the issuance pattern focused on maturities up to 12 months. In this period, turnover in the secondary market improved significantly and bid-offer spreads tightened massively. At the same time, the focus was now completely on long-term funding and the reconstruction of the PGB curve. As a consequence, the T-bill programme decreased in size and IGCP felt that some of the lines were becoming less liquid due to the size reduction and that action needed to be taken. In 2015, some changes were applied to tackle this concern.

Phase 4 (June 2014 onwards): restoring full market access

PGB market: From June 2014 onwards Portugal not only reinforced market access by doing regular bond auctions in different maturities, but also widened the investor base, achieving a very remarkable issuance in USD on the 10-year bucket, amounting to USD 4.5 billion (the largest USD issuance by a European sovereign in the 10-year maturity). Additionally, taking advantage of the general low yield environment and restored investor confidence, new syndicated issuances were conducted in longer maturities, namely a new 15-year benchmark (in September 2014), and a new dual tranche syndicated deal for new 10- and 30-year bonds (in January 2015), the first 30-year issuance since 2006. This deal was a milestone in our issuance strategy, as it attracted strong investor demand with a high-quality book, well-representative of full market access.

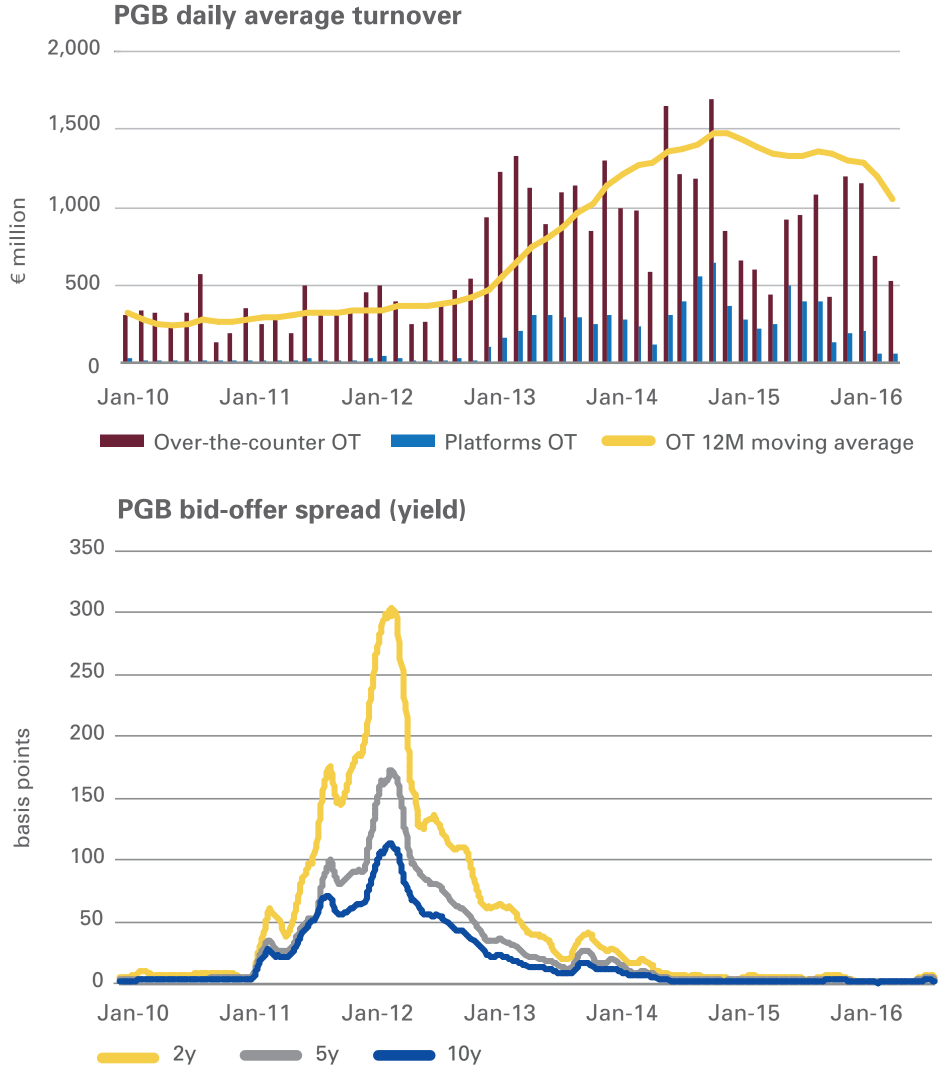
T-bill programme: In order to increase liquidity in the T-bill market, IGCP changed the issuance pattern, reducing the number of lines available, in order to make each line bigger and more liquid, as the total programme size remained fairly constant. The issuance calendar continued to have one auction per month, but redemptions occurred only once every two months. Liquidity improved and bid-offer spreads became even tighter, approaching Italian and Spanish levels. The programme nowadays runs smoothly and the size of the programme stabilized at around €14 billion.

Aftermath of the crisis: what changed in the sovereign debt market?

Portugal returned successfully to MLT debt markets. Still, market conditions are significantly different from the pre-crisis era. And while some of the factors that explain these differences are particular to Portugal, not least the fact that it still has a sub-Investment Grade status in the three major credit rating agencies, many are common to other sovereign debt markets, where a number of flash crash events have been attributed to relatively low liquidity, possibly related to regulatory changes.

In the Portuguese debt market in particular, turnover decreased significantly during the EU-IMF Programme and the bid-offer spreads increased sharply. While both these indicators are now similar to what we could observe before the crisis, the volatility is still substantially higher (as was recently witnessed in early February), which may be a symptom of a less efficient price discovery process. Nonetheless, volatility at these times compares well with previous periods of market instability, namely the crisis period, which highlights the fact that normalcy has been restored albeit with some different (new) features.

Figure 6: Liquidity indicators in the PGB market



Sources: IGCP, HRF reports by primary dealers, and Bloomberg

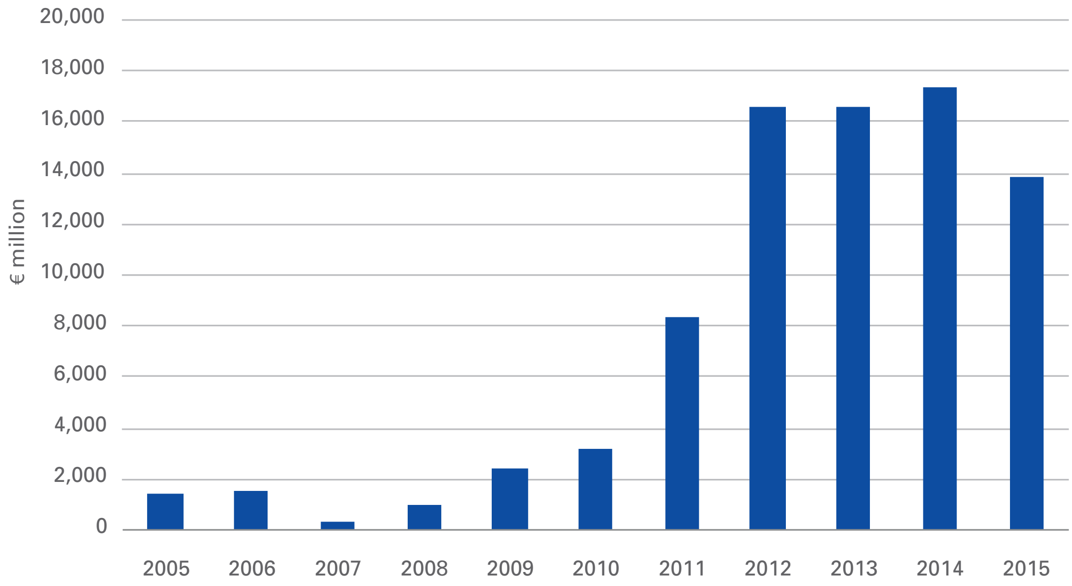
One of the main lessons of the sovereign debt crisis was that DMOs need to constantly adapt to challenging and shifting environments and market access is mostly a "work in progress" objective. Under this environment, IGCP's debt management strategy over this period can be characterized by two main features: flexibility and predictability. The uncertainty and relatively low liquidity that has characterised the market since the crisis, implies the need for more flexibility in executing the issuance programme (e.g. higher cash reserves; auctions announced with a shorter lag; more issuance through syndications and less via auctions). This in turn implies a continuous and close communication with investors (a form of forward guidance), crucial to increase their awareness of the execution of the financing programme at each point in time and hence minimise the risk of surprising the market at any new issuance announcement.

Having said this, we highlight here a number of features that show evidence of differences between the debt management strategy now and before the debt crisis. These differences are not necessarily specific to Portugal but derive more from an overall shift in the industry.

Cash position

The State's cash position is now substantially higher than before the crisis: it averaged a little more than €1 billion between 2005 and 2010, but it has been in excess of €10 billion since June 2011, as IGCP has a general objective of pre-emptively financing about 50% of the following year's financing needs. As explained above, this has been an important feature to give confidence to investors and to avoid issuance pressure in times of market volatility.

Figure 7: State's cash position (daily average)



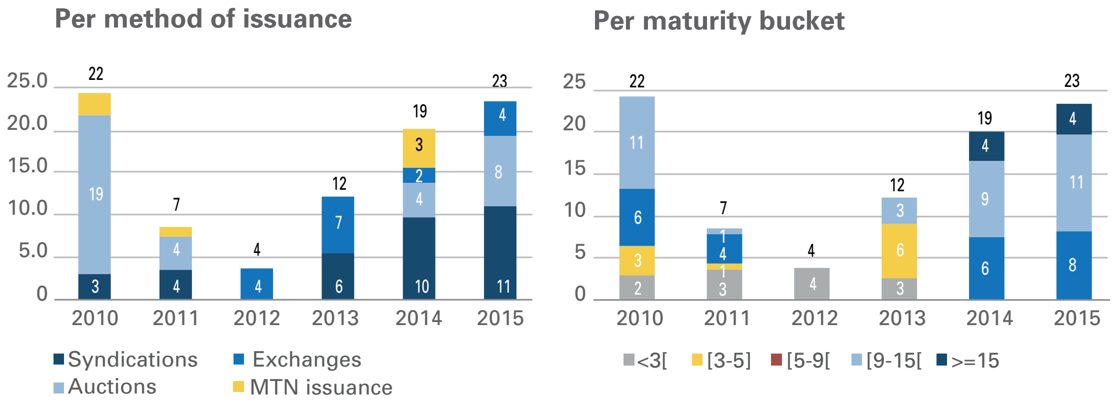
Source: IGCP

Issuance strategy

In the last years, Portugal has re-established market confidence with a regular issuance of both bond auctions and syndications. However, the need for more flexibility can be attested to by the fact that the weight of syndications in the overall MLT debt issuance is now substantially higher than before the crisis (about 50% in 2014–15, as compared with less than 20% in 2010).

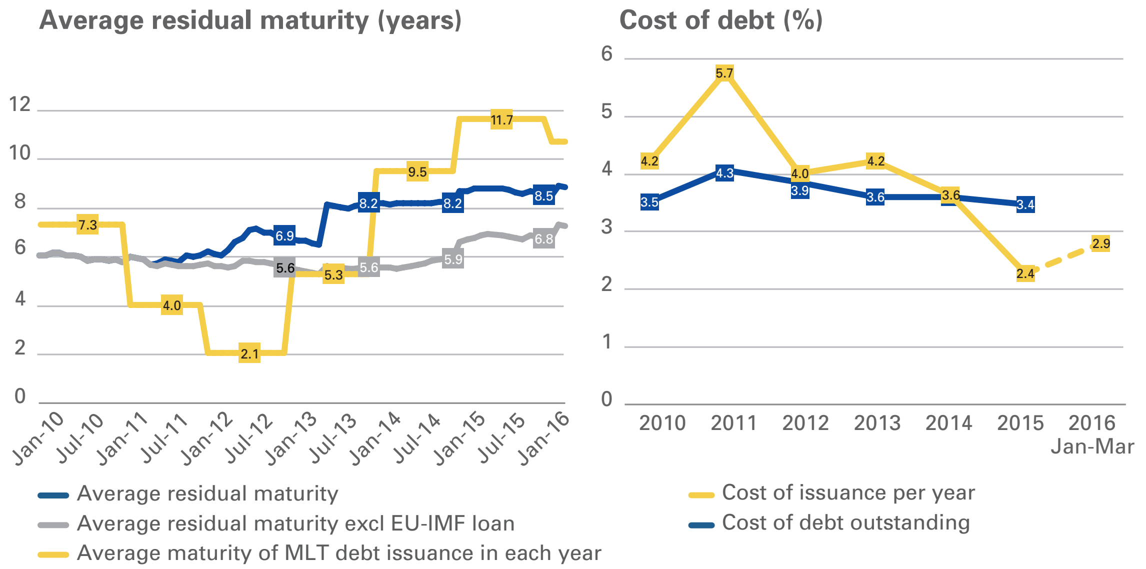
Moreover, the average maturity was significantly extended, reaching more than 8 years (before the crisis it stood at about 6 years). In 2014–15, the share of issuance in the 15-30 year bucket represented almost 20% of the total issued amount.

Figure 8: MLT debt issuance



Source: IGCP

Figure 9: Average maturity and cost of total debt

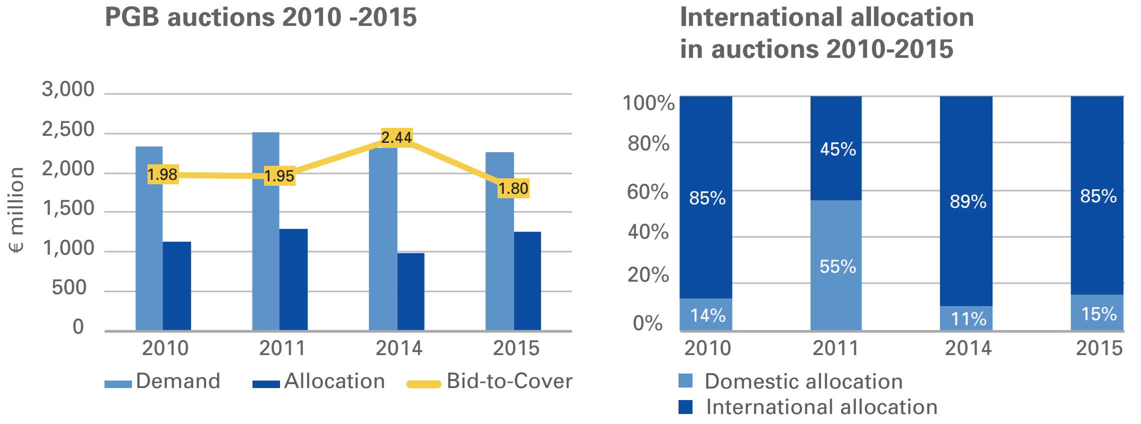


Source: IGCP

Demand and allocation per auction have been relatively stable pre and post the EU-IMF programme, with the exception of 2014, as one can see by the bid-to-cover ratio, which was clearly above the 1.8-2.0 levels that characterized 2010, 2011 and 2015. That can be explained by the fact that the single-price auction methodology was being tested for the first time in Portugal, and for this reason the market demand was higher.

Regarding the domestic and international allocation in PGB auctions it can be seen that domestic primary dealers on average take up 10%-15% of an auction, except in 2011, when the domestic primary dealers took 55% of the long-term issuance done via auctions, as market conditions were deteriorating and the international investors' community started to leave Portuguese credit risk.

Figure 10 – PGB auctions



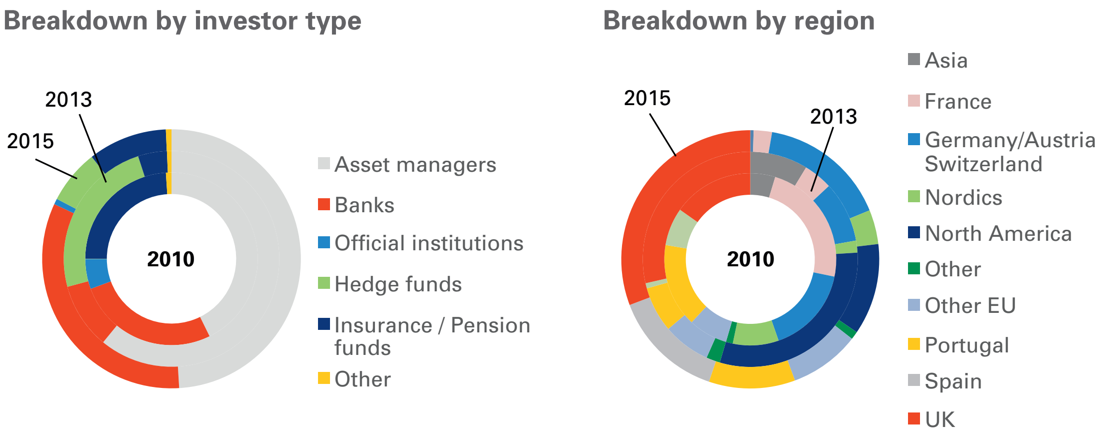
Source: IGCP

Between 2005 and 2010, retail instruments contributed negatively to the net issuance programme. Since 2013, net issuance of retail instruments has averaged more than €2 billion/year, with the outstanding amount of these instruments reaching a historical record of more than €20 billion at the end of 2015 (although the 10% weight in the total debt outstanding is still lower than the level of 15% reached in 2008).

Investor base

The investor base changed significantly during the programme. As can be seen in the charts below, before the crisis, the allocation was very well balanced across euro area countries and a strong distribution among pension funds and insurance companies. In the first issuances after entering the programme, there was a strong take-up from UK and US investors, namely from hedge funds, which played an important role in the early stages of the return to market access. In the most recent syndications, while there is a clear shift towards a distribution more identical to the one observed pre-crisis, there is still a strong take-up from UK and domestic investors (offsetting a lower distribution towards euro area pension funds and insurance companies, namely from France), which is probably still related to the sub-investment grade rating.

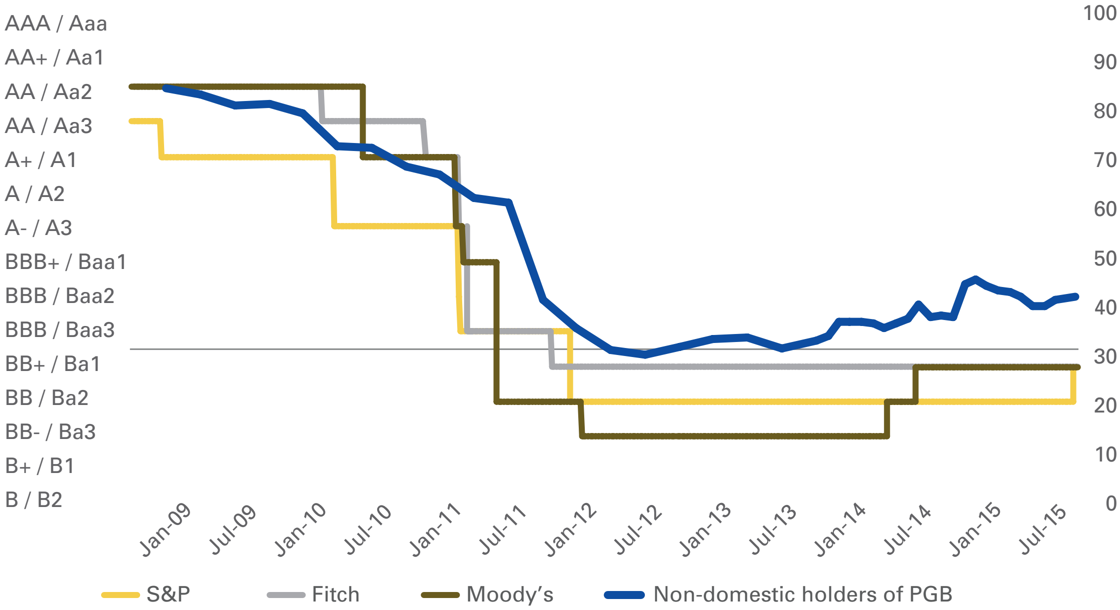
Figure 11: Distribution of PGB syndications, by geography and investor type



Source: IGCP

Moreover, the weight of debt securities held by non-resident private investors is still significantly lower than before the crisis (around 43% at the end of 2015, which compares to more than 80% before the crisis). This is probably related to the sub-investment grade rating status. Nonetheless, the current levels of non-residents' holdings are similar to those observed in other peripheral countries, so foreign holdings in the PGB market were brought closer to the European periphery standard and Portugal to that extent stopped being an outlier in this regard.

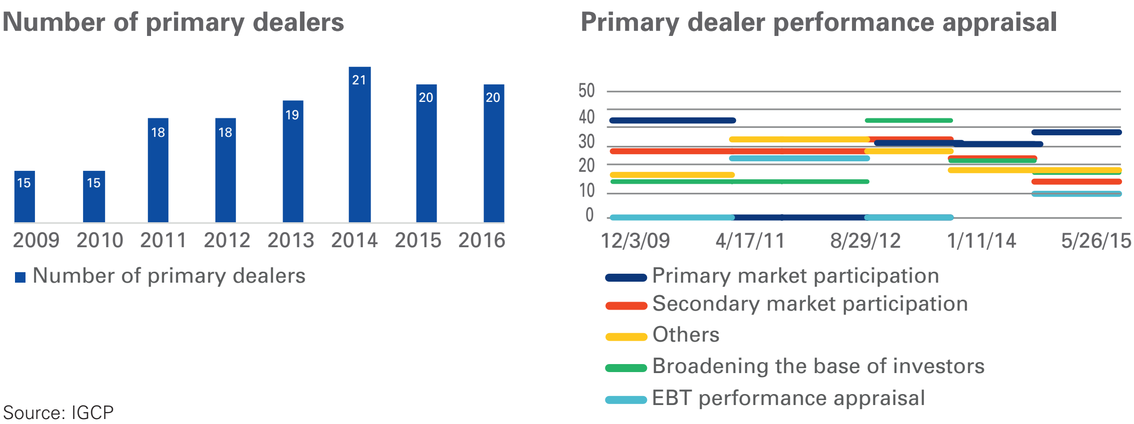
Figure 12: Ratings and non-resident private holders of PGBs (% of total)



Sources: Banco de Portugal and IGCP

An interesting feature of the Portuguese case is that, unlike what happened in other euro area countries, the number of PDs actually increased since the crisis. Primary dealership evaluation has been improved in the past couple of years to facilitate a more effective delivery of debt management objectives. Despite the fact that some operational objectives have shifted during the process of regaining full market access, primary dealership incentives have always been directed at strengthening liquidity provision, as market access hinges decisively on secondary market liquidity. Over this period, several changes were introduced in the PDs' performance appraisal, to reflect the different stages of the process of regaining market access, with the emphasis on broadening the investor base still playing a more relevant role than before the crisis.

Figure 13: Primary dealers number and performance evaluation criteria



Source: IGCP

The changes in the PDs' performance appraisal were also reflected in the organization of more one-to-one meetings with investors and a generally enhanced communication with the investor community. A thorough investors' presentation, with a comprehensive description of the recent developments in the Portuguese economy and financing programme, is regularly updated at IGCP's website, together with brief research notes on major developments on fiscal policy.

Active management of the debt portfolio

Another consequence of the rating downgrades was the reduction in the number and size of lines available to conduct derivative operations, even though IGCP changed all its contracts to the 2-way CSA over this period. Simultaneously, given the relatively high degree of exchange-rate risk attached to the IMF loan, most of the available lines have been oriented to hedge the currency risk, while the active management of duration has relied on outright issuances and liability management operations, and not on the use of IRSs, in contrast with the practice of IGCP until 2010. Hence, the benchmark model that was previously in place was suspended and is still under re-assessment.

Spain

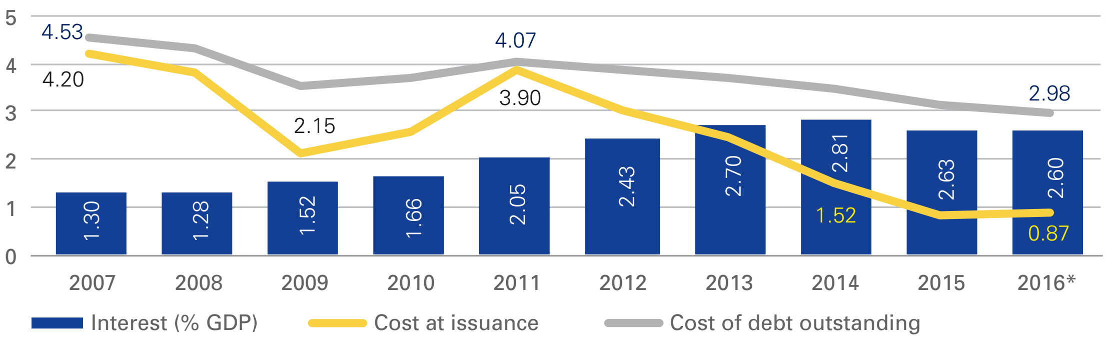
Pablo de Ramón-Laca Clausen, Tesoro Público

Introduction

The sovereign debt market is the global venue in which governments seek and obtain deficit financing, an essential component of the modern macroeconomic policy toolkit. This market is a pool of global savings, both public and private, sustained by common rules of economic sustainability and institutional guarantees. Acquiring, recovering or retaining access to this market – the permanent ability to obtain financing under reasonable and sustainable conditions – is a basic priority for most governments.

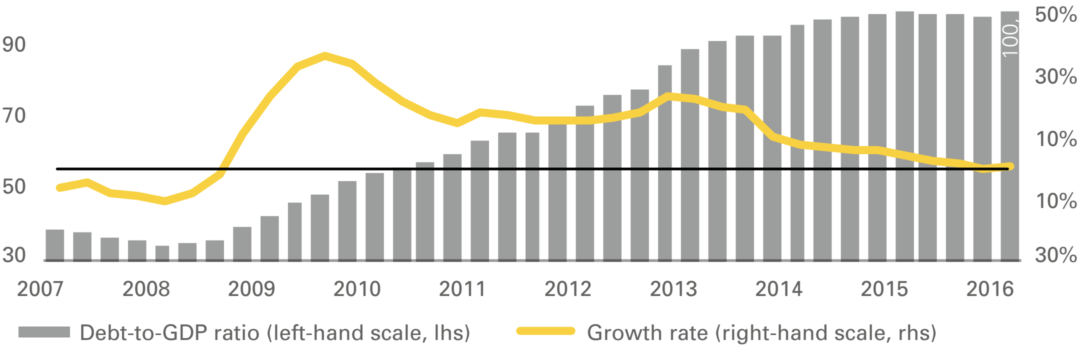
The world financial crisis that broke out almost a decade ago brought to light severe macroeconomic imbalances within the eurozone and altered the financing conditions for several countries. During this crisis some European countries lost access to the markets. This was not the case for Spain. The Spanish Treasury executed its monthly auctions as per its usual calendar despite having to deal with more volatile markets, larger issuance programmes and a rebound of its funding costs. Even when in 2012 a loan was extended to the Spanish government to help recapitalise the financial sector, Spain retained its market access and its average cost of funding never surpassed its pre-crisis 2007 levels (Figure 1).

Figure 1: Cost of debt and interest burden (as of 31 May 2016, %)



Note: (*)2016 interest burden includes 2016 budget figures and Stability Programme GDP estimate.
Source: Spanish Treasury

Figure 2: Debt-to-GDP ratio (% of GDP, and growth rate)



Source: Spanish Treasury

The changes in the Spanish Treasury's funding conditions have been extraordinary throughout this period. After an initial bout of financial market volatility in 2008 and 2009, followed by an apparent but short recovery, a second, more pronounced stage of the crisis erupted between 2010 and the summer of 2012. In November 2011, 3-month T-Bills were auctioned at a rate above 5%. In August 2012, non-resident investors only held 30.5% of total outstanding debt (having fallen from 47.5% in 2007); in 2012, the average life of bonds issued fell to a record low of 5.1 years, with 80% of medium- and long-term issuance in tenors no higher than 5 years. By 2013 this shorter-term issuance had weighed down the average life of the total stock of debt outstanding to 6.2 years, down from 6.85 years in 2007.

Since the final months of 2012, sovereign debt markets have been largely on the mend, but the recovery in the Spanish case has been particularly remarkable. In 2013 and 2014 the yield on Spain's benchmark government bonds fell by 345 basis points and the spread against Germany fell by 252 basis points; the Treasury's average cost of issuance almost halved from 3.01% to 1.52% in the same time period. By June 2016, Spain's average cost of issuance is at 0.89%, the average cost of total debt outstanding has fallen below 3% for the first time since the start of the single currency, the average life of outstanding debt has broken its pre-crisis record at 6.85 years, and the debt- and interest-to-GDP ratios are expected to fall for the second year in a row.

Spain's economic recovery results from a broad agenda of structural reforms, notably in the financial sector and labour market, alongside fiscal consolidation and an unprecedented internationalisation of the economy. Consequently, Spain is now able to enjoy GDP growth and employment creation at around 3%, clearly above the eurozone average, while experiencing surpluses in its current account, gradually restoring its fiscal balance and stabilizing its public debt to GDP ratio (Figure 2).

During this period of time, Spain has had to adapt its funding policy to a new environment defined by larger funding programmes, the design and launch by the Treasury of new liquidity facilities for regional and local governments and, more recently, by the quantitative easing policies of the European Central Bank.

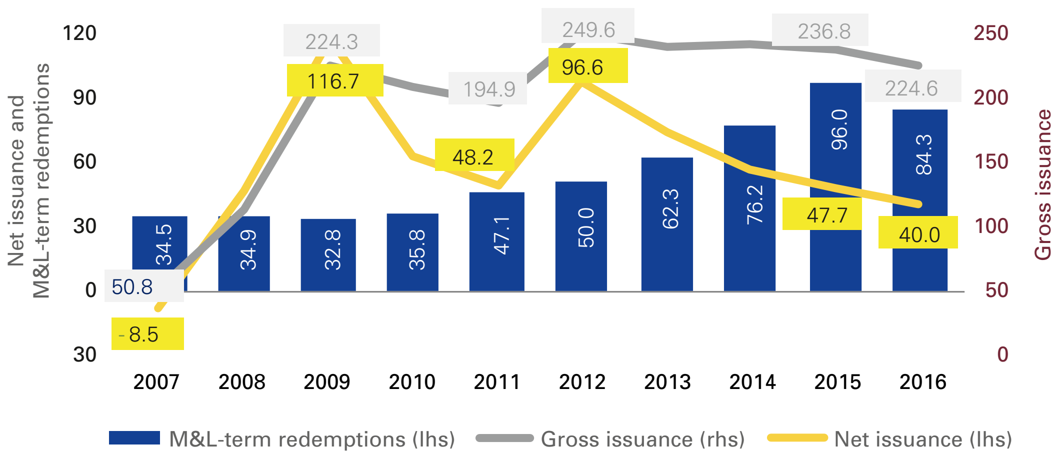
From a medium to a large issuer

Until 2007, the Kingdom of Spain's Treasury was a medium-sized issuer in the eurozone, with an outstanding central government debt of €307.2 billion in 2007 (28.4% of GDP) and a funding programme with negative net issuance. Since then, the Treasury has adapted its operations to a larger debt stock and a resulting higher volume of yearly redemptions. The need to finance a soaring deficit, in excess of 11% of GDP in 2009, expanded the Treasury's gross funding needs from €50.8 billion in 2007 to €224.3 billion only two years later. This rapid expansion was carried out through the accelerated issuance of the Kingdom of Spain's traditional securities, namely 12-month *Letras del Tesoro* (Treasury bills) and 3-, 5-, 10-, 15- and 30-year *Bonos* and *Obligaciones del Estado* (Treasury bonds).

Between 2009 and 2012, as is usually the case in crisis episodes, the Spanish Treasury's issuance profile weighed towards the short and medium part of the term structure (Figures 4 and 5). As a result, the outstanding *Letras* tripled between 2007 and 2010 and have remained stable since then. The weight of Letras in the programme increased significantly, especially during the start of the crisis. The bond issuance profile gravitated towards the 3- to 10-year part of the curve (Figure 5), and the average life of yearly bond issuance consequently fell to a minimum of 5 years in 2012 (Figure 5).

The crisis-driven reliance on short tenor issuance reduced the average life of the portfolio and increased annual redemptions. The refinancing of these redemptions increased the size of the gross funding programmes, in spite of the reduction in net funding needs achieved thanks to the reduction in the public deficit. Figure 3 shows the pronounced expansion of the funding programme between 2007 and 2009, and the gradual but commensurate increase in yearly redemptions.

Figure 3: Funding programme since 2007 (€ billion)



Source: Spanish Treasury

Beyond 2012, economic policy produced its desired outcome and more stable financing conditions allowed for a gradual normalisation of the funding programme. In this regard, Figures 4 and 5 show how the issuance has shifted towards longer tenors and how bonds have regained importance in relative terms as Spain has overcome the crisis.

Figure 4: Composition of outstanding debt (% of total debt outstanding)

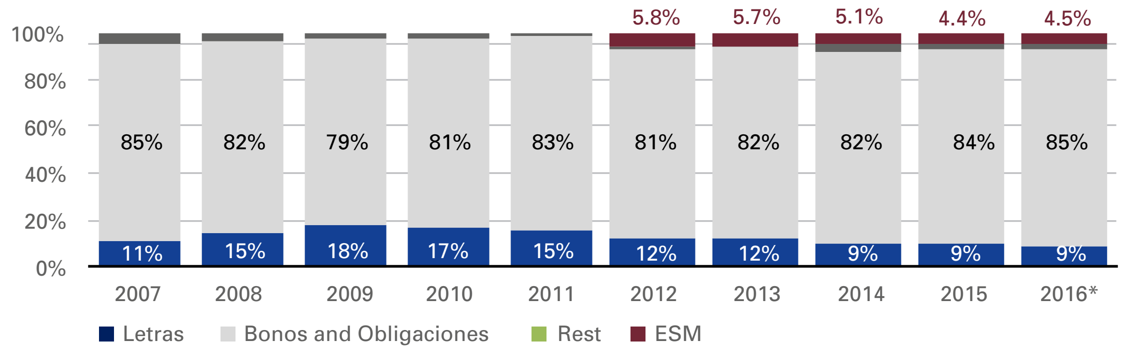
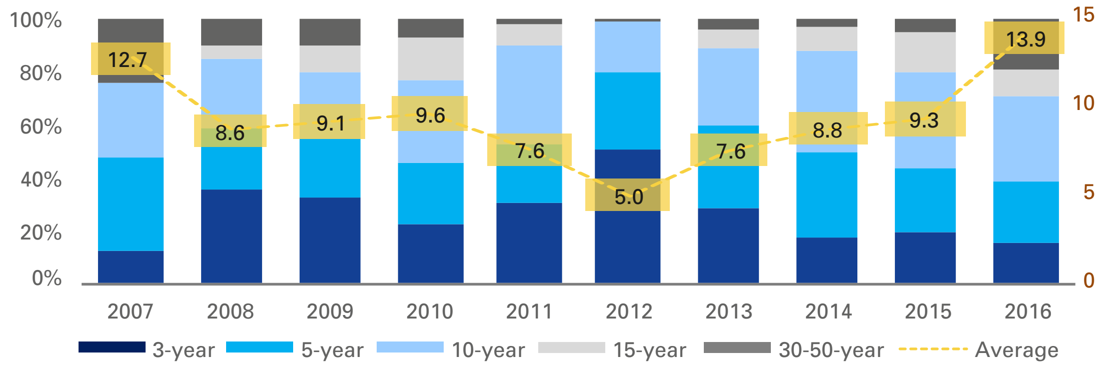


Figure 5: Average life of Bonos and Obligaciones issued (years and % of each year's issuance)



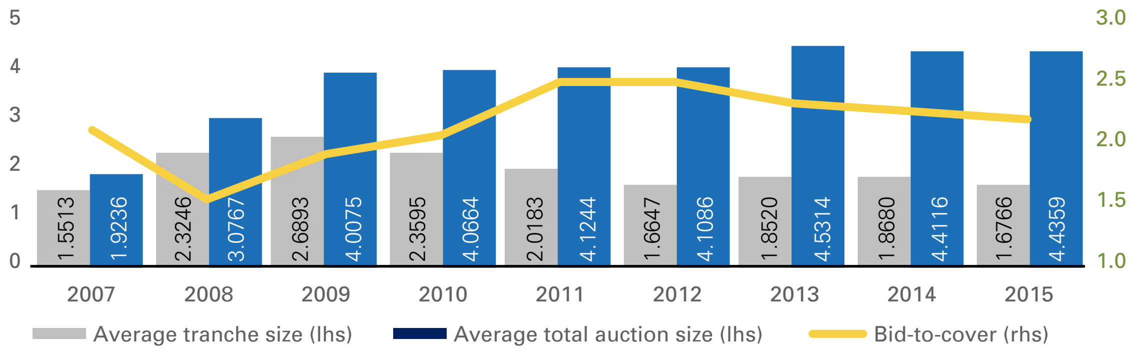
Source: Spanish Treasury

Additionally, since 2012 the Treasury has developed new financing mechanisms aimed at providing liquidity to regional governments and municipalities that, given the lower funding costs of the central government, have allowed for a reduction of the overall funding costs of the General Administration. Since then, over €140 billion have been raised by the Treasury and used to provide liquidity to regional governments through different funds aimed at, on the one hand, paying down regional governments' legacy one-off arrears, and, on the other hand, financing regional governments' debt redemptions and deficits. These new funds add to the Treasury's gross and net funding programme, albeit by replacing regional government issuance with central government issuance.

From an operations perspective, the timing of primary-market issuance did not change significantly throughout the crisis. The Treasury continued to adhere to an auction calendar announced at the beginning of each year. Larger gross issuance programmes, however, were executed by auctioning more frequently, twice a month for medium- and long-term bonds, and twice a month for *Letras*, instead of the traditional monthly auctions for each category.

As regards the selection of bonds to be issued in auctions, measures were taken to increase flexibility and better match investor demand. As a result, auction supply was diversified, becoming larger funding events, albeit combining similar or even smaller volumes of a greater number of bonds per auction. This facilitated execution since these combinations of bonds, selected to match market demand at each moment in time, were more easily absorbed. The tactical selection of bonds to issue, as well as the total size to auction on any given occasion, was made more flexible. The Spanish Treasury began to announce the bonds to be auctioned on the Friday before each auction by surveying primary dealers and evaluating market demand through different indicators. Figure 6 shows how Spanish auctions more than doubled in size between 2007 and 2009 stabilising thereafter, whereas the average size of individual tranches auctioned grew until 2010 to then diminish to levels similar to pre-crisis volumes, with no material reductions in bid-to-cover ratios.

Figure 6: Average size per auction/tranche and bid-to-cover ratio (€ billion)



Source: Spanish Treasury

In terms of product selection, the increase in the size of the Treasury's funding programme also led to the decision to introduce a new line of securities as part of the funding programme: euro area inflation-linked bonds. Other issuers in the eurozone had successfully launched this market segment. Spain followed suit and by doing so diversified its funding sources and investor base.

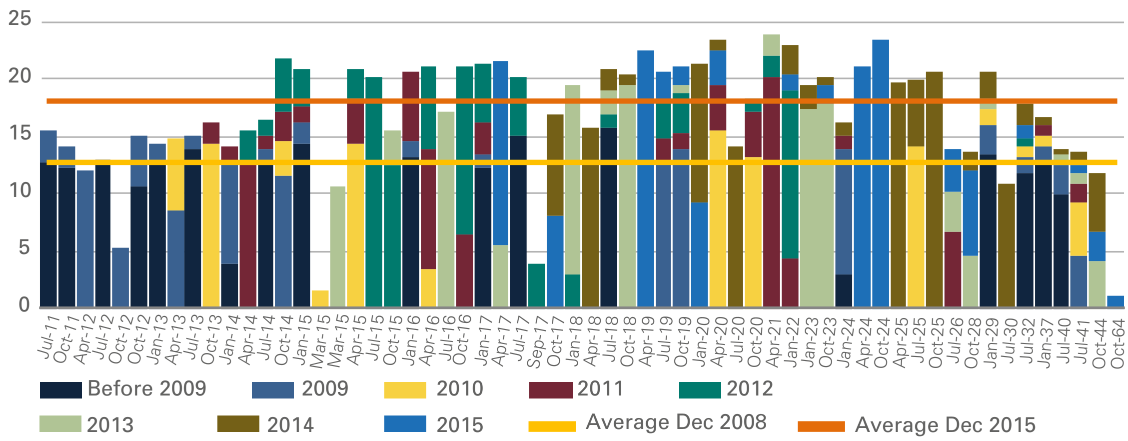
Focus on secondary market liquidity: Spain's primary dealership model

Secondary market liquidity is a critical feature for participants in the sovereign debt market. Access to a sufficient, constant flow of investment requires large internationally active funds to assign a portion of their portfolios to an issuer, which in turn requires the assurance that these positions can be scaled up or down quickly and at a relatively low cost. A market is usually seen as liquid if there is substantial and frequent trading (thus improving the likelihood of finding a counterparty to assume the other side of every trade), and the narrower the spread between the buying and selling prices at which a particular security can be traded (signalling the competitiveness of the market as well as the cost at which any given long or short position can be unwound).

The Kingdom of Spain has traditionally improved the liquidity of its market by combining a large enough outstanding volume per bond reference and a set of primary dealership rules aimed at ensuring the transparency and liquidity of its debt market.

A bigger outstanding volume usually engages more investors, making it more likely that any individual market participant will find a trading counterparty. Since the onset of the crisis, the Treasury decided to tap its off-the-run bonds along with its traditional benchmarks in order to increase the depth of liquidity available at each point on its curve. The average outstanding volume grew and the Treasury monitored off-the-run bonds choosing to tap them if at any point in time there were signs of a squeeze in the reference. Figure 7 shows how year after year the average size of its nominal references increased from €12.5 billion in 2007 to €18.1 billion in 2016.

Figure 7: Gradual build-up of size outstanding along the yield curve
(€ billion outstanding by end of each year)

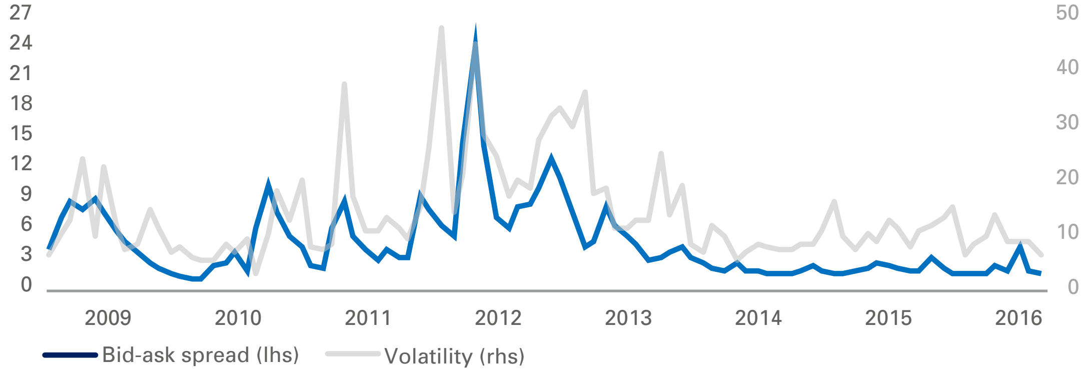


Source: Spanish Treasury
Note: dates refer to last day of each month

A market tends to be more liquid when there is a natural balance between buyers and sellers. When the market is volatile, however, and most investors are on the same side of a trade, it becomes necessary to count on a series of market players to provide liquidity irrespective of market conditions. In Spain's case, this role is fulfilled by primary dealers (PDs), a group of 22 banks committed to provide this valuable service to investors, and therefore indirectly to the Kingdom of Spain, in order to obtain regulated special access to the primary market. Even at the peak of the crisis Spain benefitted from a stable group of PDs with limited rotation in the names of the institutions acting as PDs and a stable number set at 22 banks.

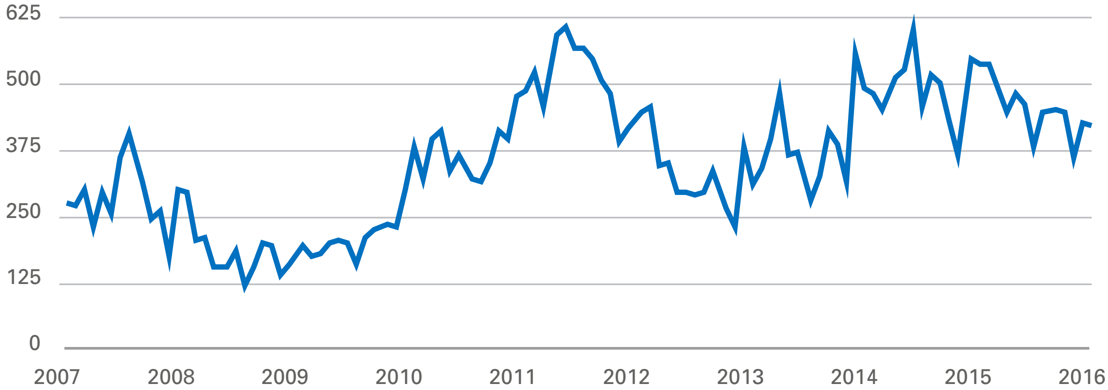
Figures 8 and 9 show how broad indicators of liquidity have fared for the Spanish market throughout the crisis. In the most volatile moments of 2011-2012, bond market turnover fell, market volatility increased and average bid-offer spreads for the flagship 10-year maturity widened. Towards the beginning of 2013, however, all of these indicators improved again to produce a more stable market to the benefit of investors. Throughout and after the crisis the Spanish PDs have played a vital job supporting market liquidity and contributing to the market's efficient functioning.

Figure 8: Average bid-offer spread in 10-year, volatility
(basis points, bps, volatility in 1-month rolling average standard deviation)



Source: Spanish Treasury

Figure 9: Turnover in Bonos and Obligaciones
(€ billion per month)

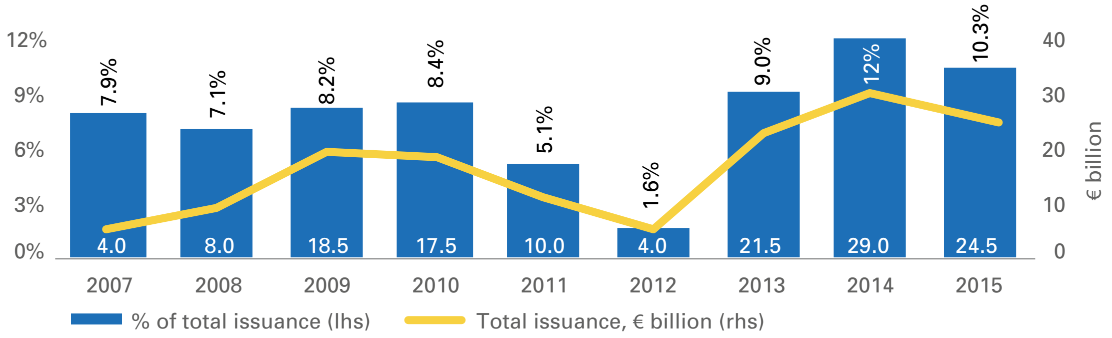


Source: Spanish Treasury

The relationship between the Treasury and its PDs is based on a list of transparent rights and obligations that each party has to observe and that are publicly regulated. PDs commit to a minimum standard of liquidity provision (maximum bid-offer spreads, minimum volumes available for sale and purchase for every quote) and regular participation in Spanish Treasury auctions. The Treasury monitors the compliance of PDs and ranks them according to their performance. In return, PDs have access to certain rights that include access to the second "non-competitive" rounds of auctions, as well as eligibility for syndication mandates (as lead or co-lead managers of varying status). Eligibility for syndication mandates is directly linked to the quality of the service provided. Non-compliant PDs shall lose access to the non-competitive rounds or even the right to be a PD.

Syndication affords the Treasury the ability to determine the exact distribution of larger initial tranches of new, usually longer-term or otherwise potentially delicate issues, to certain categories of investors, in order to ensure a stable launch in the secondary market. Figure 10 shows the percentage of total syndicated issuance carried out in the past decade. Although the vast majority of issuance has been carried out via competitive auction, a certain (relatively small) percentage of funding through syndication has been instrumental in ensuring the market remains liquid and stable throughout periods of market turmoil.

Figure 10: Share of syndications in total issuance
(% of total issuance, and total issuance)



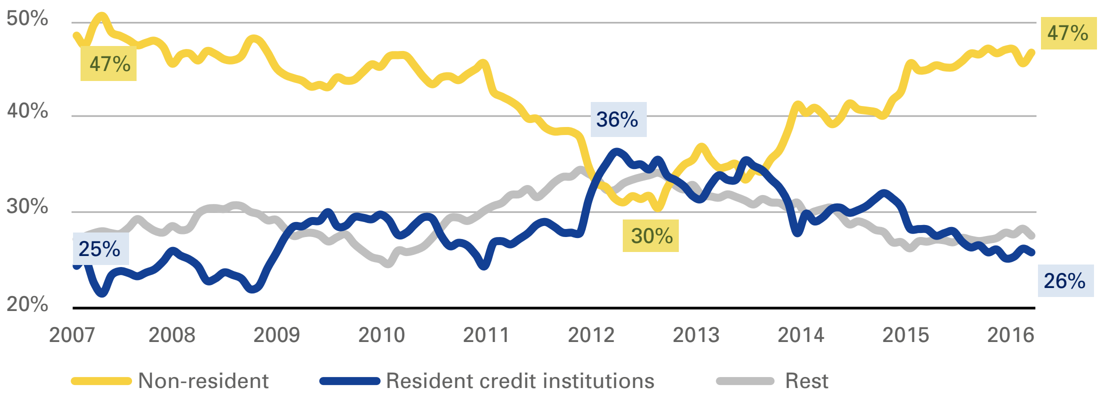
Source: Spanish Treasury

An intense focus on investor relations

Investor relations is a very important activity for every issuer and arguably more so during challenging market conditions. The Treasury engaged in regular road shows with investors and invested time and resources in explaining and communicating the strategy that would be followed to overcome the crisis.

Spain's investor base has evolved over time (Figure 11). Domestic investors, banks in particular, played a bigger role in relative terms, supporting the market throughout the crisis. Their relative importance as holders of Spanish bonds grew coinciding with the long-term refinancing operations and then gradually decreased. This home bias acted as a shock absorber for Spain. Non-resident investors gradually lost relative importance as the crisis unwound but recovered as the economic plan of the government was executed and its fruits gradually observed.

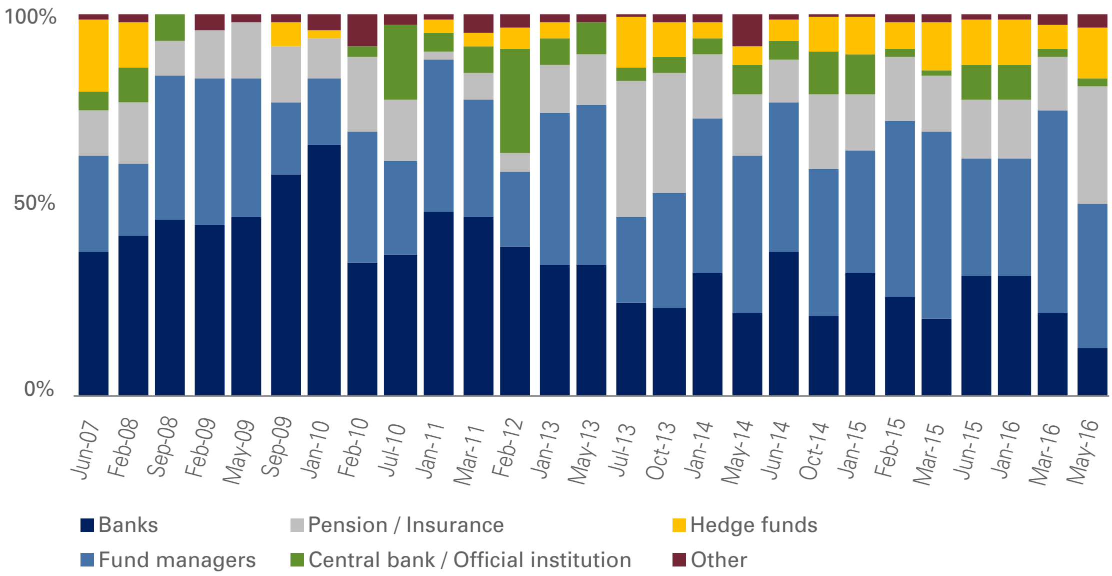
Figure 11: Term holdings of government debt (% of total debt outstanding)



Source: Spanish Treasury

The evidence from the Kingdom of Spain's syndicated issuance in the past decade (Figure 12) describes how different types of investor have been absorbing new longer-term benchmarks. The evolution over time of these investor types depends on the type of security syndicated and on the timing of the transaction. Over time, as Figure 12 shows, banks have ceded ground to real money investors.

Figure 12: Share of allocation in syndications
(% of total allocation per syndication, date of syndication)



Source: Spanish Treasury

The government's investor outreach efforts have also increased over time to help investors analyse and recognise the improvement in the Spanish economy. Nowadays, different teams of experts from the Treasury as well as the highest-ranking officers from the Ministry engage in regular and transparent conversations with investors to allow them to evaluate and decide to invest in the Spanish debt market.

Conclusion

During the crisis Spain had to adapt to challenging market conditions. Primary and secondary market policies were fine-tuned and an intense and dynamic market communication with investors and dealers was implemented to ensure that market participants could understand that the policies and practices adopted would allow Spain, as has been the case, to successfully overcome the crisis. A close relationship with the market has been instrumental in learning how to evolve from a medium-sized treasury to a large market player.

CYPRUS

Phaedon Kalozois, Public Debt Management Office

Introduction

The Republic of Cyprus lost market access in early June 2011. By that time, Cyprus's sovereign credit ratings were steadily falling but still they were well above investment grade (IG).

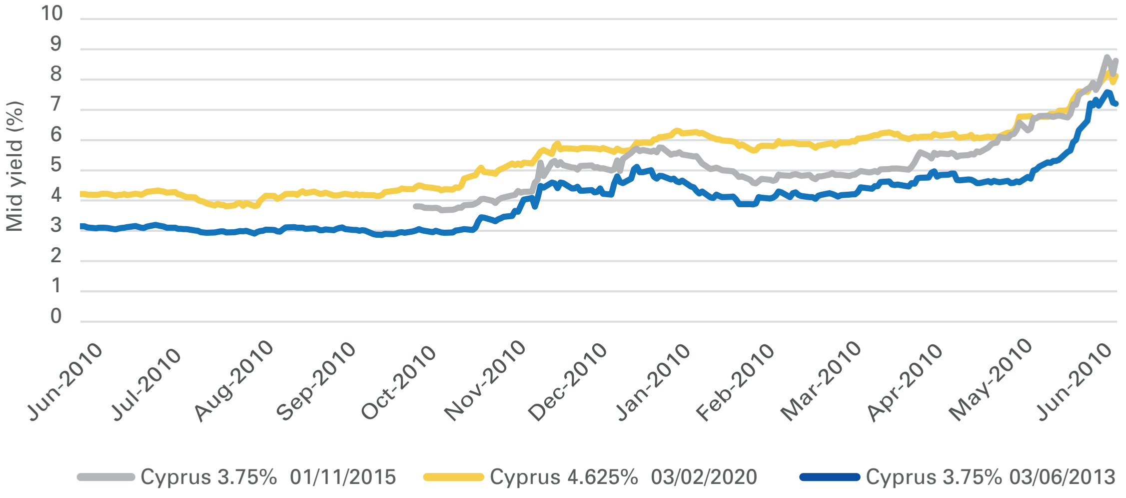
Table 1: Cyprus's sovereign credit ratings

	Fitch	Moody's	S&Ps
July 2010	AA-*	Aa3**	A+
June 2011	A-	A2	A-

Notes: *Last rating before July 2010 which was in July 2007. **Last rating before July 2010 which was in January 2008.
Source: Public Debt Management Office (PDMO), Ministry of Finance, Cyprus (Cyprus's PDMO)

At the same time, secondary market yields of Cyprus government bonds (CGB) followed a rising trend towards record-high levels.

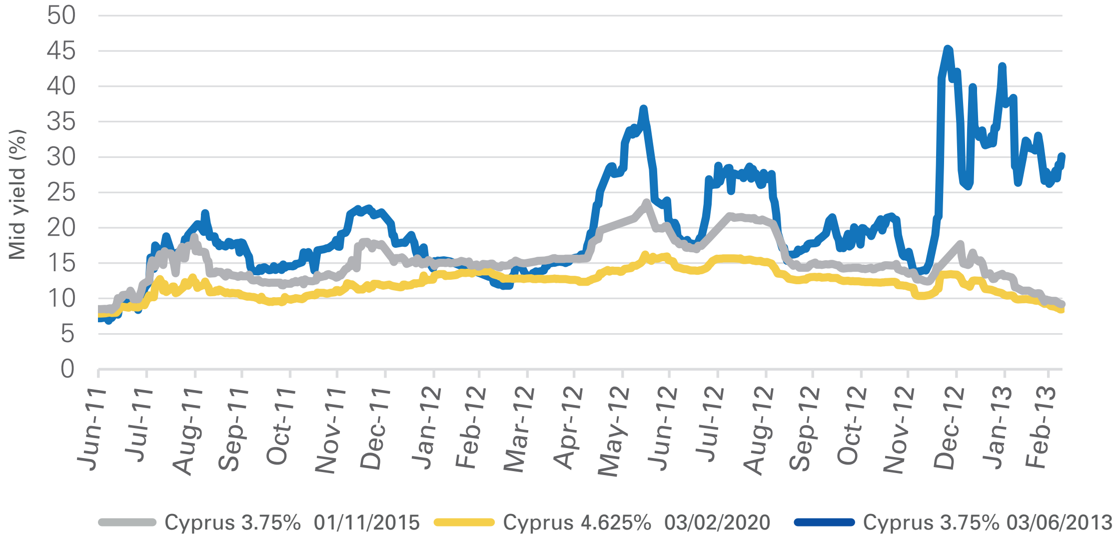
Figure 1: CGB secondary market yields: 30 June 2010–30 June 2011



Source: Cyprus's PDMO
Note: dates refer to last day of each month

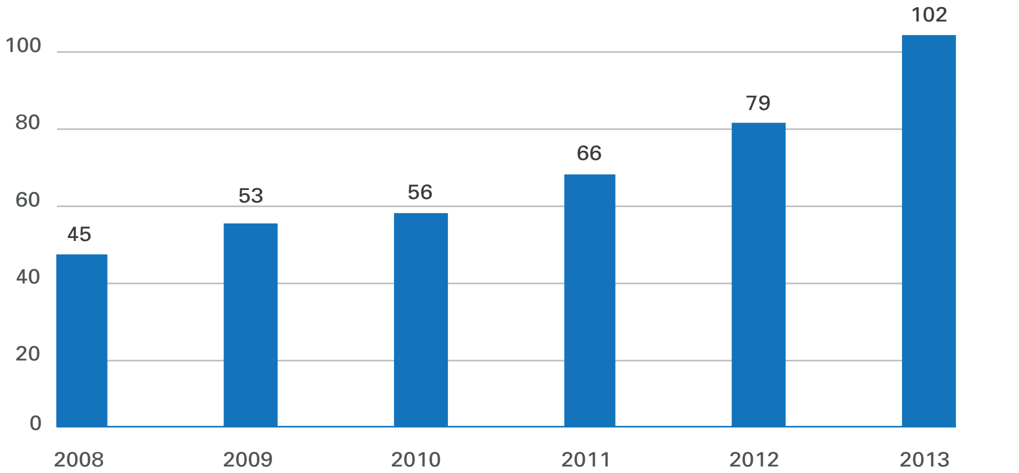
This situation was caused by a number of external and internal factors relating to the financial system but also to the implementation of a loose fiscal policy at the time. It had a serious impact both on market access and on economic fundamentals. One serious implication was the very large increase in the public debt.

Figure 2: CGB secondary market yields: 30 June 2011–28 February 2013



This situation was caused by a number of external and internal factors relating to the financial system but also to the implementation of a loose fiscal policy at the time. It had a serious impact both on market access and on economic fundamentals. One serious implication was the very large increase in the public debt.

Figure 3: Public debt as a % of GDP



Note: The 2013 public debt figure includes an accumulated amount of about €3.4 billion or almost 20% of GDP for partial bank recapitalisation by the State in 2012–2013 (about €1.9 billion in 2012 and €1.5 billion in 2013).

Source: Cyprus's PDMO

It seems that early warning indicators (market access difficulties, rising secondary market yields, falling sovereign and corporate/ bank credit ratings) did not function sufficiently in transmitting the right signals.

It soon became apparent that meeting near-term financing requirements was not enough to by-pass the crisis. The issuance of short-term government paper to raise funding, combined with a concentration of maturities in the short-term horizon, led to a deterioration of the financial and fiscal risks associated with public debt by accumulating very large refinancing needs in the near-term, while the situation in the economic system and mainly in the banking sector was rapidly deteriorating.

Short-term financing and risk indicators

Table 2 illustrates the evolution of (i) the short-term Treasury bills (TBs) as a percentage of general government debt, (ii) the percentage of public debt maturing within one year, and (iii) the weighted average maturity of public debt, for the period from 2011 to 2015.

Table 2: Public debt characteristics

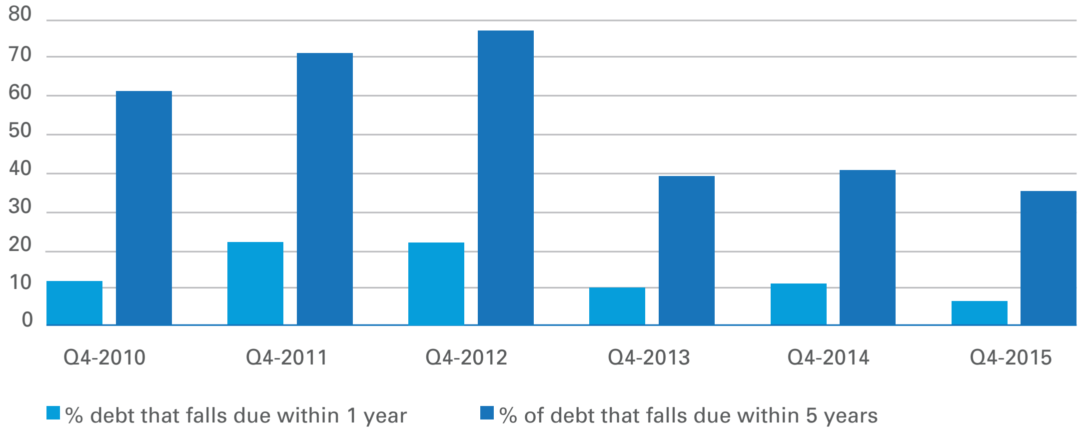
(year-end)	2011	2012	2013	2014	2015
Short term TBs and ECP as a % of public debt (%)	12.0	6.4	3.8	3.6	2.1
Public debt maturing within next 12 months (%)	21.3	21.2	9.6	10.7	6.1
Weighted average maturity of public debt (years)	4.6	4.7	7.9	8.0	8.5

Source: Cyprus's PDMO

From the above table it is clear that the said risk indicators associated with public debt, especially in 2011 and 2012, were by far inferior compared to their later 2015 levels.

The evolution of the above indicators is also depicted in the following figures:

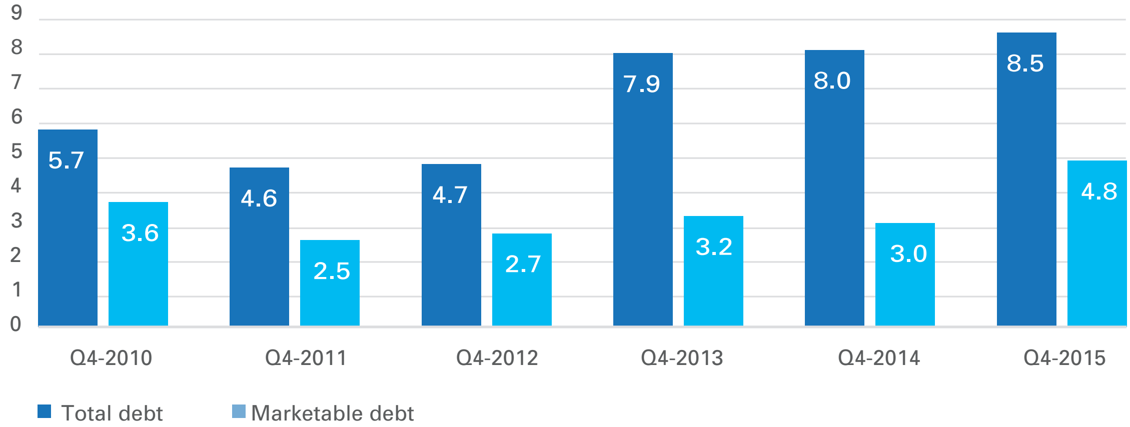
Figure 4: % of debt that falls due within one and five years



Note: The 2013 public debt figure includes an accumulated amount of about €3.4 billion or almost 20% of GDP for partial bank recapitalisation by the State in 2012–2013 (about €1.9 billion in 2012 and €1.5 billion in 2013).

Source: Cyprus's PDMO

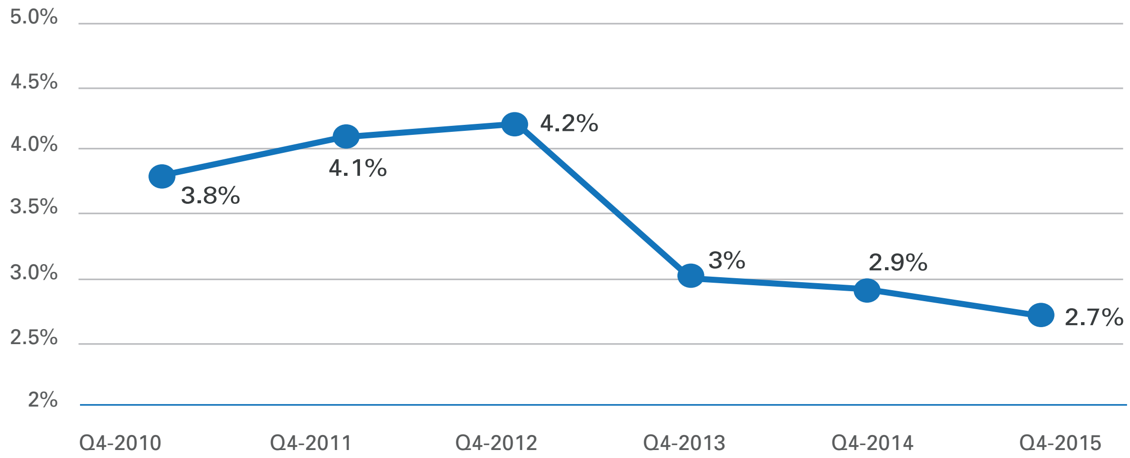
Figure 5: Weighted average maturity of debt (years)



Source: Cyprus's PDMO

As a result, the weighted average annual cost of servicing the public debt increased to 4.2% by the end of 2012.

Figure 6: Weighted average cost of servicing the PD (% p.a.)



Source: Cyprus's PDMO

Focusing on the specific reference period of the crisis, it gradually became clear that Cyprus's economy needed external official support. After extensive negotiations with the troika institutions, a Memorandum of Understanding was concluded in April 2013. Between April 2012 and April 2013 the government issued even shorter-term Treasury bills (mainly 1-week) at annual yields exceeding 5%, an all-time high rate for such a short tenor.

Having concluded the MoU with the European Commission, ECB and IMF, the Cypriot authorities implemented with diligence the agreed Economic Adjustment Programme (EAP) and delivered upfront very positive results, especially in the area of public finances. In addition, and despite the painful bail-in and the restructuring imposed on the banking sector, the international business sector of Cyprus proved to be quite resilient to economic shocks.

Usage of the official programme funding

Cyprus used only about €7.25 billion of the approved €10 billion bailout programme. It should be clarified that the €10 billion bailout funding did not allow for the repayment of a number of domestic government bonds that were due to mature within the official programme period. As a result the government, after negotiating with the holders of these bonds (domestic banking institutions), extended their maturity beyond the programme period. Despite the agreement of bondholders, the operation was considered to be a distressed transaction by credit rating agencies. Later, the government repaid the biggest portion of the bonds through market funding. The remaining portion of these bonds, which mature in 2019, are held by banks as they have a higher coupon than the current rates.

Main determinants of timing

- Timing in re-entering markets was determined by secondary yield developments. The first actual testing of market access was carried out via the execution of a small private placement transaction in May 2014.

Encouraged by the positive fiscal results and the favourable capital market environment, Cyprus re-accessed the markets with a syndicated issuance in June 2014, that is about one year after the conclusion of the MoU.

This was possible thanks to a number of factors: (i) the better-than-expected macroeconomic and fiscal performance of the economy and the steady improvement in banking sector fundamentals; (ii) the political system which showed a high degree of responsibility and stability while Cypriot institutions demonstrated that they were credible in implementing the economic adjustment programme (MoU) and as a result fiscal sustainability was safeguarded while achieving positive troika Reviews; (iii) the authorities utilised the time during which Cyprus was out of the markets in order to devise a medium-term public debt management strategy (MTDS)[1] which enabled the Public Debt Management Office (PDMO) to be continuously in touch with the markets, to be transparent and able to provide credible information to the markets; and (iv) the generally positive sentiment in the markets regarding the European periphery and a strong showing of other periphery sovereign and corporate issuers.

Two additional syndication Euro Medium Term Note (EMTN) issues were executed in 2015. These are described in the following pages.

1 In the specific area of public debt management, the Republic of Cyprus received valuable technical assistance (TA) from the ESM, the IMF, the World Bank and the Commonwealth Secretariat. TA was also extended by the aforementioned institutions and by additional organisations to the fiscal policy area as well as to other relevant fields of public financial management and public sector reform.

Key themes

Underlying determinants for successful market re-entrance:

- Enhanced efforts with investors which were supported by positive programme reviews; pre-crisis investor relations efforts were limited and not based on a continuous objective-based strategy. A more proactive approach was taken in the last few years with a specific investor relations strategy being put in place. During this time, a continuous effort was made to reach out to the investor community through direct meetings and discussions with investors and via the regular publication of information material. In particular, Cyprus engaged in a number of non-deal (non-transaction) related roadshows) during the last few years in order to continuously update investors and be ready to take advantage of favourable market conditions; also non-deal roadshows became broader, both in relation to geographical coverage and also investor type.

- Re-built market confidence: a significant effort has been made, aimed at educating investors about the actual economic situation in Cyprus, building a culture of transparency and credibility by providing reliable data and promoting a culture of delivering results based on the commitments that Cyprus had undertaken. The fact that EAP targets were met and surpassed by considerable margins provided significant goodwill with investors.

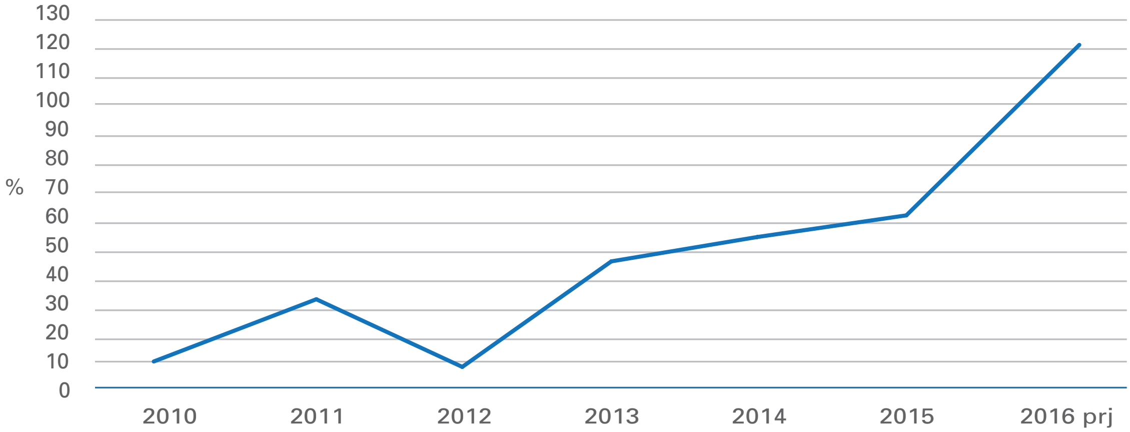
- Before the crisis, the major decision-making determinant was the cost of every single borrowing transaction. This approach has changed and no longer holds in the post-crisis period. Currently, the authorities acknowledge MTDS as a strategy on its own, distinctive from fiscal policy. As a result, MTDS is now not considered to be a tool for fiscal policy but a stand-alone strategy in itself. This allows the authorities to take medium-term decisions on the basis of medium-term cost/risk factors. Thus the medium-term cost of servicing the public debt, combined with an acceptable level of risk, is now the most important determinant of borrowing transactions. This is a fundamental change, as it allows policy-makers to implement the most rational MTDS under which other factors of strategic importance are also taken into account, including risk parameters associated with public debt management.

- Currently there is no primary dealership system in place, a fact that limits the efficiency and the liquidity capacity of the sovereign bond market in Cyprus. Nevertheless, the Ministry of Finance plans to introduce such a system as soon as market conditions allow its smooth and successful implementation. To this end, the PDMO has received technical assistance from the IMF and relevant advice from the ESM and the European Commission. The authorities are also in touch with international and domestic banking institutions in an effort to explore further the possibilities for the introduction of primary dealers in due course, depending on market conditions.

- Liability Management (LM): in the pre-crisis period, the PDMO was not engaged in any liability management transactions. The newly established MTDS incorporates clear provisions for LM transactions aimed, on the one hand, at managing re-financing risk and, on the other hand, at taking advantage of possible price differentials in the market. In addition, LM provides an extra option to investors as it creates liquidity, which functions as an incentive for their investment decisions.

- The accumulation and maintenance of large cash buffers was supportive in maintaining a positive sentiment in the market as it is seen as a sign of stability, which provides the government with a lengthened reaction period to deal with unexpected external shocks. This strategy constitutes a significant change from pre-crisis policies, where the cost of carry of maintaining cash buffers was the main, if not the only determinant of their size. In the context of the current strategy, a sufficient cash buffer is one that covers refinancing needs at least for the next 12 months.

Figure 7: Percentage of cash reserves/debt due within one year (%)



Source: Cyprus's PDMO

- Supportive low-yield eurozone environment: the low-yield eurozone environment has been very supportive in Cyprus's efforts to regain sustainable market access.

Issuance strategy

With the approval of official funding and the implementation of the measures included in the EAP, the urgent liquidity crunch that existed up to then subsided and Cyprus set forward to restore its borrowing capabilities. The current issuance strategy is fully reflected by a newly adopted, credible MTDS. In addition, the Ministry of Finance has strengthened the PDMO's internal capacity for enhancing its market intelligence function and improving investor relations.

The purpose of the issuance strategy as part of the MTDS, while Cyprus was under a programme, was to serve as a bridge between the programme period and the post-programme period; this could be achieved by maintaining a regular market presence and a sufficient international market share for the Republic of Cyprus (see Figure 9).

The main objectives of the MTDS include:

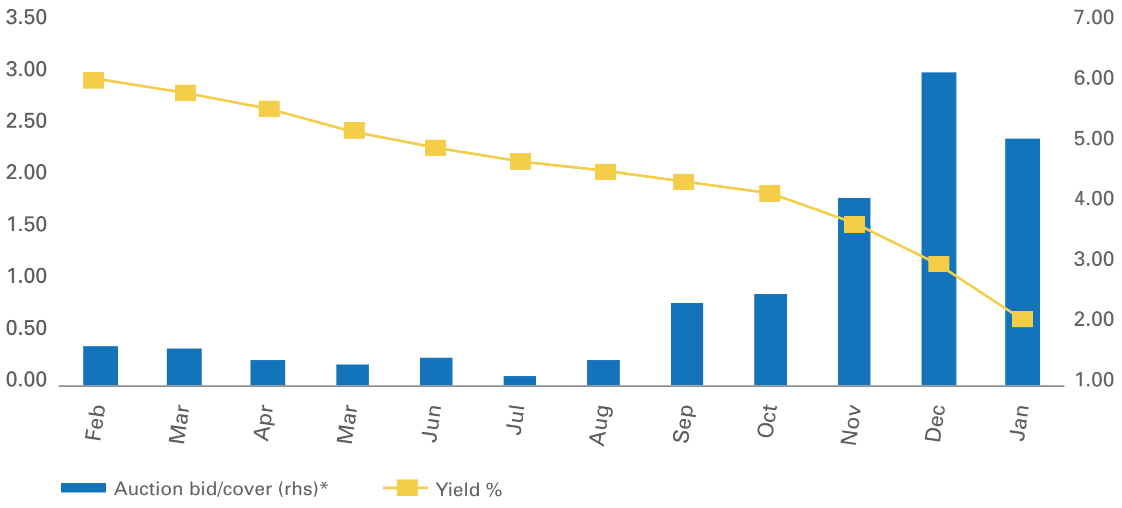
- Smoothening of debt maturity profile and increasing the maturity of marketable debt;
- Addressing refinancing risk by maintaining liquid funds (prefunding at least the next 12-month period);
- Risk mitigation via reduced exposure to foreign currency and interest rate risks;
- Building an international yield curve for Cyprus government bonds;
- Enhancement of investor relations and expansion of investor base.

The above strategy worked quite well in conjunction with the successful implementation of the EAP and the significant improvement in the Cyprus economy.

In the period 2013-2016, the domestic investor universe was not in a position to provide full financing to the government. Therefore, the PDMO targeted mainly international investors for the long-term bond issues that were executed. As the economy improved, a number of domestic investors were able to re-enter the market (see Figure 10).

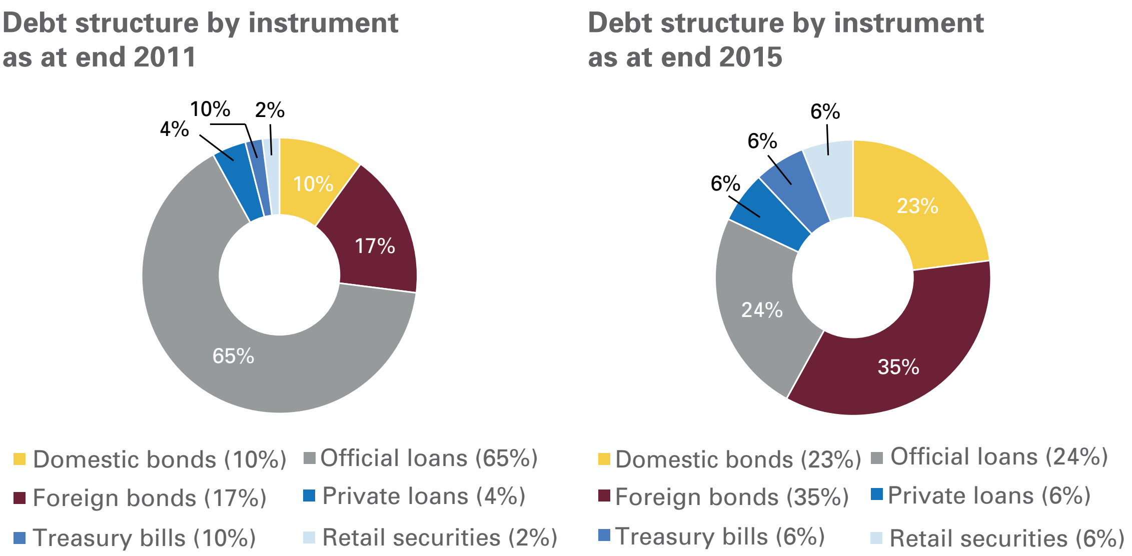
Regarding short-term paper (less than one year), the PDMO concentrated on domestic investors and mainly on bringing back to the market investors who had stopped participating due to the crisis. The target of completing the re-establishment of an orderly functioning treasury bills market was fully achieved by the end of 2015.

Figure 8: Treasury bill market in Cyprus (2015)



Source: Cyprus's PDMO

Figure 9: Public debt structure overview



Source: Cyprus's PDMO

Figure 10: Euro Medium Term Note (ETMN) market

Broadening of investor base

At the latest (Nov. 2015) EUR benchmark transaction, Cyprus achieved a broad distribution in terms of investor origin and type;

Strong participation of buy and hold investors;

This transaction was the second accelerated Switch in Europe from a Sovereign;

Combined orderbook ≥ €3.35 bn

Top-tier global investors exhibited a sizeable interest in the issuance.

Source: Cyprus's PDMO

CGB (EMTN) 4.25% 10-year 2025

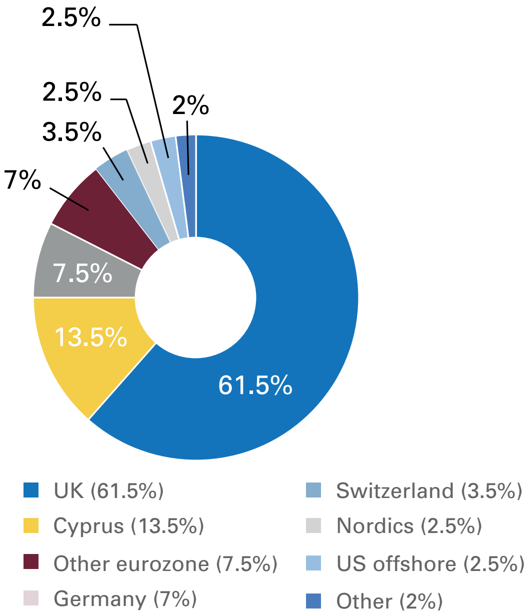
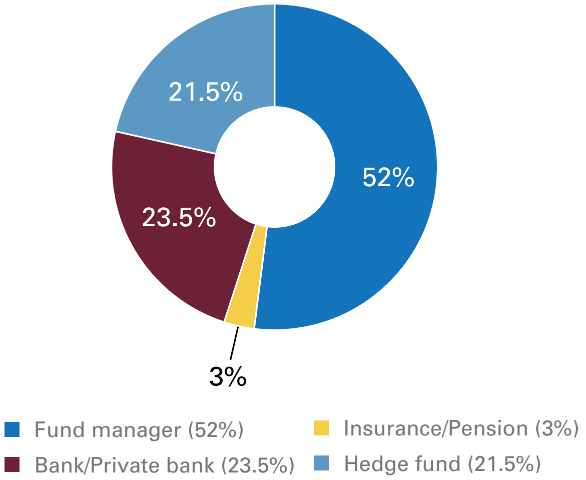


Figure 11: CGB (EMTN) 4.25% 10-year 2025, by investor type



Source: Cyprus's PDMO

New issuances of Cyprus government bonds (EMTNs) have been systematically over-subscribed and well supported by almost all market segments. Main marketing efforts were concentrated in London, Paris and Frankfurt.

Evolution of issuances and investor relations

During the program period, Cyprus issued three benchmark euro bonds through syndication and one private placement in the international markets. All issue proceeds were used to facilitate debt re-profiling through liability management exercises and the creation of large cash buffers in anticipation of the exit from the programme. These issues helped in the reintroduction of Cyprus to the markets and the creation of a yield curve which allows for the better pricing of bonds in the future.

EMTN issues issues during the programme period (April 2013-2016) are summarised below:

Table 3: EMTN issues during the programme period (April 2013–2016)

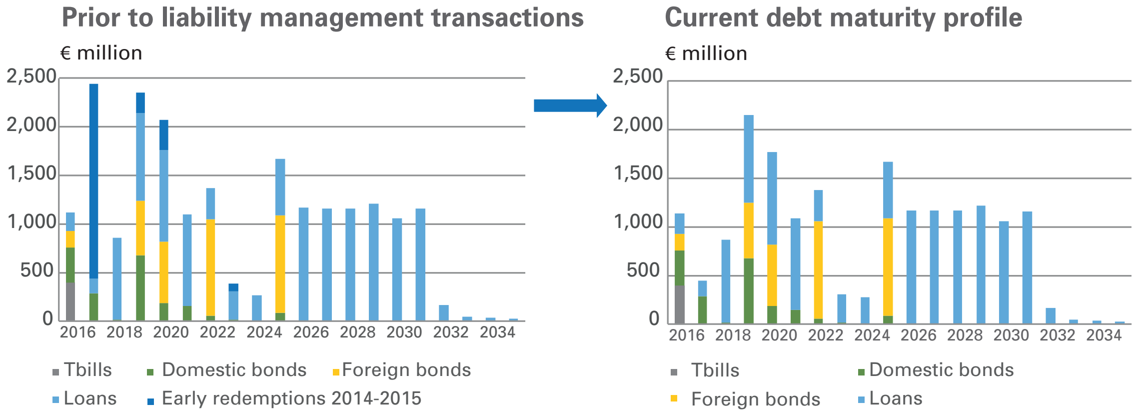
Value date	Convention	Nominal amount	Tenor	Coupon p.a.	Yield p.a.
May 2014	Priv. Placem.	€ 100 million	6-year	6.50%	6.50%
June 2014	Syndication	€ 750 million	5-year	4.75%	4.85%
May 2015	Syndication	€ 1000 million	7-year	3.875%	4.00%
Nov 2015	Syndication	€ 1000 million	10-year	4.25%	4.25%
		€ 2.85 billion (15% of PD)			

Source: Cyprus's PDMO

The use of the above market funds for LM purposes enabled Cyprus to smooth out maturities, lengthen the average maturity, reduce refinancing risk, maintain a regular presence in the market without increasing the level of the public debt, and to take advantage of borrowing cost differentials. For instance, the last syndication of November 2015 10-year tenor at 4.25% was partially exchanged (switched) with the EMTNs maturing in June 2019 (4.75%), in February 2020 (4.625%) and in May 2020 (6.50%).

The improvement in the maturity structure of public debt resulting from Liability Management actions is depicted in Figure 12:

Figure 12: Evolution to current debt maturity profile



Source: Cyprus's PDMO

Participation in primary issuances, price formation

Price formation was based on the existing spreads plus a new issue premium. An additional premium for the low ratings is embedded in the secondary market spreads. However, given the very favourable market conditions and the prevailing low yields, the final yields on new bonds were lower than the coupon rates on the existing bonds issued in the past despite the much better credit ratings assigned in the past.

Improvements in the economic situation and gradual sovereign credit rating upgrades contributed to the good performance of Cyprus's bonds in the secondary markets, which itself contributed to the enlargement of the available investor pool, both in terms of numbers but also in terms of nature, as the prominence of hedge funds was reduced in between the two issuances of 2015.

It is expected that as Cyprus' ratings improve, the investor pool will continue to grow and more conservative investors will also be involved in the market for Cyprus sovereign bonds.

Issues/concerns/obstacles investors faced

- Initially, the most serious concern of investors had to do with the confidence in the State. Not only corporate but also sovereign bond issuers need to be transparent and credible. Investors do not invest always in AAA-rated bonds but they always demand credible and full information. Gradually, confidence was restored as the State proved also to be credible in implementing the agreed EAP.

- A second consideration was the low rating of the sovereign in the non-investment category, which hindered certain investors from conducting sizeable purchases. However, the most important factor in the context of the credit ratings is the trend of improvement and the prospects reflected in the outlook assigned by credit rating agencies; the outlook needs to be positive or stable. A negative outlook assigned to non-investment grade ratings might be a major obstacle in restoring sustainable market access.

- Finally, investors were highly interested in the inclusion of Cyprus in the ECB's Quantitative Easing purchases, with respect to its timing and duration.

Key success factors in re-establishing broad-based investor relations

In summarising the key success factors for attracting a broad investor base, the following points could be highlighted:

THE RULE OF FIVE:

i. Successful application of fiscal policy as well as diligent implementation of relevant commitments under the EAP/ MoU;

ii. Adoption of a clear, reliable and transparent MTDS to which the government is committed and by which rational combinations between cost and risk are set as targets within the medium-term view;

iii. Increased visibility of the Sovereign and enhanced contact with investors in international capital markets by engaging in non-deal roadshows, conference calls and other investor–related events, as well as by the production and distribution of investor information;

iv. Improvement of the degree of liquidity of government bonds by providing additional or combined investment options, for example through liability management (e.g. buybacks or switch transactions);

v. Containment of any unpredictable credit risk by maintaining a sufficient cash buffer.

Role of the European environment

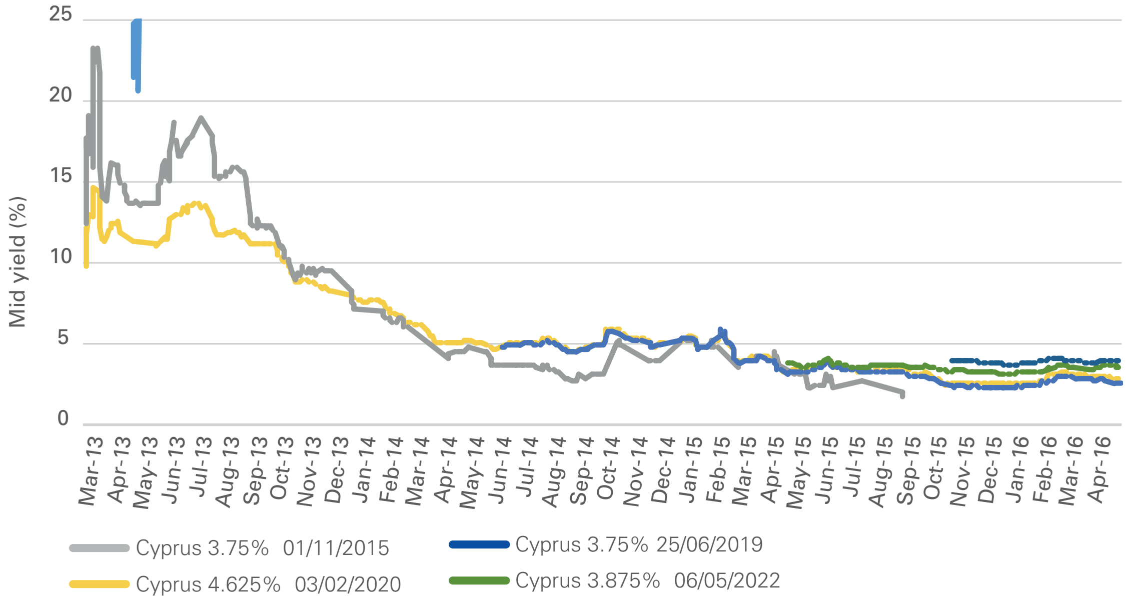
In the case of Cyprus government bonds, the ECB QE (asset purchase programme) played an important but mainly indirect role, by lowering secondary yields in the European sovereign markets;

It also played a less important – direct role – by the purchase €285 million worth of CGBs, which represents 1.5% of total public debt or approximately 4.5% market debt (as at end 2015).

Generally, the existence of a low interest rate environment has been very important in Cyprus' return to the markets as it has allowed for the issuance of new debt at attractive but fiscally sustainable interest rates, while investors seeking high yields have been willing to accept the non-investment grade in order to achieve better returns, provided that credit ratings feature positive/ stable outlooks.

The above progress is reflected in secondary market yields and partially in the Cyprus' sovereign credit ratings.

Figure 13: Cyprus government bonds secondary market yields: March 2013–May 2016



Source: Cyprus's PDMO
Note: dates refer to the 15th of each month

Table 4: Credit Ratings: March 2013–March 2016

Since 2013 on an upgrading path of up to 5 notches; credit outlook currently is either stable or positive

Credit Rating Agency	Long-term debt					
	Latest rating			Rating of Cyprus as at end March 2013		
	Rating	Outlook	Notches below investment grade	Rating	Outlook	Notches below investment grade
DBRS	B (Dec. 2015)	Stable	5	CCC	Negative	7
Fitch	B+ (Oct. 2015)	Positive	4	CCC	Negative	7
Moody's	B1 (Nov. 2015)	Stable	4	Caa3	Negative	9
Standard & Poor's	BB- (March 2016)	Positive	3	CCC	Negative	8

Source: Cyprus's PDMO

Conclusion

The first and most important goal was to restore investors' confidence by fulfilling commitments and by being transparent and reliable: the ability to swiftly implement measures to remedy macroeconomic and fiscal problems is very important for convincing investors to remain active in a sovereign market during a crisis.

Equally important is the proper management of the financial system; any financial crisis takes time to settle, however investors expect to see at least a gradual but clear progress.

Have in place a credible and rational MTDS: be ready to take advantage of favourable market developments, but never on an opportunistic basis; even in cases of crisis and difficulty in accessing the market, it is important to maintain contact with market participants and develop a transparent relationship with investors in order to facilitate re-entry into the market.

Above all, continue on the path of sustainable economic policies safeguarding long-term fiscal sustainability.

The policy framework described above enabled Cyprus to improve all risk indicators associated with public debt and to re-establish market access.