

# Introducing a Secondary Market for Government Securities

The development of a country’s capital markets has been long recognized as being critically important for promoting its long term economic growth and development. In both developed and developing countries, the market for government securities has served as the platform for the development of the broader capital market and later, as the center-piece of a fully-functioning capital market.

The Government securities market is comprised of a **primary market** in which the Government creates the security and first sells it to the market and a **secondary market**, where trading of the securities after issuance and before redemption, takes place.

The issuance of government securities in the primary market is usually for the purpose of securing resources to finance a budget deficit. This means of budget financing is generally used instead of government borrowing from the Central Bank which has highly inflationary effects. It is to be noted, however, that even in cases where there is no budget financing requirement, governments are disposed to issue securities to provide alternative investment opportunities for investors, to facilitate the development of the wider capital market and to contribute to the conduct of monetary policy.

While the secondary market in government securities does not provide additional resources, its development could be of immense benefit to the government as well as a critical ingredient in the country’s financial infrastructure. Specifically:

- By providing opportunities for more frequent trading, the secondary market improves the pricing process for government securities. In turn, the existence of secondary market prices allows market participants to make an informed judgment about the appropriate price of a security when bidding in the primary market auction.
- Secondary market trading also provides a mechanism for government securities to move from investors in the primary market to a wider group of end-investors, such as insurance companies, pension funds and retail investors.
- The development of a well-functioning secondary market in government securities may also act

as a primer for other fixed-income securities markets. As a market (virtually) free from credit risk, its yield curve becomes a benchmark for pricing other financial assets, thereby helping to establish an overall credit curve.

The secondary market for government securities broadens the range of available assets for investors and provides opportunities for more efficient liquidity management for both financial and non-financial firms. The secondary market could also be a welcome addition to institutional and retail investors who are interested in active portfolio management.

For the past several years, the Government and the Central Bank (in its role as Advisor on debt management matters) have implemented a number of reforms to improve the market infrastructure for government securities. Essentially, these reforms have sought to increase market transparency, broaden participation in the market, facilitate efficient, secure and cost-effective settlement and increase market liquidity.

### The Electronic Auction System

A market-based auction system was introduced to replace the underwriting system for the distribution of government securities in the primary market. This shift was accompanied by an increase in the number of participants allowed in the primary market. These participants, all of whom are financial institutions registered under the FIA or the SIA, were designated Government Securities Intermediaries (GSIs). The auction system also brought more competition and greater transparency to the process of price determination in the government securities market.

### Clearance and Settlement

The Central Bank has established an electronic Government Securities Settlement System (GSS) which incorporates an on-line auction system and a securities depository. The GSS is integrated with the Real Time Gross Settlement System (RTGS) to facilitate the settlement of government securities transactions and simultaneous recording of the ownership in the depository. The introduction of the GSS and the link to the RTGS will serve to guarantee quicker, safer and more efficient settlement for government securities transactions.

### Liquidity

Between 2000 and 2007, the value of government and government-guaranteed bond issuance averaged around \$3,000 million a year, with some slowdown in the more recent period. This issuance has been over the entire range of maturities in an effort to construct a benchmark yield curve. (See Table below).

Table Primary Bond Market: Public Sector Issues TT\$Million			
Year	Central Government	State Enterprises and Public Utilities	Total
2000	897.1	2546.9	3444.0
2001	676.0	2046.7	2722.7
2002	1131.0	1901.5	3032.5
2003	2000.0	3403.8	5403.8
2004	1116.0	1261.4	2377.4
2005	800.0	2359.1	3159.1
2006	700.0	1800.0	2500.0
2007	1692.0	---	1692.0

Source: Central Bank of Trinidad and Tobago.

### Secondary Market Infrastructure

Over the past year, the Central Bank, in collaboration with the Trinidad and Tobago Stock Exchange, has taken a number of steps to set the basis for secondary market trading in government securities. This list of actions included:

**First**, the Bank has been appointed as the Registrar and Paying Agent for all issues of government and state enterprise bonds issued under the Government Securities Auction System. The centralization of this function in the Central Bank will facilitate a quick transfer of ownership of traded securities. The Bank is taking steps to be appointed as the Registrar for securities issued before the introduction of the electronic auction system.

**Second**, all government securities issued under the auction system are in dematerialized form and are now recorded in the securities depository managed by the Central Bank. The de-materialization of all other government securities outstanding and their transfer to the depository is currently in progress. De-materialization of securities and their replacement by securities accounts held in the depository improves the efficiency of secondary markets by allowing transactions to take place quickly and cheaply.

**Third**, government securities intermediaries (GSIs) have been licensed to trade in government securities after being registered by the Securities and

Exchange Commission (SEC). Licensed stockbrokers will also be allowed to trade in government securities on the stock exchange.

**Fourth**, the platform of the Trinidad and Tobago Stock Exchange has been modified to accommodate secondary market trading in government securities. Interfaces have been established between the licensed participants (the GSIs and the stockbrokers), the platform and the depository.

**Fifth**, government securities trading rules have been approved by the SEC, after extensive market consultations.

As in other developing countries, the achievement of a well-functioning, liquid secondary market for government securities will present several challenges. One such challenge would be to convince institutional investors to abandon a “buy and hold” in favour of a more aggressive trading stance. Such a change will take time but would depend on meeting two preconditions viz :

- a regular, predictable and sufficient supply of primary market issuance to ensure that institutions could correct short positions as needed; and
- adequate and reliable information, including the publication of size and prices of recent transactions and bid-offer spreads. The point here is that participants will be more willing to trade if they are reasonably confident that they are getting a good price.

The Bank is working with the various stakeholders to ensure that these two pre-conditions are met.

The formal start of secondary market trading in government securities is scheduled for end-January 2008. The public will be notified of the specific date.

The Bank would like to express its deep appreciation for the considerable support and collaboration received from the SEC, the TTSE, the Securities Dealers Association and all the other stakeholders. We look forward to your continued support to ensure a vibrant secondary market for government securities.

# Arrangements for Secondary Market Trading

## Difference between the Primary and Secondary Bond Market

The first-time issue of a Government bond is known as the *primary issue* and the institutions and arrangements involved in this issue are referred to as the *primary market*.

Once the bond has been issued, an investor may decide to hold this asset until it is finally repaid (*matures*) or to sell it. In the case where a decision is made to sell the bond, the individual investor goes to an institution that is authorised to trade this bond. The institutions that perform this function are the licensed stockbrokers and the Government Securities Intermediaries (GSIs), collectively termed *Exchange Members*. These Exchange Members take orders to buy or sell and execute these transactions with other Exchange Members, either for themselves or the accounts of their clients. The institutions and arrangements involved in this trading comprise the *secondary market* for these bonds and each time a bond changes hands, it is referred to as a *secondary market transaction*.

In essence, the secondary bond market facilitates the transfer of ownership of an investment and its conversion to cash prior to its *maturity* (promised repayment) date.

## Trading System Operation

The Trinidad and Tobago Stock Exchange (TTSE) will introduce an electronic system for secondary market bond trading from January 2008. This system allows Exchange Members to enter their trading orders, and those of their clients, directly from their desks to the TTSE. These buy or sell orders are automatically matched and trades completed at the TTSE. The trading system at the TTSE is linked to an electronic depository at the Central Bank. Once a trade is completed at the TTSE, an instruction is sent to the depository which records the changes in ownership on settlement date at the same time with the transfer of funds from the buying Exchange Member to the selling Exchange Member. To accommodate the latter, all Exchange Members must maintain trading accounts at the Central Bank.

## How to Buy or Sell a Bond on the Secondary Market

In order to trade a Government bond on the TTSE, the bond must be recorded at the electronic depository at the Central Bank. Bondholders wishing to sell their bonds must therefore ensure that these are registered in electronic form at the Central Bank. The Bank is taking steps to have all Government bonds brought

into the depository. This means that these bonds must be *de-materialised*, which involves replacing the paper certificates by an electronic database. The bond certificates are therefore cancelled. Investors will receive regular statements from the depository on their holdings.

The arrangements for trading are as follows:

- 1) The investor goes to an Exchange Member and completes the client account documents and gives written instructions to buy or sell by way of a standard form.
- 2) The Exchange Member then enters the transaction to either buy or sell bonds directly from its office into the electronic trading system at the TTSE. For a buy order, the Exchange Member will verify the source and amount of the client’s funds required for the transaction. For a sell order, the client’s holdings in that bond will be verified.
- 3) A trade takes place when independent buy and sell orders are matched on the TTSE. This means that a trade will occur when two independent parties have each entered corresponding buy and sell

orders for the same bond.

Orders are first matched on the basis of price; i.e. where there is a buy and a sell order for the bond at the same price, the orders will be matched and a trade confirmed. If there are competing orders that can be matched at one particular price, the order which was entered earliest will be given priority, followed by other orders in time priority. If these competing orders were entered at the same time, the smaller order volume will be allocated first.

The quantity of a bond that will be the subject of a trade is frozen when a sell order is entered into the trading system of the TTSE. When a bondholding is frozen it cannot be otherwise sold or moved from where it is located, until the order is matched.

- 4) On settlement date, the transaction is settled, that is, the payment is made and the depository is updated simultaneously with the change in ownership. The Exchange Member completes the transaction with his customer.

# Secondary Market – Operating Rules

## Restrictions

- (i) The minimum face value of a Government bond that can be traded on the Secondary Market will be determined by each bond’s Trust Deed (this value will generally range from \$1,000.00 to \$5,000.00).
- (ii) Trading will initially take place on Tuesdays, Wednesdays and Fridays (except public holidays) from 9:30 a.m. to 12:00 noon.
- (iii) Investors cannot transfer Government bonds on the Trinidad and Tobago Stock Exchange (TTSE) without payment, for instance as a gift.
- (iv) Trades cannot be settled in securities, i.e. the exchange of another security as payment for a bond.

## Trade Date vs Settlement Date

The trade date is the date on which a trade occurs, i.e. when a buy order and a sell order are automatically matched at the TTSE.

The Settlement date is the day when the actual payment of funds due from the trade and the transfer of ownership of the bond are done. For the time being, the settlement date will be two (2) working days after the trade date (T+2). On the settlement date, a cash payment must be

made by the buying Exchange Member to the selling Exchange Member for the accounts of their clients.

## Price Quotations

Government bonds are quoted at a price per \$100.00 face value. For instance, if an investor sells \$5,000.00 face value of a government bond at a price of 98.775, the cost of purchasing these bonds will be:

$$(98.775/100) \times \$5,000.00 = \$4,938.75$$

[1]

This price does not include *accrued interest* on the bond and is called the clean price. The accrued interest is the interest earned between the initial issue or last interest payment date and the settlement date of a trade.

Government bonds pay interest periodically (usually on a semi-annual basis). For secondary market trades that occur during the period prior to the first interest payment date or between interest payments dates, a buyer of a bond must pay the seller both the clean price as well as the *accrued interest*. This is paid because the buyer will receive the full coupon due for the period from the last interest payment date to the next.

For instance, if \$5,000.00 of the above-

mentioned Government bond, with a coupon rate of 8.00% and interest dates of June 30 and December 31, is traded on July 31, the accrued interest will be determined for the period July 1st to 31st, or thirty-one days. The accrued interest due is calculated as:

$$(\$5,000.00 \times 8.00\%) \times 31/365 = \$33.97$$

[2]

The accrued interest will be calculated by the TTSE. The full payment or settlement value is referred to as the *dirty price* and is computed as follows:

$$[1] \$4,938.75 + [2] \$33.97 = \$4,972.72$$

[3]

This settlement value will be included in contract notes issued by the selling and the buying Exchange Members to their clients. The contract notes will also confirm the trade date and the settlement date and any other fees charged by the TTSE or the Exchange Member for their services, and any taxes payable on the transaction.

## Published Information

The last trade price, the highest unfilled bid (or buy order) price and lowest outstanding offer (or sell order) price for each bond will be published on the following day. The details of all the bonds listed for trading on the TTSE can be obtained from Exchange members and the Central Bank, as well as the TTSE itself.

## INSTITUTIONS AUTHORISED TO TRADE IN GORTT BONDS - EXCHANGE MEMBERS

### STOCKBROKERS -

- West Indies Stockbrokers Limited
  - Caribbean Stockbrokers Limited
  - AIC Securities Limited
  - Republic Securities Limited
  - Bourse Securities Limited
  - CMMB Securities Limited

### GOVERNMENT SECURITIES INTERMEDIARIES (GSIs) -

- ANSA Merchant Bank Limited
  - Citicorp Merchant Bank Limited
  - First Citizens Bank Limited
  - Intercommercial Trust & Merchant Bank Limited
  - Republic Finance and Merchant Bank Limited (FINCOR)
  - RBTT Merchant Bank Limited
  - Scotiastrust and Merchant Bank Limited
  - Trinidad and Tobago Unit Trust Corporation
  - FirstCaribbean International Bank Limited
  - Caribbean Money Market Brokers Limited