



Tenth Annual  
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**Bond Market Forum**

*Secondary Market Liquidity in Domestic Debt Markets*

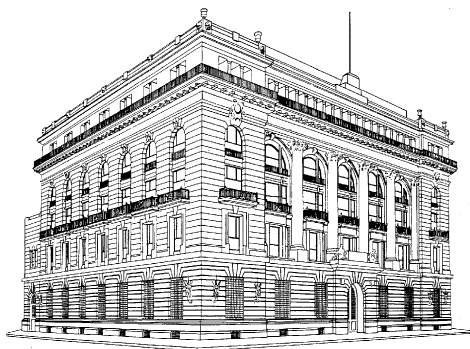
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# Improving Market Structure and Liquidity

April 2008



BANCO<sub>DE</sub> MEXICO



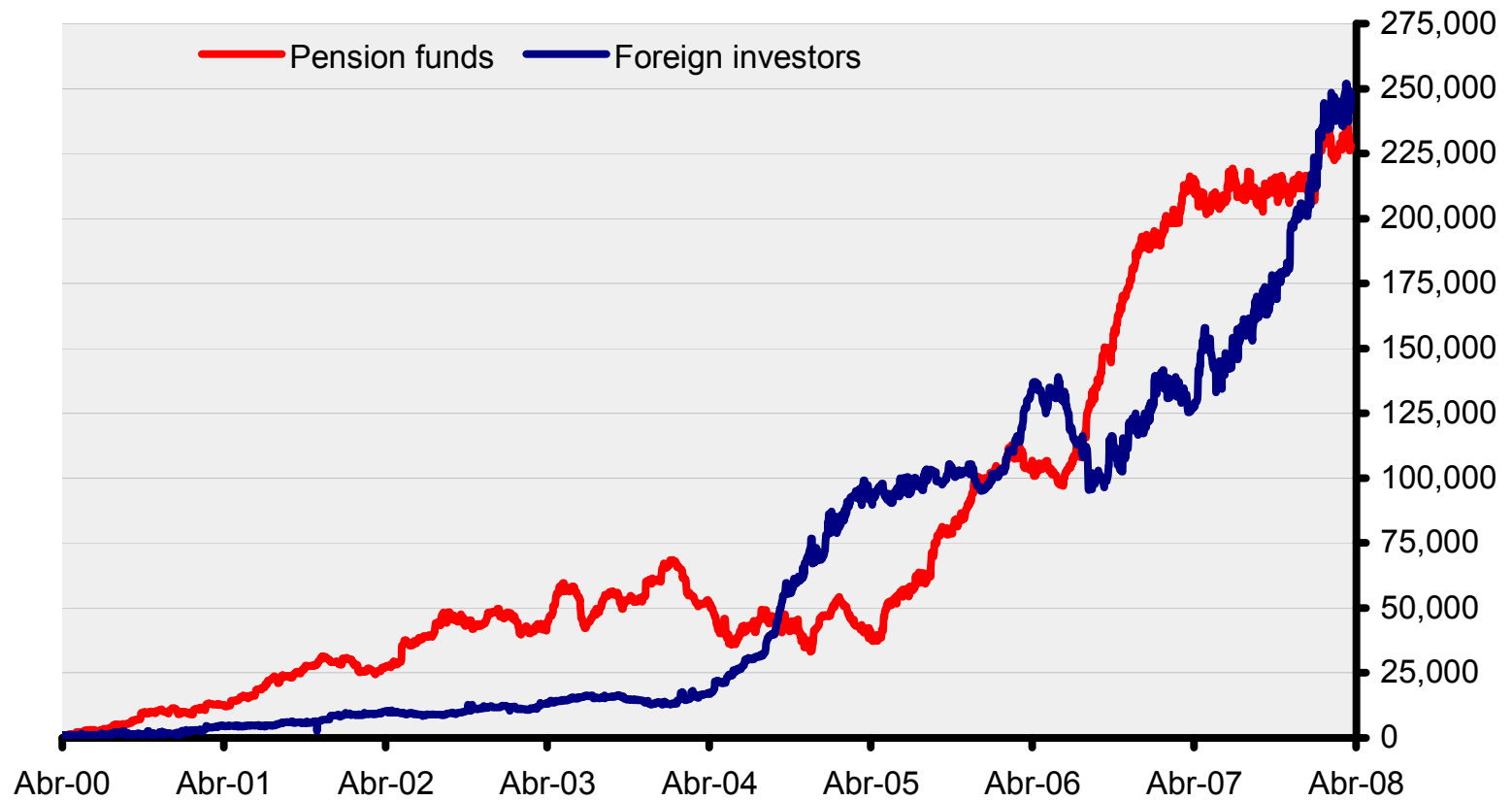
## I. Background

- ❑ Local bond markets have reached a considerable degree of development:
  - ❑ Yield curve was extended to 30 year maturities.
  - ❑ Regular auctions of 3, 5, 10, 20 and 30 year bonds.
  - ❑ Bid-offer spreads of 1 basis point in long term bonds.
  - ❑ Ongoing market makers program.
- ❑ These accomplishments have been translated into a robust investor base, both local and foreign.

# I. Background



**Holdings of long term government bonds  
MXN, millions**





## II. Recent developments

- ❑ Over the last months some changes have been implemented to promote further development of the market:

### 1. Securities Lending:

- ❑ The first steps of securities lending were under the market makers program:
  - ❑ Eligible institutions borrow government securities from the central bank.
  - ❑ Even when this program established the ground for securities lending, it reached a point where it was a negative incentive for further development, hence some changes were implemented:
    - ❑ Fees changed from fixed for all participants to variable depending on their activity outside the facility.

## II. Recent developments



**Notional loans outstanding and accumulated fees**  
MXN, millions



## II. Recent developments



- ❑ Some additional changes were :
  - ❑ The definition of foreign institutions was broadened to allow for hedge funds and not only traditional foreign investors.
  - ❑ Insurance companies are now able to lend securities.
  - ❑ The fiscal regimen was updated to reflect that:
    - ❑ Securities lending is not treated as an actual sale for purposes of calculating taxes on capital gains.
    - ❑ Fees coming for securities lending receive the same fiscal treatment as interest payments.



## II. Recent developments

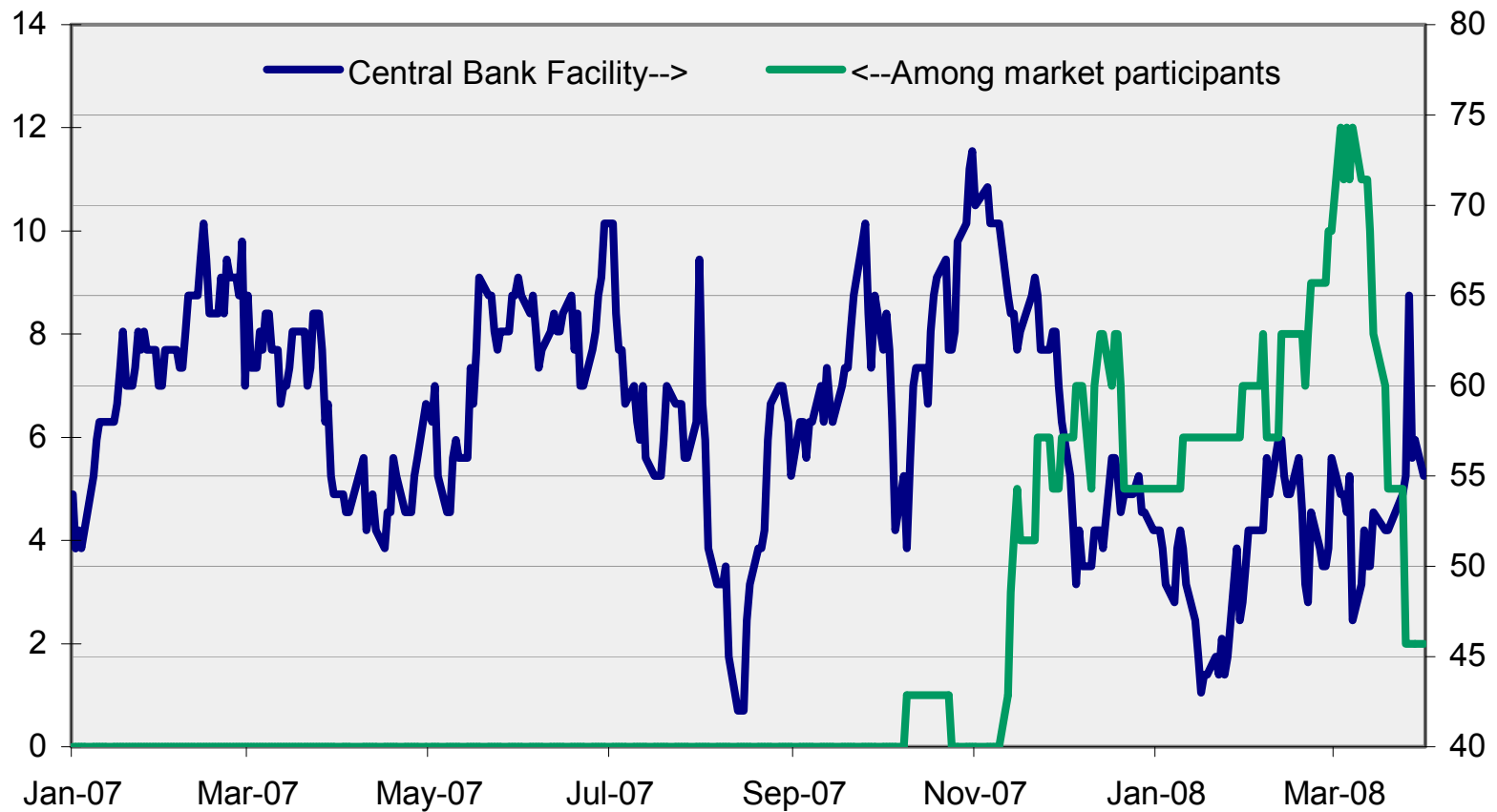
- ❑ The most recent efforts to promote securities lending have already shown some results:
  - ❑ Local investors' understanding of the importance and profitability of securities lending has improved.
    - ❑ Some pension funds are already lending securities and those that are not ready to lend have set a higher priority to do so.
    - ❑ Insurance companies are starting to lend.
  - ❑ Different fee structures for market makers lending window have pushed institutions to lend and borrow outside the facility.



## II. Recent developments



### Securities Lending Amounts outstanding, MXN Billions





## II. Recent developments

### 2. Bond exchanges and buybacks:

- ❑ Government bond exchanges started in 2005 to optimize cash management:
  - ❑ A long term maturity is offered in exchange for short term debt. In other words, extension of liabilities without using cash.
  - ❑ The price of the long term bond is fixed and investors bid in an auction for the price of the short term bond they deliver.
- ❑ However, some problems were found along the way:
  - ❑ High relative prices due to concentration in short term bonds. The exchanges validated off market prices.
  - ❑ Incompatible with investors' buy and hold strategies.



## II. Recent developments

- ❑ Bond exchanges have been redefined:
  - ❑ They are now used to manage on the run vs. off the run securities.
    - ❑ Liquidity is added to new securities in a more rapid way via exchanges with off the runs.
  - ❑ Benefits are still to be confirmed.
- ❑ Buybacks are introduced as a better alternative for cash management:
  - ❑ Short term securities are bought.
  - ❑ Price setting is simpler.
  - ❑ Amounts are not specified, the auction is similar to a window to surrender bonds at a set price.



### III. Final remarks

- ❑ The government bond market has reached an advanced stage of development.
  - ❑ There are still improvements to be made but liquidity and performance have been quite satisfactory.
- ❑ Corporate bond markets have not yet fully developed and should be the next sector to promote.
  - ❑ Issuance is still limited and only for large firms.
- ❑ Credit derivatives were just recently authorized but regulation is still under review.
  - ❑ Timing has obviously not helped, better to stay on the restrictive side?
- ❑ Adoption of best market practices, such as codes of conduct should also be enforced.