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Retail government

DEBT PROGRAMMES:

practice and challenges

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In today's highly institutionalised and technology-dominated securities markets, placing government paper with individual investors has been an elusive goal for many public debt officials. Collective investment vehicles such as pension funds, insurance companies, investment trusts and endowments have dominated the buy side of the market, and market infrastructure (auction systems, settlement and clearing arrangements) has adapted to the preferences of these wholesale buyers.

INTRODUCTION

In this environment, it's easy to forget that 'retail' placement of government debt has a long and illustrious history. In the 1630s, France was issuing *rentes* to private financiers to support the Thirty Years' War. In the 1750s, the UK introduced its legendary 'consols,' examples of which remain outstanding and in the hands of individuals and their descendants to this day. Proceeds from this early retail issuance programme funded, in part, Britain's wars with *rentes*-financed Napoleon. In the US in the 1860s, Philadelphia banker Jay Cooke's peddling Treasury paper to individuals helped Lincoln finance the Civil War and preserve the Union. Perhaps financial historians may be forgiven for identifying retail bond distribution with warfare, but in today's general-purpose government financing programmes, placement with individuals is simply one tool in the government debt managers' kit.

In the remainder of this article, we explore motivation and practice among the numerous retail debt programmes run by governments around the world. We draw on the experience of several countries and explore the main challenges in implementing such programmes in emerging capital markets. While today's retail debt programmes contribute to better debt management and financial sector development, they can be expensive to implement, and achieving critical mass in the investor base can be a challenge.

WHAT IS A RETAIL DEBT PROGRAMME?

In general, investors can acquire government securities through two main channels: the primary market and the secondary market. However, individual (retail) investors often do not have the same access to securities as institutional investors because they have smaller amounts to invest.

Some governments have pursued various approaches to provide retail investors better access to debt instruments; others have chosen not to take specific steps to reach out to individuals.

Retail investors typically acquire securities in the secondary market. They have access to government securities through financial intermediaries or through collective investment vehicles such as a mutual fund or pension fund. In Australia and New Zealand, for example, this is the only way individuals can purchase government debt. Denmark and France have built additional infrastructure to facilitate access to government securities by individuals, by creating easy and inexpensive settlement and registration systems.

In countries where governments have established deliberate policies to raise a part of their financing needs directly from retail investors in the primary market, individuals may acquire government securities through retail debt programmes (RDPs).

There are two types of government securities that are offered to retail investors in the primary market.

The first type

The first type is the standard marketable instrument bought by wholesale investors. Retail investors can access these instruments by participating in regular debt auctions, often on a non-competitive basis.

The second type

A second type of instrument is securities specifically designed for retail investors, often referred to as savings bonds. These securities provide similar streams of cash-flows as standard securities in the wholesale market, either as coupon or zero coupon bonds, but are non-marketable. They are designed to be easily understood by individual investors, have little price risk, and offer provisions for liquidity, such as embedded 'put options', that allow them to be redeemed before maturity.

Government debt instruments available to retail investors

Exhibit 1

Countries	Marketable		Non-marketable	
	Standard securities		Savings bonds	Lottery bonds
Belgium			Yes	
Brazil	Yes			
Bulgaria			Yes	
Canada			Yes	
China			Yes	
Germany	Yes		Yes	
Indonesia			Yes	
India	Yes		Yes	
Ireland	Yes		Yes	Yes
Italy	Yes		Yes	
Japan			Yes	
Pakistan	Yes		Yes	Yes
South Africa			Yes	
Sweden	Yes		Yes	Yes
UK	Yes		Yes	Yes
US	Yes		Yes	

Source: Government websites, interviews and various publications

Summary of objectives for offering retail debt programmes in selected countries

Exhibit 2

Country	Retail debt programme objectives
Belgium	<ul style="list-style-type: none"> • Diversify investment instruments offered to retail investors • Promote retail investor participation in the bond market
Brazil	<ul style="list-style-type: none"> • Democratisise investment in government bonds • Increase financial literacy of the domestic population • Promote strong national brand • Stimulate the culture of long-term savings • Diversify the investor base • Introduce competition among financial intermediaries in the retail market
Canada	<ul style="list-style-type: none"> • Raise stable, low-cost funding for the government
India	<ul style="list-style-type: none"> • Provide means for long-term diversified investments for retail investors • Ensure cost-effective way of raising long-term funds for the government • Provide an investment mechanism for senior citizens and pensioners
Ireland	<ul style="list-style-type: none"> • Provide investors with alternative savings products
Italy	<ul style="list-style-type: none"> • Provide alternative investment choice to retail investor
Japan	<ul style="list-style-type: none"> • Reduce the overall cost of government borrowing • Diversify the investor base • Promote retail participation in the bond market
Pakistan	<ul style="list-style-type: none"> • Provide the government with additional source of funding • Encourage and mobilise savings by the public • Diversify the investor base • Diversify investment instruments available to retail investors • Develop a secondary market for government bonds
South Africa	<ul style="list-style-type: none"> • Diversify the investor base, funding instruments, and funding sources • Diversify investment instruments offered to individuals • Promote culture of savings in the population
Sweden	<ul style="list-style-type: none"> • Borrow at the lowest possible cost, taking into account the risks • Offer individuals secure and diverse investments with low fees • Contribute to fair competition in the financial markets
United Kingdom	<ul style="list-style-type: none"> • Minimise financing costs over the long term, subject to risks • Diversify investment instruments offered to investors • Provide totally secure place for people to invest • Provide the government with additional source of funding
United States	<ul style="list-style-type: none"> • Borrow at the lowest possible cost recognising the constraints

Source: Government websites, interviews and various publications

'Exotic' instruments with unconventional cash-flows which provide investors with assurance of the principal protection, such as lottery or prize bonds, are popular in some countries. These provide principal protection for all investors, but interest payments are distributed through a lottery.

Exhibit 1 presents selected countries that offer government securities to retail investors, by type of instruments.

OBJECTIVES OF RETAIL DEBT PROGRAMMES

The objectives for offering retail debt programmes vary among countries (see Exhibit 2).² There are, however, two sets of objectives that are commonly identified.

The first objective

The first objective centres on public debt management to meet the government's financing needs in a cost-effective manner over the medium term, subject to risk.

The second objective

The second is driven by the need to develop domestic financial markets and to foster innovation in the financial sector by, for example, promoting competitive pricing, financial product development, democratising investing in government products, and educating and encouraging a culture of savings in the population (see Exhibit 2).

Until the mid- to late nineties, countries such as Belgium, Canada, Greece, Ireland, Italy, Sweden, the UK, and the US had strong reason for maintaining their RDPs, namely, to finance part of their large gross funding needs and to manage their elevated exposure to financial risk resulting from accumulation of public debt which was fed by lax fiscal policies. In these countries RDPs were seen as instrumental in filling the funding gap and in mitigating financial risk by diversifying the investor base (see Exhibit 3 for an example on how Italy was able to manage its financial risk through RDPs).

Italy's retail debt programme

Exhibit 3

The household sector was fundamental to the public debt management strategy of extending portfolio average life and breaking the dependence on the banking system in the late 1970s and mid-1980s. In the first stage, innovative instruments were introduced with longer maturities but linked to floating rates or foreign currencies. To ensure acceptance of these new securities, the government accepted significantly higher costs. For instance, interest rates on short-term securities sold to retail investors were higher than those of long-term bonds sold to the banks. In addition, high commissions were paid to intermediaries to distribute the securities to the final investors and preferential tax treatment was offered to increase the after tax return on these government securities.

These policies helped diversify the investor base and lengthen the portfolio average life, both of which substantially reduced refinancing risk. In this first stage the authorities decided to mitigate the exposure to refinancing risk at the expense of increasing the portfolio vulnerability to market rates. It was only in a second stage, after the nineties, with the independence of Bank of Italy and joining the eurozone, that better fundamentals allowed a fully fledged strategy to address the financial risk of the debt portfolio through the development of the domestic debt market.

Based on Alessandra Campanaro and Dimitri Vittas "Greco-Roman Lessons for Public Debt Management and Debt Market Development".

Source: World Bank Policy Research Working Paper 3414. September, 2004

However, with sound macroeconomic policies and a shrinking public debt in many countries, especially since the late nineties, the rationale for maintaining such programmes has been increasingly questioned.^{3, 4}

First, in some countries, the cost-effectiveness of retail debt programmes, or lack thereof, has been under scrutiny, as small denominations of retail securities have tended to be more expensive to distribute and manage than standardised securities for the wholesale investors.

Second, particularly for small countries in the euro area and countries such as Canada, the main concern has become how to maintain a liquid government debt market. In such an environment, retail debt programmes, particularly the non-standardised products, are seen as fragmenting the market, reducing the liquidity of the standardised securities, and raising the cost of financing.

Third, even in countries where financing needs continue to be large, the purpose of fostering financial market development has become obsolete. As domestic debt markets have matured and become more competitive and liberal, governments have been able to attract international investors.

So, are RDPs a 'mission accomplished' in mature capital markets?

Not so, say Ireland, Japan, Sweden, and the UK. In these countries, retail debt programmes continue to provide a cost-effective alternative to standardised securities market for institutional investors, as higher costs of RDPs are passed on to investors through lower yields allocated to non-competitive bidders. Ireland and the UK value the role that retail debt programmes play in facilitating direct access for pensioners and low-income households to government savings products, despite falling borrowing needs.

Scholars in the US have argued that retail debt programmes can be useful in providing access to government savings products for moderate-income households.⁵ Sweden also points that retail debt programmes 'contribute to fair competition,' especially if the banking

market – as is the case in Sweden – is dominated by a few players and could be described as an oligopoly.⁶

Whether the mission is accomplished or not, governments have continued to take actions to improve the cost effectiveness of retail borrowing. The main thrust of these actions has been to recover the initial startup cost – upfront investments in product and technological innovation, including electronic distribution and settlement and dematerialisation – by securing a critical mass of investors and thereby increasing the gains from economies of scale. Innovations in marketing, outsourcing processing functions, eliminating tailored retail securities, and shifting to standardised instruments, have also helped drive unit costs down.⁷

IMPLICATIONS FOR EMERGING CAPITAL MARKETS

While the capital markets have advanced in many countries, the financial sector in some emerging markets has not yet matured and may still be fairly inefficient and oligopolistic. Their debt levels may be high and debt composition risky, partly due to the lack of a strong and diversified domestic investor base. There may be a role for retail programmes that may no longer be viable in countries with more mature capital markets. As experience in some countries shows, however, retail debt programmes are not a panacea: they may be costly and difficult to implement.

Before considering a new RDP, governments should analyse its benefits and costs, with special attention to:

- (i) the clarity of objective to meet the expected benefits of the programme; and
- (ii) the true economic costs, including expected costs which reflect initial investments in technology and infrastructure, the distribution, marketing and back-office processing costs, to determine whether subsidies are required or costs are to be passed on to investors.

A clear objective is key to the design of retail debt instruments and distribution channels. For instance, in countries where the rationale is to diversify the funding source and to reduce excessive reliance on commercial banks, such as in South Africa, facilitating direct access through the primary market makes sense. If the purpose is to increase savings by reaching out to the non-banked population, an appropriate option might be to distribute savings deposits via post office networks (as in Pakistan) or state-owned institutions (as in China, Pakistan, and India).

While costly, saving deposits attract investors who value the liquidity and flexibility of the instrument, understand the returns profile, and appreciate personal contact at the point of sale. In countries where the motivation is to diversify the investor base to a target of fairly sophisticated retail investors, such as in Brazil and Indonesia, offering standard debt instruments – also offered to wholesale investors – through the internet may be effective. The combination of distribution on an electronic platform and straight-through processing of back-office operations could make this a highly cost-efficient option.

Assuming the objective and expected benefits are clear, the payoff of the programme will depend on the costs. Back-office processing and distribution costs of retail debt programmes can be particularly high, given small denomination and non-standard instruments typical of these programmes. Significant upfront investment could be required to launch a retail debt programme, including costs for establishing a legal framework to regulate the issuance and distribution of new securities, and for modifying the settlement, registry, custody or payment mechanisms. On the systems side, electronic platforms for distribution of securities and interfaces between custody, registry and payment systems may have to be built. The government's ability to quantify these costs and its willingness to disclose them is critical to preserve the principles of transparency and accountability.

Costs per unit will remain high until RDPs reach a critical mass. To achieve this, a substantial marketing effort is required to attract investor interest. This effort is difficult where potential investors may not be connected to the internet, may not trust book-entry securities or even the banking sector, or may not understand how fixed income instruments work. Such an investor profile will make it difficult to reduce distribution costs, and rather will increase processing charges and force the issuer to undertake expensive public education campaigns. In addition, where distribution depends on commercial banks, incentives for distributing retail securities may not be sufficiently attractive, hindering efforts to reach a broader investor base and reducing the distribution cost through outsourcing.

Even after a full cost-benefit analysis determines the feasibility of a retail debt programme, two issues arising in the implementation phase could be particularly thorny for emerging capital markets.

First, potential competition with financial intermediaries is a complex issue in countries where markets are thin and shallow and risks for market makers are high. Retail debt programmes may be counter-productive to encouraging financial intermediaries to act as market makers for government debt, especially where the obligations and responsibilities of market making are not clear.

The second problem may arise when the authorities are reluctant to pass the high costs of the programme in the form of lower interest rates for retail investors. To avoid discouraging retail investors from participating, retail debt programmes might be temporarily subsidised to cover the fixed costs until the programme reaches a critical mass and to later phase out subsidies. However, care must be taken to ensure that subsidies do not go into the wrong hands. For instance, if investments were made to reduce costs by electronic distribution, but the target retail investors do not have internet access, or do not trust non-certificated securities, the programme may risk channelling subsidies to the wealthy.

THE FUTURE OF RETAIL DEBT PROGRAMMES

With the plethora of issues to consider, the rationale for establishing new or maintaining existing government retail debt programmes requires careful consideration. For some emerging capital markets, RDPs can help governments make their debt management more resilient by diversifying the investor base and by introducing healthy competition to the banks to help narrow the often wide spreads between lending and deposit rates. For others this alternative can be too costly or of low priority at a time where most efforts concentrate on organising and developing domestic markets for wholesale investors.

What is certain is that offering government bonds to individual investors – either as part of debt management or as a development strategy is not a thing of the past. The changing macroeconomic environment, financial sector innovation, and technological advances will continue to stimulate the debate over the usefulness, viability, and cost effectiveness of RDPs, and will shape their existence for the foreseeable future.

Notes:

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2. The objectives have also varied over time within countries.
3. Australia and Denmark ceased to offer RDPs in the 1980s.
4. The US public debt dynamics have reversed its course since 2002.
5. Peter Tufano and Daniel Schneider (2005) “Reinventing Savings Bonds”, Harvard Business School.
6. Erik Thedéen, (2004) “Retail borrowing - an important part of the national debt”, Swedish National Debt Office, June.
7. Robin McConnachie (1997) “The Retail Market for Government Debt” Centre for Central Banking Studies, Bank of England, and Thomas G. Glaessner and Zeynep Kantur “Two Case Studies on Electronic Distribution of Government Securities: The US Treasury Direct System and The Philippine Expanded Small Investors Program”, World Bank Policy Research Working Paper 3372, August, 2004.



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