REPÚBLICA DOMINICANA

Ministerio de Hacienda

STRATEGY FOR THE IMPLEMENTATION OF A DOMESTIC GOVERNMENT SECURITIES MARKET IN THE DOMINICAN REPUBLIC

Santo Domingo, Dominican Republic

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ACRONYMS

AFP	Administradoras de Fondos de Pensiones
SBA	Stand-By Agreement
ASD	Análisis de Sostenibilidad de Deuda
BCRD	Banco Central de la República Dominicana
BVRD	Bolsa de Valores de la República Dominicana
CMCA	Consejo Monetario Centroamericano
CDEEE	Corporación Dominicana de Empresas Eléctricas Estatales
CdD	Consejo de Deuda
CEVALDOM	Depósito Centralizado de Valores
DGCP	Dirección General de Crédito Público
DIGEPRES	Dirección General de Presupuesto
FMI	Fondo Monetario Internacional
IIF	Instituto Internacional de Finanzas
MH	Ministerio de Hacienda
MTDS	Estrategia de Gestión de Deuda de Mediano Plazo
OMAs	Operaciones de Mercado Abierto
OTC	*Over-the-Counter* (Fuera de Bolsa)
SIPEN	Superintendencia de Pensiones
SIV	Superintendencia de Valores
SUPBAN	Superintendencia de Bancos
TN	Tesorería Nacional
UPF	Unidad de Análisis de Política Fiscal

SECTION I: INTRODUCTION

1. This paper is a summary of a detailed strategy and action document for the development of the government securities market in the Dominican Republic. This document was prepared by the Ministry of Hacienda. Other market participants such as Banco Central, CEVALDOM, the Superintendent of Securities, the Superintendent of Banks, the Superintendent of Pensions and several financial institutions were consulted for the preparation of strategy paper. The strategy document summarized below is a work in progress and will serve as basis for the Government's vision for the development of the domestic government securities market. It will also serve as an action plan for the Government and it is hoped that as consensus is built over time among market participants, this document could also include actions items for other parties involved in the development of the capital markets.

Background to the Strategy

2. The importance of an efficient domestic government securities market to both debt management objectives and the wider economy is not in doubt. As set out later in this paper, this objective is fully recognised by the Government and a number of initiatives have been taken over the last few years. More recently when the IMF approved in November 2009 a 28-month Stand By Arrangement (SBA) in support of the authorities and "to safeguard the macroeconomic achievements of the last several years",[1] one of the required structural benchmarks was to "design a strategy to develop domestic capital markets and debt management including by lowering the country risk and the borrowing costs for the economy".

3. The IMF further noted in its most recent Article IV report that "while the financial system continues to improve, private investment could grow faster if borrowing costs were reduced. The authorities' efforts to achieve fiscal consolidation over the medium term will go a long way towards reducing long-term interest rates and foster private investment. However, there is room for action in the short-run as market conditions do not reflect (at times) the underlying fundamentals of the economy. To address this issue, the authorities will design by September 2010 a plan to: (i) develop capital markets; (ii) adopt a debt management strategy; and (iii) reduce the perception of country risk and the borrowing costs in the economy, including by having greater communication with international capital market participants. Implementation of the strategy will become structural benchmarks for the remainder of the program."[2]

4. This document meets the requirement in respect of capital market development, the first item in the list above. The focus of the strategy paper is the development of the government bond market although the relevance of this to the development of wider markets is made clear. The other items above are being addressed separately, notably with the work being done within Dirección General de

[1] The main objective of the programme is "to limit the pro-cyclicality of policies while strengthening medium-term sustainability to lay the foundations for a gradual recovery and sustained growth." IMF EBS 10/58, March 2010
[2] IMF Country Report No. 10/135, May 2010

Crédito Público (DGCP) on a medium-term debt management strategy (MTDS) and the associated financing plan, and on the preparation of a strategy to improve the credit rating of the Dominican Republic to investment grade.

5. This document sets out in Section II the Government's objectives in developing this strategy, and its wider vision; Section III provides the core of the strategy and the action to be taken in the months ahead; Section IV follows with arrangements for taking the strategy forward.

Summary of Agreed Action

6. The schedule in Annex A summarises the agreed action, key responsibilities and timetable (the order of actions in the schedule is not exactly the same as in the text below). Capital market development is a project; and as with other projects, the action needs to be sequenced and dependencies and bottlenecks identified. Moreover, the actions themselves vary in nature. Some are highly specific and can be discharged in the near future. Some, particularly those relating to money market reform will have to be taken forward over a much longer term. Indeed, money market development is a major project in its own right, and the details and timing will have to be further developed.

7. A number of agencies will be involved in taking forward the strategy. Reflecting this, the Government will establish a Steering Group and supporting Technical Committee with representatives from those most involved with responsibility to complete the action plan set out.

SECTION II: THE GOVERNMENT'S OBJECTIVES

The Importance of the Domestic Market

8. Governments around the world have recognised the importance to both debt management objectives and the wider economy of an efficient domestic government securities market. Many governments include market development as a formal debt management objective, alongside the objective of financing its borrowing needs at the lowest cost over the medium term, consistently with a prudent degree of risk.[3]

9. For a government, the ability to sell its debt into the local market reduces portfolio risk, especially market risk, by reducing exposure to foreign currency movements. It also widens access to funds, which can be particularly important at a time of financial crisis when external markets may be closed, or unduly expensive. During the early months of the recent financial crisis international global markets for the most part were shut down and governments were faced with uncertainty regarding the refinancing of large debt maturities. Access to the local market provides a cushion and a source of resilience in the face of such crises. Over time it also reduces the costs of funds, through a liquidity premium[4] and competition in an efficient market.[5]

[3] World Bank and IMF (2003)

[4] The more liquid is a security, the easier and less costly it is for an investor to sell, and therefore the

10. But an efficient government bond market is also important to the private sector through its role as a catalyst in building the wider financial market, in particular the money and fixed-income markets, by facilitating intermediation and the flow of funds between lenders and borrowers. Specifically a liquid government securities market provides:

a. A risk-free asset for use as collateral (making it easier for intermediaries to finance their balance sheets).

b. A risk-free asset also for developing efficient asset portfolios (making it easier for portfolio managers to build their preferred cost and risk profile). In the jargon, government securities "complete" the market.

c. A pricing benchmark: corporate bonds and other instruments can be priced against the government bond yield curve; and the government bond market can be used by issuers and intermediaries to hedge against movements in the general level of interest rates. This underpins not only the pricing of corporate bonds and other credit products but also the repo, interest rate futures, and other derivatives markets, including the interest rate swap market.

11. An efficient and liquid fixed income market is of wider benefit to the economy through improved resource allocation from effectively channeling local and foreign savings into domestic investments and diversifying the investment opportunities for both retail and institutional investors. More precisely, five categories of benefits from private sector bond markets have been identified:[6] they (i) diffuse stresses on the banking sector by diversifying credit risks across the economy, (ii) supply long-term funds for long-term investment needs, (iii) provide long-term investment products for long-term savings and lower funding costs by capturing a liquidity premium, (iv) endow financial products with flexibility to meet the specific needs of investors and borrowers, and (v) reallocate capital more efficiently. These are all features that should emerge as an economy develops and grows. By providing longer-term, fixed-rate, local-currency funding, private sector debt bonds help reduce interest rate, foreign exchange, and refunding risk, giving more resilience to the wider financial market. The sharing of infrastructure, both physical (such as trading platforms and the settlement system), and the embodied skills of e.g. market makers, helps to bring down costs.

12. There is therefore a growing consensus that financial market development not only reduces the costs of financing, it also facilitates wider government financial

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lower the liquidity premium attached to the security when issued. In the secondary market, liquidity means the ability to buy and sell close to the market price.

[5] "Efficiency" means low transactions costs, healthy liquidity, competitive market processes with a high degree of heterogeneity between participants, low transaction costs, safe and robust settlement and custodial infrastructure, high substitutability between financial instruments, and "market completeness" (which allows the full range maturity transformation and allocation of capital to productive uses).

[6] World Bank and IMF (2001), page 361

polices and increases savings and thereby investment, boosting economic growth.[7] In this sense therefore a developed domestic bond market is an objective that is both justified in its own terms, and one that contributes specifically to the debt manager's objective of minimising the costs of financing the government's borrowing requirement, subject to risk. The beneficial effects on related markets, notably the money market, also directly facilitate an effective and efficient monetary policy

The Government's Vision

13. For these reasons, the Government is fully committed to development of the domestic government bond market. Its policy approach will be driven by its vision of a government bond market that:

a. Is competitive and liquid, and provides access to finance as required for effective execution of the Government's debt management strategy and at interest rates that are in line with macroeconomic fundamentals.

b. Underpins the development and resilience of the wider financial market, in particular the fixed-income market, by facilitating intermediation and the flow of funds between lenders and borrowers, with longer term benefits to resource allocation and economic growth.

14. To this end, the Government has identified the following key characteristics:

a. Maintenance of a credible and stable macroeconomic policy, that is consistent with long term debt sustainability.

b. A well-functioning money market that fully supports the conduct of monetary control through market-based instruments. It also facilitates more active management of the Government's short-term cash flows.

c. Public debt is issued by the Central Government in the local debt market with the BCRD using a stock of sovereign public debt instruments to conduct open-market operations for monetary policy purposes.

d. A primary government bond market that is transparent and predictable, where the Government issues a range of bonds with maturities up to 20 years, taking account of investor requirements and in amounts sufficient to facilitate liquid trading in the secondary market. The Government is also fully able to conduct secondary market operations, such as bond exchanges and or buy backs, whether the purpose is to meet its debt portfolio targets, manage cash flows efficiently, remove market distortions or otherwise respond to market needs.

e. A secondary government bond market, where transactions are low cost (i.e. with negligible fees and a narrow bid-ask spread), and (except for the largest transactions) can be made across the full range of government bonds without moving the market. Investors would be served by a group

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[7] Zsófia Árvai and Geoffrey Heenan (2008)

of competitive market-makers who, in return for making a market to all investors, have direct access to the primary market. The Ministry of Finance has a specific target that by 2015 annual turnover of MF bonds should be at least twice the value of the outstanding stock.

f. A range of market participants – banks, brokers, pension and insurance funds, other nonbank financial institutions, and other companies and individuals – that are able make investment or trading decisions constrained largely only by their own fiduciary, commercial or prudential requirements, with the market and sectoral regulators as necessary underpinning good market practice and participants' understanding and management of risk .

g. A supportive market infrastructure, that contributes also to the development and resilience of wider financial markets. The necessary characteristics include smooth and secure settlement arrangements with bonds (and other securities) continuing to be held in dematerialised form, a non-distortionary tax framework, a clear legal environment, unambiguous accounting and disclosure requirements, and market regulation that successfully balances the need to maintain confidence in the integrity of the market with the avoidance of provisions that impose unnecessary costs on participants. Trading systems, trading conventions; and trade and price reporting would all be transparent and effective.

h. Developed parallel markets, most immediately the repo market; and over a longer period futures and swap markets

SECTION III: THE FUTURE STRATEGY

<u>Macroeconomic Framework</u>

Fiscal Policy

15. The Government recognises the importance to investors, both domestic and foreign, of a credible commitment to prudent and sustainable fiscal policies and stable monetary conditions.

16. External observers have noted that the Dominican Republic's ability to post positive GDP growth during 2009 – the highest GDP growth in Latin and Central America – suggests an increased capacity of monetary and exchange rate policies to manage external shocks and to mitigate the impact of adverse external conditions on domestic economic activity.[8] Additionally, the recent IMF SBA provides a framework for fiscal stability. In the short-term, the Government is implementing a counter-cyclical policy, through an expansionary fiscal stance and an accommodative monetary policy, to counteract the effects of the global financial crisis on the economy. Over the medium-term it is committed to a gradual fiscal consolidation to

[8] See Standard & Poor's (2010) and Moody's (2010). The latter report also noted, however that "last year's events confirmed that reduced fiscal space and limited access to market financing restrict the government's capacity to adopt counter-cyclical policies."

ensure fiscal sustainability and the return of the public debt-to-GDP ratio to a declining path. At the same time, recognising the importance of increasing the potential for growth and sustaining a strong expansion in economic activity, the Government will implement a range of structural reforms in key areas. These include institutional reforms aimed at strengthening public financial management to allow the adoption of a medium-term expenditure framework to support fiscal consolidation. Other reforms include achieving higher tax collections by improving tax administration, strengthening enforcement of the legislation on fuel taxes, limiting tax exemptions and incentives; and reform of the electricity sector. Monetary and financial sector reforms include enhanced banking supervision; and the implementation of an inflation targeting framework to help control inflation, and anchor expectations, that will contribute to safeguard financial stability.

17. The outcome of this programme will be to reduce the vulnerabilities exposed during the global crisis, and lay the foundations for a gradual recovery and sustained growth.

18. One hurdle to improving domestic and international investor confidence is the lack of timely and easy-to-understand fiscal performance and budget execution information. In recognizing that, the MH (DIGEPRES) currently publishes monthly outturn expenditure and revenue data in great detail and MH intends in future to publish a commentary on fiscal performance and budget execution data in an understandable and easy to read format.

Agreed Action

- The Unidad de Análisis de Política Fiscal (UPF) MH will publish a monthly summary fiscal report.

Debt Management

19. The creation in 2006 and subsequent development, of DGCP has been widely acknowledged as a major reform. DGCP has been credited with improving transparency, along with the provision of detailed information on public debt data, as well as with creating a domestic capital market for government bonds, a major step forward in terms of both financial and institutional strength.[9]

20. Substantial progress has been made over the past year in strengthening DGCP's debt management policy and execution capacities, by building the front and middle office areas in particular: and the back office has retained its previous strength. A strong debt management capacity in DGCP is an important factor to

[9] See for example Moody's (2010) which also notes that "the office has also earned high marks from the Institute of International Finance, which ranks the DR among the top 10 emerging markets in terms of data dissemination practices and investor-relations practices." Of course, there remain major challenges, thus Moody's also notes that, among other vulnerabilities, that "exchange-rate event risk" is a relevant factor as foreign currency-denominated financial obligations account for a significant share of the government's debt. Even though external financial vulnerabilities have declined in line with a higher level of international reserves, potential concerns remain given a somewhat limited ability to manage balance-of-payments shocks."

improving not only the country's credit rating, but also to building investor confidence in the local debt market.

21. The Government attaches particular importance to its work on the development of a debt management strategy. The Government has previously set out the thrust of its debt management strategy in the Debt Management Plan and Financing Plan for 2009. However, it is currently working on a fuller MTDS, together with a more sophisticated debt sustainability analysis (DSA), both of which will be published later in 2010 with the budget for 2011 that is presented to Congress. This work will provide an important underpinning to market and investor confidence that the Government is determined to improve the economy's resilience to future shocks, reducing the vulnerabilities otherwise inherent in both the size and composition of the debt stock.

22. The Government will continue to build capacity in DGCP, in line with internationally recognised sound practice. It attaches importance to attracting and retaining a fully professional staff, and ensuring that they have the necessary systems and training support.

Money Market

23. The importance of a more developed money market to the bond market has been stressed above. The development of a well-functioning money market, however, requires three key conditions to be fulfilled:[10]

a. An increase in the use of market-based (indirect) methods of implementing monetary policy by the BCRD.

b. Adequate management systems that provide reliable estimates of future government cash flows and forecasts of aggregate bank liquidity.

c. The presence of banks and other financial institutions with incentives to develop efficient liquidity and risk management services.

24. An efficient money market stimulates the development of more active debt securities markets by lowering liquidity risk premiums and enabling investors to hold larger portfolios of longer-term instruments. Access to liquidity and securities is important for proper secondary trading activities. This should evolve in parallel with the government securities market. A well-developed money market also helps promote private issuance of negotiable certificates of deposit, promissory notes, and commercial paper. As in the case of government debt, active markets in short-term instruments support the development of longer-term corporate bond markets. Some of the interactions between these markets are illustrated in Figure 12.[11]

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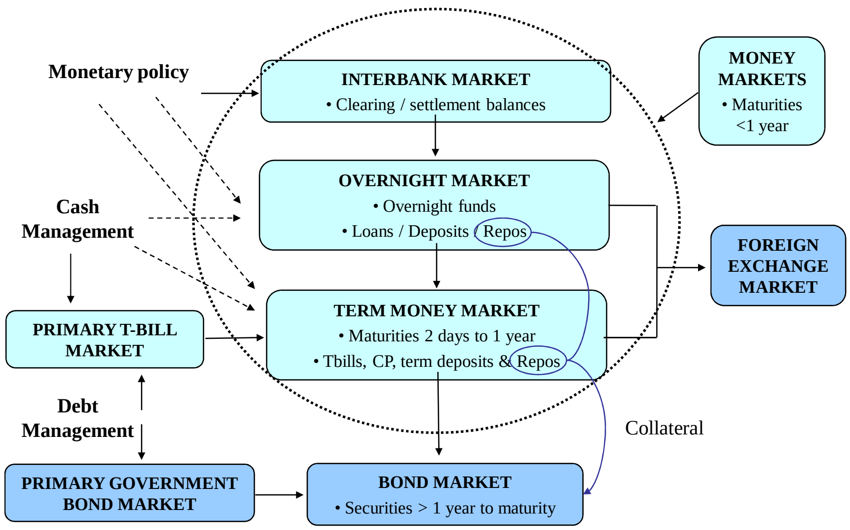
[10] World Bank (2007). The authors also note that the development of an active money market might be held back by the failure to adopt a master repo agreement and netting and close-out mechanisms, and from the lack of transparency concerning money market indices and activity volumes.
[11] Mike Williams (2010), page 12. This paper elaborates how an efficient and active government cash management function can contribute to financial market development.

Figure 12: Money Market: Interaction with other Financial Markets



25. The money market in the Dominican Republic has room for improvement:

a. The BCRD issues a large volume of securities to control domestic market liquidity, a situation that is routed in the resolution of the crisis of 2002-03. To control the liquidity impact of its assistance to banks, the BCRD issued a significant amount of certificates. It has continued to maintain a substantial volume of issuance: the stock outstanding of the BCRD's bills, notes and certificates at end June 2010 was over DOP 200 billion, compared with outstanding MH bonds of DOP 35 billion.

b. The BCRD's debt is issued in physical form, but it has taken important steps to begin to dematerialize its instruments before the end of the year. In the past, a substantial amount of the outstanding BCRD debt was placed directly with the market, but with the expansionary monetary policy implemented in the last 2 years, a significant amount of those instruments, placed directly through the public, were not renewed and its amount has decreased significantly.

c. Government cash management is one the next steps that MH will follow in order to improve cash flow forecasting and use actively Treasury bills to manage in-year cash flows.

d. The inter-bank market is not very active. Inter-bank loans in 2009 were only DOP 20 billion,[12] a tiny sum in comparison to the banks' balance sheets. In practice, historically, the banks seem to prefer to deposit surplus cash with the BCRD rather than with each other.

e. There is no private sector repo market. In 2008, the BCRD issued regulations for open market operations (OMOs) using repo between the BCRD and the banking system. It provides for the use as collateral of BCRD securities, MH securities or other securities determined by the BCRD.[13] But the private sector market is inhibited by commercial legislation that cuts across financial market requirements by in effect allowing the courts to take control of collateral on behalf of a third party that is in dispute with the borrower in the repo transaction. That in effect means that the lender cannot be sure that the collateral is sound. Moreover current SIV regulations do not provide for classic repo; it is instead treated as two separate transactions: a spot and forward.

26. Against this background, the Government and the BCRD will be taking forward the following reform programme:

a. The BCRD is developing a strategy to move towards an inflation targeting framework in which the BCRD's interest rate policy plays an important role in signalling its monetary policy stance. Greater use of interest rates as an important instrument of monetary policy should stimulate money market development by aligning interest rate incentives, developing a short-term yield curve, improving competition between banks and integrating market segments.

b. DGCP will discuss with the SIV and private sector the legal framework requirements for a properly functioning repo market, and agree on the actions required and timetable.

c. The BCRD is planning to initiate the dematerialization of its new debt issuances to be registered in Cevaldom later in 2010.

d. The MH is committed to developing over time a more sophisticated cash management function, although this will be a lengthy project.

Agreed Action

- The BCRD will complete its strategy to move towards an inflation targeting framework, in which interest rate policy plays greater signalling role.
- DGCP will discuss with the SIV the legal framework for repo, and agree the action required and timetable.

[12] Source: BCRD website
[13] BCRD "Instructivo para la Realización de compra de Títulos-Valores con Pacto Retroventa (Repos)", VI (6). (Diciembre 2008).

- The BCRD will dematerialise its new debt issues and register them with Cevaldom later in 2010.
- The MH will include in its operating and strategy plan a more sophisticated cash management function.
- All MH bond issuances will be standardized and placed through competitive public auctions.

Quasi-Fiscal Deficit

27. The parallel issuance of both BCRD and MH securities is an obstacle to market development. Essentially the same demand is spread over two types of instruments so the volume of each issue is likely to be smaller than it might otherwise be which will tend to reduce liquidity. It may be possible to mitigate it by greater coordination between BCRD and MH. may reduce the obstacles the securities may still compete in the secondary market as they move closer to maturity.

28. Following its support to the banking system in 2002-03 the BCRD's capital was greatly affected. Recognising the importance of a strong capital base, the government enacted the BCRD Recapitalization Law in mid-2007, which sets a ten year period to recapitalize the central bank through budgetary transfers with the pace linked to a projection of nominal GDP and the interest cost of BCRD's certificates.

29. Were the pace of recapitalisation to increase, and more closely match the BCRD's own debt refinancing requirements, there would be an apparent increase in the Government's gross debt stock and in its fiscal deficit. On the other hand, that would be matched by a fall in the quasi-fiscal deficit and the combined balance sheet would have been improved.

30. Action will be taken forward in both the short and the longer term:

- In the short-term, improved coordination is necessary to ensure that future debt issuance decisions on the part of the MH and the BCRD are coordinated

Agreed Action

- Improved coordination of future debt issuance decisions by the MH and the BCRD.

Primary Market

Primary Market: Supply

31. The DGCP will continue to develop the issuance policies that have been established in recent months, in particular it will:

a. Follow an issuance strategy that is predictable, transparent and market-based

b. Strengthen the development of a benchmark yield curve in key maturities.

c. Avoid market fragmentation by issuing only conventionally-structured instruments.

32. DGCP will in addition develop the capability for bond exchanges (conversions or switch auctions[14]) and buy-backs. These are essential if it is to manage the debt portfolio more actively. They can be particularly important to:

a. Shape the debt portfolio is a way that is consistent with the government's strategic objectives set out in the Medium Term Debt Strategy (MTDS).

b. Build the volume outstanding of benchmark securities, improving liquidity.

c. Smooth the cash flow consequence of bonds close to maturity.

d. Facilitate market making in the event of market dislocation of distortion.

33. There are a number of ways in which exchanges can be done: by quoting a price ratio; by quoting the price of one bond and asking for price bids on the other to be exchange against it; by offering a new bond and accepting the old one as payment and so on. Depending on how important it is to achieve a full exchange, some price incentive may be necessary. The exact modalities of the operation: process, timing of the steps, announcement and settlement arrangements, etc should be set out in a consultative paper for the market, to give them an opportunity to comment, or in particular to set up their own systems as necessary.

Agreed Action

- DGCP will publish by the 2nd half 2011 a consultative paper on how it will handle operationally bond exchanges or buy backs.

Primary Market: Demand

34. An increase in demand in the long-term will flow from the development of a wider range of financial institutions in the local market. Although the AFPs have a natural demand for long dated securities, they are currently the only long-term savings institutions of any note in the market. The lack of mutual savings funds also inhibits the development of the diversity of investors that is important for the development of the secondary market.

35. The AFPs' demand is currently subject to constraints on their asset allocation decisions imposed by their regulator, the Superintendent of Pensions (SIPEN). They may currently hold no more than 15% of their portfolios in MH securities, although over time this proportion is likely to rise to 20%.[15]. The expected growth in the AFPs'

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[14] Terminology varies, but under a switch auction some part of an existing bond is switched through an auction process into another existing bond or a new bond. A bond conversion seeks to convert the whole of the outstanding stock of a bond.

[15] The current constraint is not thought to be biting on the AFPs' behaviour as they themselves are developing their own fund management capabilities. It is, however, extremely unusual internationally for pension funds to be constrained from holding bonds issued by their own government. More common is the requirement, which can also be damaging, that the funds hold bonds far in excess of

portfolios means that they, with the banks, are likely for many years to be the main holders of bonds issued by the MH. Although it is appropriate that the widening of the AFPs' portfolios marches in step with the development of their capabilities, it is important that the actions of SIPEN (Comisión Clasificadora de Riesgos y Límites de Inversión) do not have a distortionary impact by cutting across the AFPs own asset allocation choices based on their fiduciary duties and structure of their liabilities.

36. Transparency is important. The MH sets out its financing plan for the year ahead with the annual budget, also giving details of the issuance programme and auction calendar. Details of each auction are then announced the week ahead of the auction. In addition, the MH holds periodic meetings with intermediaries and investors to explain its policies and gain feedback. These arrangements will be developed further, in particular with the introduction of a regular quarterly meeting with intermediaries and investors, following which the Government will publish more details to the extent possible of its auction programme.[16]

37. The Government will also continue to promote investor outreach. The improvements made over the last two years by DGCP have been widely recognized, e.g. by the rating agencies (see references above) and by the Institute of International Finance (IIF).[17]

Agreed Action

- By the end of 2010 the DGCP will establish a programme of conference calls for international investors.

<u>Secondary Market</u>

38. DGCP has worked with the SIV, Cevaldom, the BCRD and the Superintendent of Banks (SUPBAN) to promote reforms in the government securities market and the capital markets in general. The MH will continue to lead efforts to educate market participants, government institutions and the public regarding its vision for the development of the government debt market. Periodic meetings with market regulators to develop a work plan and to review results are necessary to ensure coordination at the policy level. A recent decision by SUPEN in respect of banks' marking to market (discussed below) suggests that coordination of this kind continues to be necessary.

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the value that they would themselves judge appropriate.

[16] This might include, for example an indication of when a new bond will be introduced, or how in broad terms the volume to be sold will be distributed across different maturities. The formal auction announcement will remain as now. No market sensitive information would be revealed at the meetings – that would follow in the quarterly announcement – but they would be an opportunity for the market to give its views to MH and for MH to explore market reactions e.g.to the prospective issuance programme or to possible policy innovations.

[17] IIF "Investor Relations: an Approach to Effective Communication and Enhanced Transparency: Update of Key Borrowing Countries" (April 2008), page 18

Regulatory Framework and the OTC Market

39. The Securities Law 19-00 does not contemplate an OTC government securities market where the banks can participate as market makers. Article 5 of the law requires public offerings of securities in the secondary market to be traded through brokers registered with the SIV. Entities, such as banks, that are not registered with the SIV are prohibited from being a trading intermediary.[18] They are able to act as a financial intermediary or hold securities on their own account; but they cannot buy on behalf of their clients or broker transactions.

40. The MH believes it is essential for commercial banks and other banking institutions participate in the secondary market since the success of a market maker rests on its ability to take positions which include purchasing large quantities of securities for their own account with the objective of later selling them to other investors. In order to be successful, the public debt market should have a wide range of participants with sufficient capital to provide liquidity to the market. Without institutions that are prepared to warehouse bonds for a period, it is very difficult to develop a secondary market. Sellers or purchasers of bonds will otherwise be dependent, in a market with relatively few transactions, on finding counterparties with simultaneous mirror requirements. The consequence will be a widening between effective selling and buying prices, characteristic of a highly illiquid (and non-transparent) market. That will in turn damage the primary market as purchasers will apply a “liquidity discount” to purchase prices on instruments that could prove difficult to sell.

41. The MH intends to authorize an electronic platform to facilitate the sale of securities in the secondary wholesale market. The platform, EBond, will be provided by Bloomberg, who already provide the auction platform for bonds issued by the MH; that will avoid the auction participants from having to incur any expenditure in connecting to a separate system.[19] Under the proposed arrangements, market makers (see below) will be required to quote on-screen prices to each other, creating a professional inter-dealer market. Each market maker will be able to deal with clients and end investors in the normal way. This platform will be low cost and transparent: Bloomberg will publish transaction details.

42. An electronic market of this kind is not envisaged under the current legislation. The SIV has, however, recently (in mid August 2010) published for consultation regulations that envisage a series of segmented markets (“organized secondary markets”) that would be separately organized and each be subject to rules or codes of practice applying to that market only. There would be separate markets for:

a. The stock exchange;

b. Official debt market;

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[18] These provisions, which would be unusual internationally, reflect concern about the banks’ ability to manage a trading book following the crises of the 1990s and early 2000s.

[19] The BVRD also intends to deploy EBond. Although that might provide scope for integrating the exchange and OTC markets, the BVRD will continue to be handicapped by the need to remunerate its members; moreover, it is for DGCP to set its rules for its own market.

c. Debt market for debt approved by the superintendent;

d. Futures and options markets, whether backed by a financial or non financial instrument.

e. Whatever other market that meets the established requirements provided for in the law and regulations. ."[20]

43. Each segment would be subject to rules laid down by companies ("sociedades rectoras"), owned by members of the market concerned. There is a risk that these proposals will add to transactions costs, not least through the addition of fees to cover the costs and return on subscribed capital of the company. If, the different market segments were to develop different custodial or settlement arrangements, a possibility that seems to be envisaged, there would additional costs in building safe and efficient links between systems and unnecessary frictions introduced into transactions between the different market segments. A savings fund for example is likely to wish to hold its government bonds and private sector bonds in the same custodial account.

44. The draft regulation recognises to some extent the particular nature of the market in government debt, which is a wholesale market dominated by sophisticated investors. Moreover, the special position of the Government (and BCRD) is recognised under the Securities Law. Thus Article 9 notes that "securities issued by the central government and the Central Bank do not require the approval of the regulator (SIV)". Regulations already made under the Securities Law give the Government and the BCRD the status of an "Differentiated Issuer".[21] The MH will accordingly be promulgating its own rules applying to the government bond wholesale OTC market.

45. The MH will need to review the relevant trading and manuals and other documentation of Bloomberg to ensure that it meets its and the market's requirements.

Agreed Action

- EBond will be beta-tested in 2011.

Marking to Market

46. SIPEN has recently decided to stop banks from marking to market their securities since valuations have been done arbitrarily causing wide variations on banks' income statements and balance sheets. As a result there may not be incentives to take buy and sell positions and there is greater risk of unrealized losses if interest rates rise (prices fall). Separately, the SIV has been working to authorize a private company to calculate a "price vector" for each security issued to ensure that banks and other institutions have a similar valuation for the same security. SIPEN

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[20] Artículo 57 of "Propuesta de Reglamento Sobre el Objeto de Negociación, Funcionamiento y Organización del Mercado de Valores de la República Dominicana."

[21] Reglamento de Aplicación de la Ley de Mercado de Valores, No: 729-04, Articulo 62

already publishes a price vector for use by the AFPs, although officials have indicated that they would be prepared to substitute a vector published or endorsed by the Government if one were available.

47. It is essential that securities in trading books are marked to market. But the use of different price vectors also creates uncertainty, particularly when the precise calculations are likely to be done differently. Developed markets identify a vector which is widely used, which may be one calculated by the debt management unit on the basis of data supplied by market makers; or calculated by a market platform and endorsed by the debt management unit or equivalent. The vector is not only used to value securities portfolios, but also to value collateral in repo transactions.

48. The introduction of EBond, which will be the source of information on all OTC transactions, provides an opportunity to develop a MH-endorsed price vector. However, it may suffer from too few transactions in some bonds in some periods. An alternative approach would be to ask the market makers to inform DGCP at the close of each day where they think that the price lies in the market, whether or not there had been transactions; DGCP would average the data (adjusting for outliers, etc) and republish to the market. A possible course of action would be to rely initially on Bloomberg but collect data from the market makers, to explore over time whether it was sufficiently robust and free of manipulation before promulgating it as the vector.

Agreed Action

- DGCP will develop with Bloomberg a price vector.

Other Tax Issues

49. In relation to tax, it was noted above that all outstanding MH securities are tax exempt for both international and local investors and may be used by local companies to pay their taxes. But there is a possibility that future MH securities could be issued without the tax exemptions for local corporate and individual investors, presenting the possibility that a particular series of MH bonds could have different tax treatments than those currently traded in the secondary market. Article 6 of Law 163-09, which authorized MH to issue bonds in 2009 to pay the CDEEE debt, provided that all debt issued starting under the 2009 budget would be exempt from taxes for everyone and that the principal could be applied against taxes.

Agreed Action

- The MH will propose an amendment to the law to harmonize the tax treatment of local holders of MH bonds into line with that of international holders.

Market Making

50. The Government is introducing a market makers programme. After extensive research it judges that the Peruvian and Colombian experiences provide the best analogues for a successful programme. Both countries have established programmes that have increased liquidity and transparency in their government debt markets, reducing domestic borrowing costs. The size and development of the domestic market in the Dominican Republic presents challenges and the government

intends to design a program which does not limit the number of participants in the primary auction to avoid potential collusion by the market makers. Before implementing the programme, DGCP is evaluating the performance of institutions in the secondary market over the period February to December 2010 to determine whether the local market is capable of sustaining it.

51. With the objective of promoting the development of the primary and secondary public debt market, the MH has drafted regulations for the Market Maker program that establish the terms and conditions for the program. The Market Makers will play an important role as wholesale distributors of securities by improving the distribution channels to institutions committed to purchasing government securities. In addition, they will promote the development of the secondary market by increasing price transparency and creating market depth.

52. The Market Makers program is intended to provide stable demand for the securities in public auction. In the secondary market, Market Makers are required to dedicate capital to purchase securities and maintain inventory with the goal of reducing the liquidity Premium.

Agreed Action

- DGCP will test market makers program in 2011 and amend draft regulation in the light of experience.

Widening the Market

AFPs

53. Currently the AFPs conduct their transactions through the BVRD. As the AFPs' capabilities develop, the market grows, and transparency improves (not least as a result of EBond) the AFPs are likely to move to the OTC market (anecdotal evidence suggests that many transactions are currently agreed OTC and only put through the exchange subsequently). It is for consideration that a regulatory requirement should then be placed on them to secure "best execution". Under this requirement, common in more developed markets, the AFPs would be have to obtain at least 3 quotes from different market participants before executing a transaction. That would have the additional benefit of helping to develop more competition between the different intermediaries and avoid the current risk, inherent in vertically integrated financial groups, of cross subsidy and monopoly pricing.

54. DGCP does not intend to allow direct access to the auction of the AFPs (or of any other end-investor category). That would potentially undermine the ability of the market makers to make a market by denying them access to a significant share of the flows of both demand and supply in the market. Unless they can be confident of obtaining bonds in the primary market, they will be unwilling to accept an obligation to make a market in the secondary market. Some protection of the market makers'

flows is important, and a common feature in many countries, at least until the market is much more competitive and liquid.[22]

Foreign Investors

55. A diverse investor base is required for a dynamic and liquid secondary market. The role played by foreign investors in the development of the market in some countries has been noted above. They can catalyse development of the necessary infrastructure and infuse new competition into otherwise stagnant markets. Foreign investors will consider the yield on domestic government securities in light of international interest rates, an exchange rate risk premium reflecting the expected rate of exchange rate depreciation or appreciation, and a default risk premium.

56. Equally, foreign investors can add to interest rate and exchange rate volatility in the event of inappropriate macroeconomic policies or contagion from external crises, which in turn can hinder development of the government securities market. In this sense foreign investors can act as "sleeping policemen", providing a break on risky fiscal policies.

57. In many respects the legal and regulatory regime applying in the Dominican Republic recognises the importance of foreign investors. Arrangements have been developed by Cevaldom which would allow international custodial banks to create sub-accounts in Cevaldom in which they would hold domestic securities on behalf of international investors. Overseas institutions are able to issue domestic currency bonds in the local market providing they are incorporated locally; and there are more relaxed arrangements applying to multilateral organizations or related institutions. There are also examples of companies issuing DOP bonds in overseas markets.

58. The MH has asked that Cevaldom provide a solution for institutional investors requiring a link to an international depository such as Clearstream or Euroclear to allow them to hold either domestically or overseas global bonds issued by the Government. Progress in this area has been slow; Cevaldom has developed an electronic link with Clearstream but its inauguration is currently being held up by the SIV's requirements on the sub-account structure under which the bonds would be held in Clearstream.

Agreed Action

- DGCP will take forward with Cevaldom, an agreed action plan to allow domestic investors conveniently to hold externally issued DR Government bonds.

Cevaldom

59. Cevaldom is a key component of the market infrastructure. It is essential that market participants, including the MH, have confidence in the safety and security of

[22] Among OECD countries there is a broadly equal split between those who protect market makers' access to the auctions and those who open auctions more widely.

its operations and of its custodial or stewardship functions. This has two dimensions:

a. There should be no risk that participants' assets (including those of the Government) will be compromised; and that in the event of loss through Cevaldom's negligence it has sufficient capital or insurance to meet its liabilities in full.

b. There should be no risk that transactions fail to be executed as intended because of an operational failure on Cevaldom's part. Its business continuity arrangements should allow for continuous operation in the event of any system failure or external event.

60. Currently the EBond system is not connected directly to Cevaldom and settlement messages are not automatically passed to Cevaldom. Instead EBond generates electronic tickets that have to be input directly by participants into Cevaldom. This arrangement carries additional costs and risk. But Cevaldom and Bloomberg are in discussion as to how best create a direct link; and resolution is expected in the near future.

Agreed Action

- MH and BCRD will explore the possibility to draft an agreed risk management framework and plan for CEVALDOM - 2nd quarter 2011

SECTION IV: TAKING THE STRATEGY FORWARD

61. Capital market development is a project; and as with other projects, the action needs to be prioritised and sequenced, and dependencies and bottlenecks identified. An integrated approach is needed to implement the reforms across the board.

62. Moreover, the actions themselves vary in nature. Some are highly specific and can be discharged in the near future. Some, particularly those relating to money market reform, will have to be taken forward over a much longer term. Money market development is a major project in its own right, and the details and timing will have to be specified separately. To that extent this plan is unfinished business.

63. The other notable characteristic of the programme outlined is the involvement of a range of agencies: mainly the MH and the BCRD but also the SIV and others. For this reason, some inter-agency machinery is needed to take forward the capital market development plan. That should operate at both the policy and technical level. The following is proposed:

a. The Deputy Minister of Finance will chair a small Steering Group, with high officials of the BCRD and the SIV. The Steering Group will be able to invite others to attend its meetings; the head of DGCP will normally attend. The Steering Group will receive reports from the Technical Committee, and also resolve any policy disagreements, reporting to the Minister/Governor as necessary.

b. The head of DGCP will chair a Technical Committee, with officials from DGCP, the BCRD, the SIV and (as required) SIPEN, SUPBAN and others. The Technical Committee will have direct responsibility to deliver the action programme, reporting to the Steering Group. The Technical Committee will be able to set up sub-groups that include private sector representatives; and in any event will be expected to consult with the private sector.

64. Many of the authorities' levers operate through the private sector – banks, investors, exchanges etc, – and a dialogue will need to be maintained throughout, to explain, to consult, to learn and to encourage. The reform programme should be backed by an effort actively to educate market participants, government institutions and the public regarding the Government's vision for the development of the government debt market.

Agreed action

- Date of the first meeting of the steering group to be defined after the appointment of its members.
- DGCP will develop an education and communication strategy to ensure that the market and wider public have a full understanding of the Government's vision and can contribute to it.

ANNEX A: TIME TABLE AND SUMMARY OF AGREED ACTION

	Lead	Timeframe
1. UPF/MH will publish a monthly summary fiscal report	MH/UPF	• First publication 2nd half 2011
2. BCRD to complete strategy to move towards inflation targeting framework, with interest rate policy playing greater role	BCRD	• Strategy agreed and published end of Q3
3. BCRD in its inflation targeting strategy, aims to make greater use of indirect instruments	BCRD	• Central Bank evaluates the greater use of indirect instruments as a monetary policy instrument in its inflation targeting strategy
4. DGCP will discuss with the SIV and market participants the legal framework for repo, and agree the action required and timetable	MH/DGCP & SIV	• Action and timetable to be agreed by 1st quarter 2011 • Followed by consultative paper to market
5. BCRD begins the process of issuing dematerialised instruments and registers them with Cevaldom	BCRD	• Monetary Board issues a resolution authorising the BCRD to dematerialize new bills and notes
6. BCRD and MH to hold a meeting to identify possible options to reduce or eliminate the need for the BCRD to issue securities in the local market within the current legal framework of the recapitalization law	MH & BCRD	• By Q2 2011
7. Improved coordination of future debt issuance decisions by MH and BCRD	MH/DGCP & BCRD	• Define a joint strategy to improve coordination by end 2nd quarter 2011.
8. The MH will include in its operating and strategy plan a more sophisticated cash management function.	MH	• 3rd quarter 2011
9. All debt issuances will be standardized and placed through competitive auctions.	MH	• 3rd quarter 2010
10. DGCP will publish a consultative paper on how it will	MH/DGCP	• Paper published 2nd half 2011

handle operationally bond exchanges or buy backs		
11. DGCP to establish a programme of conference calls for international investors	MH/DGCP	• First call by 1st half 2011
12. EBond will be beta-tested in 2011	MH/DGCP & SIV	• DGCP to agree operational arrangements with Bloomberg; • DGCP will discuss with market – Q4 2010
13. DGCP to develop a price vector with Bloomberg	MH/DGCP	• DGCP agrees methodology with Bloomberg • Bloomberg has new price vector 2nd Half 2011
14. MH to propose amendment to the law to harmonize the tax treatment of local holders of MH bonds into line with that of international holders	MH/DGCP & DGII	• DGCP to propose with intent to include in Bond Law 2011
15. DGCP test market makers program in 2011	MH/DGCP	• DGCP to amend draft regulation in the light of experience and market comments – 2011
16. DGCP to take forward with Cevaldom, an agreed action plan to allow domestic investors to hold externally issued DR Government bonds.	MH/DGCP	• Action plan 2nd half of 2011
17. MH and BCRD will explore the possibility of drafting a risk management framework and plan for Cevaldom	MH/BCRD	• 2nd quarter 2011
18. The Government will establish a Steering Group and Technical Committee to deliver the agreed action plan.	MH & BCRD & SIV	• First meeting of technical committee by Q1 2011. Date of the first meeting of the steering group to be defined after the appointment of its members.
19. MH/DGCP develop a communication / education strategy to ensure that market and wider public have a full understanding of Government's vision regarding this strategy	MH/DGCP	• Submit draft to first meeting of Steering Group

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