Foreign Investors in the Local Bond Market

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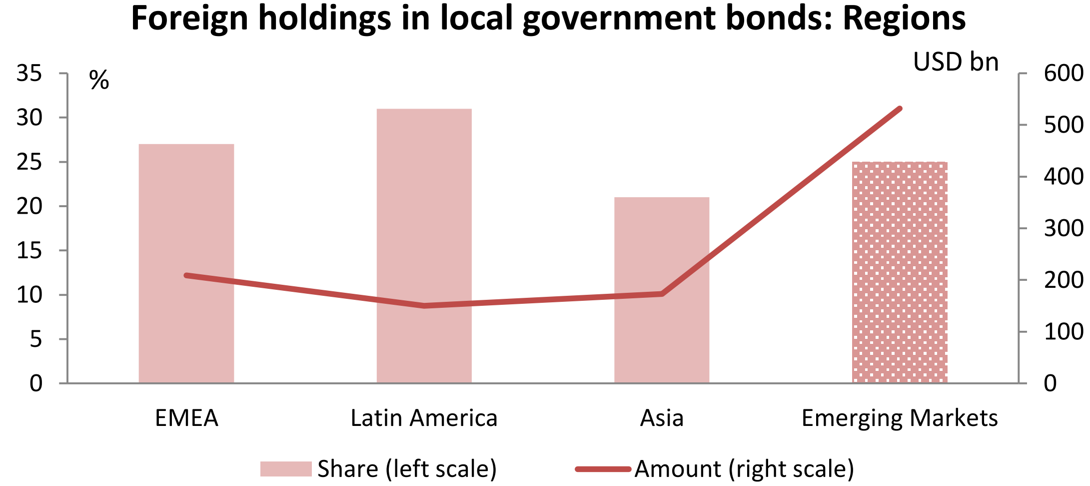
1. Introduction

- Belarus is interested in developing its local bond market further, in line with international experience
- Reasons:
  - More diversified funding structure
  - Less FX risk
  - Sovereign debt market is crucial for other segments as benchmark (pricing)
- Foreign investors can play an important part in that development
  - Additional demand that helps to decrease yields and extends maturities
  - But: This requires favorable conditions and an easy access to the market, i.e. linking domestic and international infrastructure
- This presentation: Looks at the local market, international trends and gives recommendations on how to increase the non-resident share in the local sovereign debt market

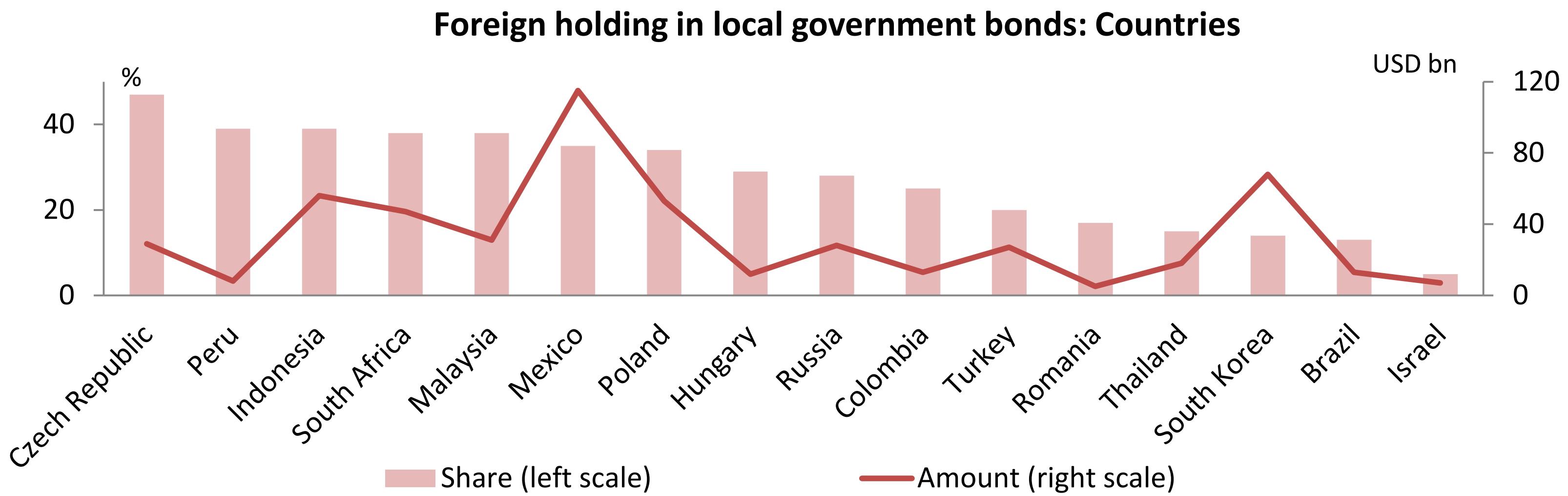
2. International trends and developments



Source: Deutsche Bank, Haver Analytics; Note: latest data available

- A key development in emerging markets (EM) over the past years has been the growth of local (currency) bond markets
- The difficulties in borrowing in their own currencies ("original sin") became less pressing, as the share of domestic currency bonds increased
  - Local currency share of sovereign debt has grown from 50% (2000) to about 75% (2015)
- Foreign investors played an important part in that development and displayed a growing preference for EM local government bonds
  - Low yields in developed markets post crisis and improved macroeconomic fundamentals and policymaking in EM
- **Overall, 25% of all EM local government bond are currently held by foreign investors (USD 532 bn)**

2. International trends and developments



Source: Deutsche Bank, Haver Analytics; latest available data

- On a country level, the Czech Republic has currently with 47% the highest share of foreign investors in its local government market
- In absolute terms (i.e. reflecting the size of the market), foreign investors hold USD 115 bn of local government bonds in Mexico
- Russia: 28% currently, up from 0% in 2006

3. The local bond market in Belarus

Domestic Public and Publicly Guaranteed Debt as % of GDP,

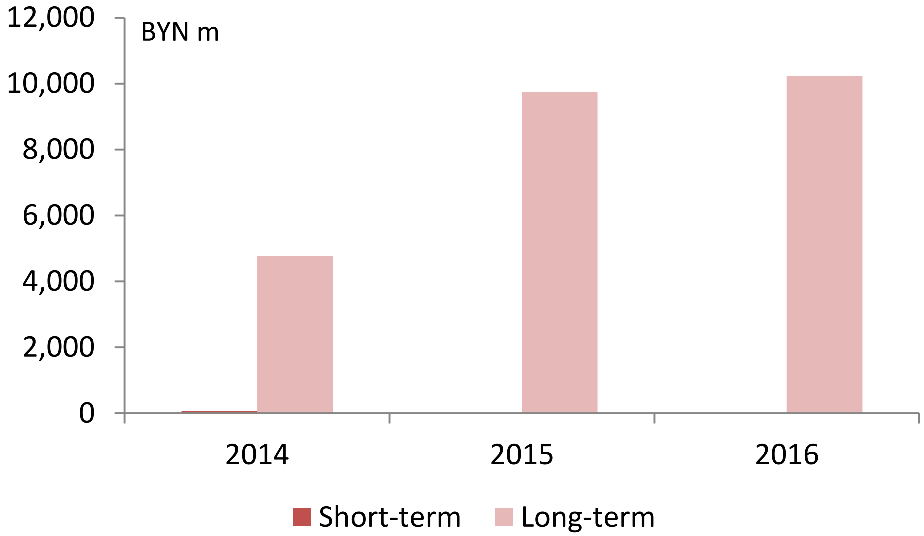
	2014	2015	2016
Total	16.1	20.6	20.4
Direct Debt	7.3	12.2	13.2
Central government	6.0	10.8	10.9
Local authorities	1.3	1.4	2.3
Guaranteed Debt	8.7	8.4	7.2
Central government	5.1	4.7	4.2
Local authorities	3.6	3.7	3.0

Source: Ministry of Finance

- If compared to total public and publicly guaranteed debt (2016: 52.3% of GDP, IMF), the domestic central government bond market looks small (2016: 10.9% of GDP), even though it has risen (2014: 6.0% of GDP)

3. The local bond market in Belarus

Central government direct debt by maturity

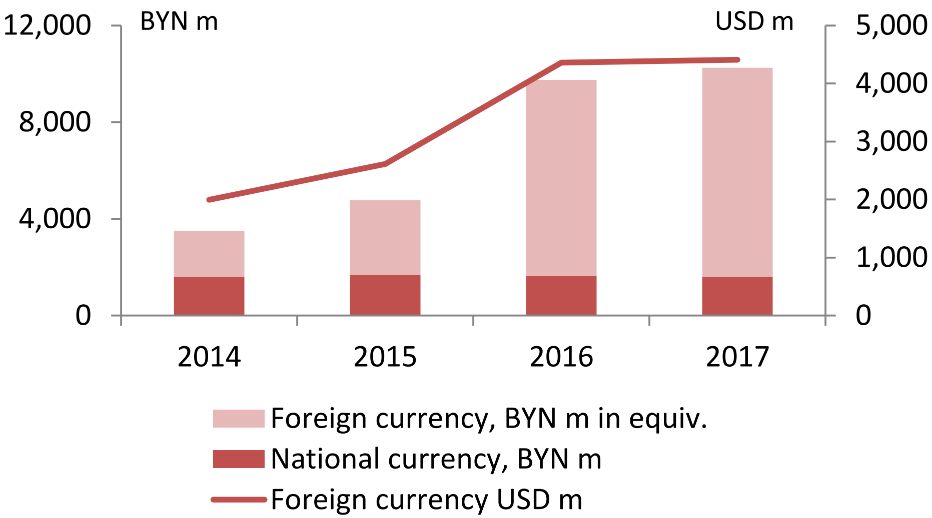


Source: Ministry of Finance

- The vast majority of instruments is long term, i.e. has a maturity at issuance of over a year
  - Average maturity of short-term bond (GKO) was 19 days in BYN and 7 days in USD/EUR (2016)
  - Average maturity of long-term bond (GDO) was 789 days in BYN, 1352 days in USD and 1658 days in EUR
- Issuance of GDO/GKO mainly via direct sale, not exchange auctions (BCSE)
- Secondary market trading quite low: 50% of primary trades (2016) for GDO (almost none for GKO)

3. The local bond market in Belarus

Central government direct debt by currency



National Bank of Belarus

- Clear dominance of FX-denominated bonds on the local market
  - 84% (Jan 2017), up from 54% in Jan 2014
  - In part due to depreciation of BYR/BYN vs. USD/EUR
- Banks are the main investors in government bonds: 84% (Jan 2017), mainly driven by FX-denominated bonds
- **Foreign investors do not play a role in the market: Only 0.1% of holdings**

4. How to facilitate market access

1) Macroeconomic and financial stability

Of crucial importance for foreign (and local) investors:

- Credible monetary and fiscal policy framework
  - Low and stable inflation
  - Sustainable economic growth
- No external/internal economic and financial imbalances
  - Current account balance and external debt sustainable
  - Fiscal deficits and public debt level under control
- Strong internal and external buffers (e.g. adequate FX reserves)
- Sound financial and banking system
- Adequate country rating, stable or better positive outlook
  - Belarus: Caa1/B-/B- (M/S&P/F, all stable)

4. How to facilitate market access

2) Issuance: Introduction of a consortium

- Normally an agreement between the issuing Ministry of Finance and one or more financial intermediaries to guarantee a successful placement of the bond
- Two possibilities:

Underwriting group	Issuing group
For a fixed price, selected banks have exclusive rights to the bond. Risk of the placement lies with the consortium	Responsible only for selling the bond to the customer. Risk of non-placement lies with the issuer

- Difference also in the amount of commission. May be difficult to find an underwriting group for government bonds from emerging markets.
- **Important (again): Country rating**

4. How to facilitate market access

2) Issuance: Introduction of a consortium

The consortium should have international reputation to achieve agreement with a CSD (Clearstream, Euroclear, Clearnet etc.) → see following 4)

- Better placement with foreign investors

The consortium should provide for a (reasonably) liquid secondary market

- Secondary market is important if the bond is meant for private investors; not so important if aimed at institutional investors by
  - Assuming role as market maker,
  - Arranging an agreement with an (external) specialist agent as market maker

4. How to facilitate market access

3) Bond terms

a. Coupon

- The (fixed) coupon of a bond in local currency must price-in the exchange rate risk for foreign investors (ca. + 500 to 600 base points on top of foreign currency coupon)
- Semi-annual coupon (instead of annual) should be considered
- Once a liquid bond market is established, other products might be introduced:
  - Inflation-linked, FX-linked, Floating rate

b. Maturity

- Start with 1 - 3 years
- Later extend yield curve

c. Denomination

- If targeted at private investors, lower minimum size than for institutional investors required
- Russia: RUB 1,000 (approx. EUR 15)

4. How to facilitate market access

4) International central securities depositary (ICSD)

- Example: Clearstream Luxembourg. International investors are easier to reach if the bond is held (= registered) at an ICSD. Three possibilities:

a. Agreement between local CSD and international CSD

- Clearstream Luxembourg: Links to 55 local CSDs

Requirements:

- ICSD holds a foreign nominee account at the local CSD. Problem: Account is a so-called „omnibus account“ i.e. the ICSD is the account holder but the underlying securities belong to several different investors
- Set-up of such an account is complicated and costs time and money, especially for the ICSD. The ICSD therefore examines in detail if the existing or emerging market is worth the effort
- The ICSD also checks (in advance) for compliance risk, i.e. any potential risk from the type of organisation run by the local CSD and the issuer

4. How to facilitate market access

4) International central securities depositary (ICSD)

b. Agent to act between local CSD and ICSD

- Agent uses an existing (or newly set up) account at the local CSD
- ICSD sets up an omnibus account (see above) with the agent
- Easier for local CSD but expensive
- Costs for ICSD the same
- Agent receives payment for cost and risk

c. Conversion of bonds into Depositary Receipts (DR)

- DR-Trustee, who must hold an account at the ICSD, manages the conversion
- Trustee buys bonds on the local market, keeps them in his own portfolio and issues DRs at a certain ratio in BYN or another currency. All risks lie with the trustee, for which he is (highly) compensated
- Simplest solution for local CSD and ICSD, but probably most expensive for the issuer. Compliance check (see above) by ICSD cannot be avoided!

4. How to facilitate market access

5) Direct connection to a local CSD abroad

- Only possible for bonds in FX (dollars, euros etc.)
- CSD abroad must agree to such an arrangement (possible for example with Clearstream Banking in Frankfurt)
- Connection to CSD via the consortium bank's account at the CSD
- Consortium bank takes on further tasks for the issuer (paying agent)
- Compliance check (see 4a above) is made for issuer <u>and</u> consortium bank

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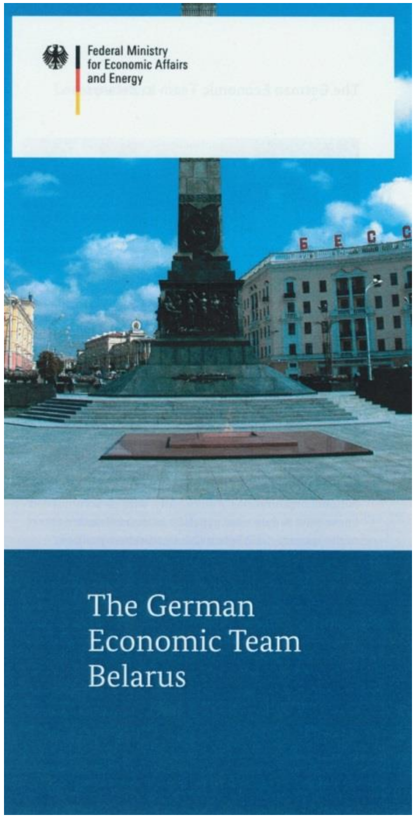

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