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OPENING REMARKS

at the

"Launch of Secondary Market for Government Securities"

by

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An important aspect of the mandate of any Central Bank and particularly a Central Bank of a developing country is the development of an active capital market. Why? Because an efficient capital market is an indispensable requirement for sustainable economic transformation.

The reasons for this are well-known to you, I am sure, but let me simply re-iterate a few of them. An efficient capital market :

- Supports the mobilization of domestic savings by providing investors with alternatives for investment and risk diversification.

- Permits companies and governments to raise long term resources at lower cost.

- Promotes efficiency and competition in the financial system.

- Creates an avenue for the population to participate in the corporate sector and share in its wealth.

There is a more or less widely recognized sequencing for capital market development and it goes like this:

- It usually starts with treasury bill issues, to fund government's short term financing needs and the formation of some kind of money market in which there is the trading of short term funds — a good example is the inter-bank money market.

- The second stage is usually a primary government securities market where government issues bonds to help finance capital projects. In the early stages, government securities may be issued to a captive market - for instance to pension funds and insurance companies to help them meet statutory requirements. During this stage, the distribution process tends to be non-transparent and, in a seller's market, at below-market interest rates.

- As the economic transformation process evolves, governments seek to promote a third stage – that is the development of a rudimentary equities market.

With these basic structures in place efforts are focused on refining and improving the infrastructure related to the government securities and equities market ... until, there is a move to the third stage, that is:

- the development of a secondary market in government securities and a bit later, a market for corporate securities and a derivatives market.

These stages very often overlap and small developing countries seldom move beyond the state of primary government bond issuance and illiquid equity markets. We in Trinidad and Tobago are trying to move beyond the limitations dictated by small size to create a diversified capital market to facilitate the process of economic transformation and to set the stage for our emergence as an international financial center.

In Trinidad and Tobago, the Government and the Central Bank have made a series of critical interventions, during the second stage, to spur capital market development along market-based lines.

For example, in 2004 the mechanism for primary market issuance evolved from an "underwriting" system, which helped minimise placement risk and ensured allocation, to **an auction mechanism,** which served to increase transparency, stimulate competition and improve the process of price determination.

In the context of this auction mechanism, the Bank designated a number of financial institutions as **government securities intermediaries (GSIs),** licensed to participate in government bond auctions either on their own account or on behalf of the public.

To facilitate clearance and settlement of purchases through the auction system, **the electronic government securities system (GSS)** originally established for treasury bills and treasury notes, was expanded to accommodate government bonds. The GSS incorporates both an on-line auction system and an integrated securities depository. The GSS is currently integrated into the Real Time Gross Settlement system (the RTGS) to facilitate the settlement of government securities transactions and simultaneous recording of the ownership of securities in the depository.

Ladies and gentlemen these various interventions; the auction system, the GSIs, the on-line system and the central depository system, all set the stage for the introduction of **the secondary market for government securities,** which we are pleased to launch today.

How does the primary market differ from the secondary market for government securities? Simply put, the primary market for a security is the place where an issuer creates the security and sells it into the market; it involves the creation of new securities with the government as seller. The secondary market covers trading of securities after issuance and before redemption.

It is our conviction that the secondary market can offer tremendous benefits to the economy of Trinidad and Tobago. It will firstly foster further capital market development and facilitate the achievement of the various objectives listed above and secondly, the secondary market could bring significant benefits to investors.

What are the systemic benefits of a secondary market in government securities:

- First, market trading provides a mechanism for government securities to move from investors in the primary market to a wider range of end-investors such as pension funds, insurance companies and retail investors.

- Second, by providing opportunities for more frequent trading, the secondary market improves the pricing process for government securities.

- Third, 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 of credit risk, its yield curve provides a benchmark for the pricing of other fixed-income securities such as corporate bonds.

And as I said, there are also benefits for investors: all classes of investors – the institutional investors like the pension funds and the insurance companies; the fast-rising mutual funds industry; the corporate sector; and even retail investors.

The secondary market could offer corporate treasurers new opportunities for liquidity management.

Since secondary market trading will, for the first time, facilitate market pricing of securities, it will allow pension funds and mutual funds to value their fixed income portfolios on an on-going basis. One would expect that a more accurate assessment of their portfolio will help pension funds better plan their investment strategies.

Another important advantage is that the secondary market will extend the menu of investment instruments; no longer will the investor be compelled to hold on to his five-year bond; rather, the pension fund can sell its five-year bond and invest in bonds of longer or shorter maturities according to interest rate expectations.

As regards the retail market, recent initiatives in the primary bond auctions have made investment in government bonds more accessible to the individual investors. You may recall, the last three bond auctions allowed individuals to purchase bonds in amounts as small as $1,000. With the secondary market, the small investor can now approach any Government Securities Intermediary (GSI) to buy and sell bonds, at any time, and have confidence in the transparency of the pricing process.

Our mandate to foster the development of a secondary market in government securities will also include efforts to develop the use of these securities in repurchase agreements (repos). The repo market permits borrowing and lending among market participants, including financial institutions and corporates, to take place on a safe and secure basis while reducing both credit risks and transaction costs. The SEC is now in the process of devising a set of rules and a standard "repo" agreement to underpin the "repo" market.

Let me concede that the promotion of a vibrant secondary market for government securities has proven to be a major challenge for developing and emerging market economies. Newly developed secondary markets are usually very thin and illiquid, with few people willing to sell and many willing buyers. There is no doubt that success depends on the active participation of a whole host of stakeholders - the Government, the Central Bank, as well as all the market participants. If the secondary market is to work:

- Institutional investors will need to look for opportunities for profitable trading and not simply accept the traditional "buy and hold" culture.

- Banks and other financial institutions, who are the main holders of government paper, will need to see the profit-making opportunities in promoting the sale of government securities to end-investors.

- The Central Bank has the responsibility for fostering credibility in the auction process, and maintaining efficient clearing and settlement systems. Currently only the securities issued in auctions since 2004, are currently included in the depository managed by the Central Bank and listed on the Stock Exchange. The Bank needs to be appointed Registrar for government bonds issued before 2004 and is working with trustees to effect this. When this exercise is completed, bondholders will be asked to deposit their bond certificates with the Bank in exchange for an electronic deposit record of their bond holdings. This process will increase the volume of bonds available for trading on the stock exchange.

- Government, for its part, must guarantee a regular and predictable supply of primary issuance so that institutions could be assured of replenishing their positions after selling securities from their portfolios. One way of ensuring supply, is to bring public entities into the auction mechanism instead of relying on bank financing or the underwriting process.

- The SEC has the mandate for preparing and enforcing the rules and regulations pertaining to the secondary market. These include regulation of the market intermediaries, market surveillance and transparency and reporting requirements and market conduct regulation; the latter includes trading rules and arrangements aimed at preventing improper trading practices such as market manipulation and insider trading practices.

So the launch today is just the beginning. We all have our work cut out for us and we all need to work closely together, if we are to create a liquid and vibrant secondary market for government securities. I told you earlier that most developing countries shun this step because it involves the creation of new institutions as well as important behavioural changes.

But, if we want to have a developed capital market; and if we want to be an international financial center we need to make a quantum leap from occasional primary issuance and a few isolated “over the counter” trades to a formal secondary market that gains credibility among local as well as international investors.

As this is the Carnival Season, it is perhaps fitting to take Stalin’s advice “we can make it if we try”.

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