DOMESTIC SYNDICATIONS

BACKGROUND NOTE

This note on domestic syndications is part of a series of background notes produced under the Gemloc Advisory Services Program as a by-product of its strategy to support the development of liquid local currency bond markets.

Domestic syndications can be a powerful tool in development of government bond markets, providing access to immediate liquidity for new benchmark bonds and diversifying an investor base. Additionally, domestic syndications serve well to bring and launch innovative instruments in the domestic securities markets. The objective of this background note is to illustrate the various aspects of syndications to be considered by a debt manager in deciding whether a domestic syndication is an appropriate placement mechanism in certain cases. The paper reviews goals, prerequisites, limitations and drawbacks of syndications and provides real-life examples in the case studies.

The authors wish to thank Anne Leclercq, Director of the Front Office at the Belgian Debt Agency, for reviewing the paper and Juan Manuel Govea Soria, Director of Institutional Investors Relations at the Mexican Treasury, for his contribution to the Mexico case study. A special thank you note to Zauresh Kezheneva who helped to edit this background note.

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1 This background note has been prepared to support World Bank technical assistance programs for the development of local capital markets. Comments to asilva3@worldbank.org, baudouin.richard@live.be, and iraghavan@worldbank.org are welcome.
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### Abbreviations and acronyms

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<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>AS</td>
<td>Auctioned Syndication</td>
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<tr>
<td>BDA</td>
<td>Belgian Debt Agency</td>
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<td>BBS</td>
<td>Book-Building Syndication</td>
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<td>DDA</td>
<td>Dutch Direct Auction</td>
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<td>DMO</td>
<td>Debt Management Office</td>
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<td>DSTA</td>
<td>Dutch State Treasury Agency</td>
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<td>EMU</td>
<td>The European Monetary Union</td>
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<tr>
<td>FRN</td>
<td>Floating-Rate Note</td>
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<tr>
<td>MoF</td>
<td>Ministry of Finance</td>
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<td>PD</td>
<td>Primary Dealer</td>
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1. INTRODUCTION

This background note is meant to assist debt management offices (the “DMO”) in assessing whether a bond placement scheme combining auctions and syndications is an appropriate strategy in their markets and, if so, to assist them in designing the corresponding procedures.

Syndications are currently best known in connection with the placement of external debt abroad. By contrast, a “domestic syndication” has three specific features: (i) a bond being placed is a local currency denominated bond issued in the domestic market; (ii) a bond is generally placed with both domestic and foreign investors; (iii) the outstanding amount of a bond is meant to be subsequently increased through a calendar of auctions. In practice, domestic syndications are invariably used to launch a benchmark bond.

Domestic syndications began being used in the European Monetary Union (EMU) in 1999. Their usage is now widely spread across the OECD. At first glance, this seems to be an evolution backwards. Discontinuation of bank financing extended under the form of “club deals” and their replacement by competitive auctions in the domestic government securities market is a standing feature of the reforms initiated across the globe over the last 50 years to increase the efficiency of public debt management.

Domestic syndications have three justifications. First, they can score better than auctions on four points: (i) they provide immediate liquidity; (ii) they diversify the investor base by attracting new investors; (iii) they are an efficient tool to ensure firm prices in the secondary market; (iv) they offer timing flexibility: by contrast with auctions, syndications do not need to be subject to an issuance calendar. Second, the issuer can play an active role in structuring the transaction and in overseeing its implementation. This was not the case in the “club deals” done in the past. Third, domestic syndications are also an efficient tool to launch new financial instruments, as they enhance price discovery. As a result of the above features, domestic syndications lower funding cost for an issuer.

Another valuable feature of domestic syndications is that some of their specific procedures can be used in external syndications. This applies, in particular, to selection of banks managing a transaction.

Domestic syndications have prerequisites, limitations and drawbacks. In particular, DMOs need to be clear on the objective pursued, as a domestic syndication may not be the most effective way of achieving it in their specific market.

This background note is organized in three parts. First, syndications in general. A general description of syndications is followed by a review of the distinctive features of external and domestic syndications. Second, external syndications. The analysis of rationale for external syndications is followed by a description of the procedures generally implemented. Third, domestic syndications. This section covers their rationale, a survey of the markets using them and an analysis of the features specific to this placement procedure. Some case studies follow with a more detailed analysis of the objectives pursued and of the procedures implemented in three representative countries: Belgium, Mexico and the Netherlands. Finally, some specific topics are briefly reviewed before concluding.

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2 Thus, in local format as opposed to a euro or global bond format;
3 i.e., placing the first issuance of a security. Domestic syndications are normally not intended to tap an existing bond;
4 In this context, a “Club deal”, alternatively called “bank consortium”, means a financing extended jointly by a group of banks which effectively dictate their terms and conditions to the borrower;
5 Referring to financial instruments that represent an innovation in the domestic market;
2. SYNDICATIONS

This section describes the standard features of syndications in general, followed by an analysis of the specific objectives and distinctive features of external and domestic syndications.

2.1. Standard features of syndications

Syndication is the process of putting together a group of banks which jointly underwrite and distribute a new security offering. The members of a syndicate commit to buy a certain amount of securities at a certain price. They are expected to place the securities in their customer base. In the event of a lacking demand by customers, however, the banks will keep the securities on their balance sheets.6 The members of a syndicate earn two commissions: an underwriting commission for committing to provide funding and a selling commission for placing the securities.

Banks consider syndications to be a very attractive business. This applies particularly when a bank is mandated to be arranger of the transaction (“lead or joint lead manager”). In addition to the commission earned, a lead or joint lead mandate raises the ranking of a bank in the league tables published to show the most active syndication managers. This enhances a business reputation of the bank, thereby attracting other mandates. The banks participating in syndication are also given an opportunity to strengthen their relationship with their customers by being first in offering them new securities. As a result, syndication is a very competitive business.

Syndicated transactions receive considerable coverage in the financial press. Syndications are a highly specialized business. The major players are a small number of large international banks. Most transactions are reviewed in great detail. The competitors of the appointed joint leads do not miss the opportunity to highlight any shortcoming in the “market comments” section of press reviews, expecting to increase their own chances of becoming lead managers next time.

This public scrutiny contributes to ensuring that the level of the selling price agreed upon between the DMO and the joint leads is a fair deal for both issuer and investors. This applies especially when joint leads are important players in the business. The best known players are the most sensitive ones to the detrimental impact of unfavorable comments published in the press on their syndicate desk.

2.2. External vs. Domestic syndications

External and domestic syndications share a number of common procedures. Yet, they pursue different objectives and each has some specific features.

2.2.1. Specific objectives pursued

External syndications pursue primarily two objectives: (i) to fund the foreign currency requirements of the government and/or meet funding needs which are beyond the absorption capacity of the domestic market and (ii) to diversify the investors’ base by familiarizing international investors with the issuer’s credit. External syndications raise an issuer’s market profile and visibility.

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6 Syndication is thus akin to a private placement where the issuer is ensured to have a certain amount of funding at a predetermined price. The specificity of a private placement is that the issuer negotiates with a smaller number of banks (typically between one and three institutions). The size of the funding is also smaller than in syndication. In general, the banks know beforehand where they will place the securities. The main advantage of a private placement is that it can be completed fast and with no publicity. Please see Appendix 1 for further comparison;
Alternative or additional objectives can be (i) to obtain a lower cost funding than on the domestic market by doing a currency swap\(^7\) and (ii) to provide a pricing reference for bonds issued in the international market by domestic agencies or corporations.

**Domestic syndications** pursue three objectives: (i) to provide immediate liquidity to a new domestic benchmark bond by issuing a large amount; (ii) to widen the investor base and (iii) to enhance the good functioning of the secondary market by creating the right mix between real money investors and trading accounts amongst the bondholders.

The widening of the investor base generally includes an expectation to draw foreign investors to the domestic market. Syndication is a tool much more efficient than an auction to do so as it minimizes the investor’s risk (section 4.1.2.). Successful domestic syndications attract a significant amount of foreign buying. Yet, the latter is not necessarily a prerequisite for a domestic syndication to be justified.\(^8\)

An additional (or alternative) objective of a domestic syndication can be to support launching a financial instrument which is an innovation in the domestic market. Syndications facilitate price discovery (section 4.1.1.B). The banks leading the syndicate can also help the issuer and/or the market in mastering the technicalities of the new instrument.

### 2.2.2 Distinctive features

**In an external syndication, the issued security is an international bond.** The transaction is subject to foreign law.\(^7\) The bond is denominated in foreign currency. It is usually placed only abroad. It is not intended to be tapped again in the future. The funding need being met is usually not recurrent. The syndication itself is a placement procedure used relatively seldom.

**In domestic syndication, the issued security is a standard domestic benchmark bond** of which the outstanding will be subsequently tapped by auctions following the standard auction procedures applicable in the domestic market. The transaction is governed by domestic law. The syndication itself is a securities placement procedure which tends to be recurrently used. Many DMOs have made domestic syndications an integral part of their debt issuance policy for issuing new benchmark maturities.

**Well managed domestic syndications decrease the issuer’s funding cost.** The higher liquidity of the security and the larger number of investors allow selling bonds at a higher price than in an auction, particularly for the size issued. A domestic syndication also provides some additional benefits which jointly further decrease the net cost of the funding (see section 4.1.2 and Box 1 below). These advantages generally outweigh the amount of commissions paid.

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\(^7\) This assumes that an arbitrage possibility exists between the two markets (“swap window”) and can be taken advantage of;

\(^8\) As an illustration, Mexico (section 4.6.) did not mention foreign investors as a specific objective nor did it set any target market share for placement abroad;

\(^9\) Generally, the UK or New York law;
**BOX 1**

<table>
<thead>
<tr>
<th><strong>External syndication</strong></th>
<th><strong>Domestic syndication</strong></th>
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<tbody>
<tr>
<td><strong>Objectives</strong></td>
<td></td>
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<tr>
<td>• to meet foreign currency needs and/or financing</td>
<td>• to increase size of issuance (-&gt; immediate liquidity)</td>
</tr>
<tr>
<td>• needs beyond the absorption capacity of the domestic market</td>
<td>• to attract foreign investors to the domestic market</td>
</tr>
<tr>
<td>• to diversify the investor base</td>
<td>• to facilitate the issuance of new instruments (price discovery)</td>
</tr>
<tr>
<td>• to lower funding cost (if possibility of swap arbitrage)</td>
<td></td>
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<tr>
<td><strong>Distinctive features</strong></td>
<td></td>
</tr>
<tr>
<td>• bond denominated in foreign currency</td>
<td>• domestic benchmark tapped by auctions thereafter</td>
</tr>
<tr>
<td>• transaction subject to foreign law</td>
<td>• transaction subject to domestic law</td>
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<tr>
<td>• placement abroad</td>
<td>• placement both domestic and abroad</td>
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<tr>
<td>• non (or little) recurrent placement procedure</td>
<td>• recurrently used placement procedure</td>
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<tr>
<td><strong>Additional benefits</strong></td>
<td></td>
</tr>
<tr>
<td>• raises issuer’s profile and visibility</td>
<td>• decreases funding cost</td>
</tr>
<tr>
<td>• provides a pricing reference for other borrowers</td>
<td>• ensures firm prices in the secondary market</td>
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<td></td>
<td>• supports primary dealers’ (PDs) motivation to perform</td>
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<td></td>
<td>• strengthens investor relationships</td>
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<tr>
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<td>• can support liability management operations</td>
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3. EXTERNAL SYNDICATIONS

This section reviews the rationale for external syndications, followed by a description of the procedures usually implemented.

3.1. Rationale for external syndications

The reason for using syndications to place external debt is clear. The investor base is little known to the issuer and requires a special marketing effort to be tapped. Nonresident investors lack familiarity with the issuer and the financial instrument to submit large and/or aggressive bids. Auctions are seldom used – if at all - for non-domestic issuance by sovereigns. In most cases, they would not produce best prices outside domestic markets.

3.2. External syndication procedures

Syndications are usually prepared by a marketing campaign. The issuer updates investors on the country credit and government securities market. The rationale and the main features of the transaction are described. This is typically done in the framework of conference calls and/or road shows organized abroad.

Thereafter, the syndication of a bond issuance usually covers six steps:

<table>
<thead>
<tr>
<th>Syndication steps</th>
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<tbody>
<tr>
<td>1. appointment of a syndicate group</td>
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<tr>
<td>2. pricing guidance</td>
<td></td>
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<tr>
<td>3. official announcement of the transaction / book building</td>
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<tr>
<td>4. closing of the books</td>
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<tr>
<td>5. allocation of orders</td>
<td></td>
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<tr>
<td>6. management of the market post-syndication</td>
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</table>

(1) Appointment of a syndicate group

A syndicate usually comprises a small number (3 or 4) of joint leads and up to a dozen of co-managers. The joint leads\(^\text{10}\) assume responsibility for arranging the transaction. The co-managers are working in the framework set by the joint leads.

The selection of joint leads is a critical decision. The success of a transaction and the joint leads’ ability and experience are closely linked.

The joint leads can be selected on a competitive or on a judgmental basis. In the first case, the banks which have offered the lowest funding cost\(^\text{11}\) are appointed. In the second case, the appointed banks are the ones which the issuer deems to be best equipped to achieve the assigned objectives, i.e., considered are the ability and experience of the bank for the transaction, the strength of the bank’s relationship with the targeted investor base, the capacity and resources of the bank to support the syndicated bond in the secondary market.

\(^{10}\) Also called “book runners”;

\(^{11}\) i.e. the highest bond price and the lowest commissions;
The syndication corresponding to the first type of appointment is called a “bought deal”. Competitive bidding creates a risk that the bond will perform poorly, particularly in the secondary market, when the fee is too low. Experience suggests that exercising judgment in appointing joint leads is generally a more efficient procedure (section 4.9).

(2) Pricing guidance

The strategy is to determine the selling price of the bond based on investor demand. This procedure applies when joint leads are selected on the basis of their placement capabilities and expertise in managing the market after launch12. The joint leads informally13 check with a sample of representative investors in their respective customer base the price range that would attract buying orders and for what amounts. The corresponding price range is expressed as a “spread range” over a reference rate.14

(3) Official announcement of the transaction and book building

The announcement of the transaction indicates the target amount to be issued15 and a spread range for the pricing. The order book lists the orders by price levels and by amounts, same as for bids submitted at an auction. The market is kept informed of the size of the book and of the spread range which is narrowed as the order book grows. Some investors adjust their bids accordingly.

(4) Closing of the books

When enough orders have been collected, a cut-off price is set at the level which provides the desired amount of funding. The cut-off price is proposed by the joint leads and approved by the issuer. Same as in an auction, the bonds will be allocated to investors, who have submitted orders at the cut-off price or higher. Same as in a uniform price auction, all investors who are allocated bonds pay the same price (the cut off price).

(5) Allocation of orders

Successful syndications are typically oversubscribed, i.e., the amount of orders submitted at the cut-off price or higher is larger than the amount of the funding wanted. The orders then need to be allocated for a certain percentage of their amount. This can be done in different ways: (i) allocation of the same percentage across either all investors or by type of investors, or (ii) individual allocation on a case by case basis as a function of the type of investor and/or its geographical location and/or the quality of its relationship with the DMO16, etc., or (iii) a combination of (i) and (ii).

The main objective pursued in allocating orders is to ensure firm prices in the secondary market by enhancing the stability of the placement and the liquidity of the bond. The stability of the placement can be increased by giving allocations to final investors who are likely to keep the bonds in portfolio for some time.17 The liquidity of the secondary market can be enhanced by granting a

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12 Instead, in a “bought deal”, the price is set at the level at which joint leads have committed to underwrite the transaction;
13 The transaction is not yet announced officially;
14 Ex. US Treasuries + 100 to 120 bp or German Bunds + 20 to 25 bp; the level of the spread is a function of several variables, such as the credit rating of the issuer, the maturity of the deal, the condition of the market, etc.;
15 Ex. “benchmark size”;
16 Ex. participation of the investor in bonds buy-back and exchanges, information given by the investor to the DMO on its portfolio management strategy;
17 Ex. central banks, insurance companies and pension funds;
certain percentage of allocations to actively trading market participants.\textsuperscript{18} The combination of stability and liquidity creates the optimal conditions for having firm prices in the secondary market. An additional objective often pursued is to strengthen investor relationships. This can be achieved by granting larger allocations to investors who are recurrent buyers, or active participants in bond exchanges or buy backs\textsuperscript{19}, or providers of useful market feedback, etc.

\textbf{(6) Management of the market post-syndication.}

The joint leads are assigned responsibility for ensuring the liquidity of the secondary market. They also commit to ensure that the price of the bond will remain firm during a period of a few weeks after launch.

\textsuperscript{18} Ex. hedge funds;

\textsuperscript{19} Syndications can indirectly support liability management when this allocation strategy is made explicit;
4. DOMESTIC SYNDICATIONS

This section covers the rationale for domestic syndications. It includes a survey of the markets using them. It analyses the features specific to domestic syndications. Some case studies follow with a more detailed analysis of the objectives pursued and procedures implemented in three representative countries: Belgium, Mexico and the Netherlands. Finally, three specific topics are briefly reviewed: syndication fees, the factors contributing to the success of domestic auctions and the issues that would be raised by a domestic syndication done without being supported by a PD system.

4.1. Rationale for domestic syndications

At first glance, domestic syndications are a paradox. Auctions are the standard issuance procedure in modern government securities markets. Auctions are a competitive and commission free process. They represent an improvement to the noncompetitive placement systems which used to prevail in most government securities markets before. In principle, auctions should yield the lowest financing cost.

The rationale for domestic syndications is that they can produce better results than actions in some specific circumstances. Yet, domestic syndications have limitations and their own drawbacks.

4.1.1. The drawbacks of auctions

Auctions do not always produce the best results in four respects: timing, size, price and investor base.

(i) Timing: auctions are subject to timing constraints. Auctions are done in the framework of a calendar. This is a sound market practice. In the long run, predictability decreases the financing cost. In the short run, however, the corresponding lack of flexibility can raise a risk (issuance in unfavorable market conditions) or represent a missed opportunity.

(ii) Size: auctions allow raising only relatively small amounts. Auctions are subscribed primarily by dealers who carry the securities until such time as they can on-sell them to customers. End investors generally participate little in auctions for three reasons: (a) the auctions may not take place at the right time (because of the calendar); (b) the investor is not certain to acquire the amount of securities wanted (his bid may not be successful); (c) if the bid is successful and if the auction is multiple price, the price may be too high ("winner’s curse"). By contrast, in a liquid secondary market, an investor can buy the amount he wants at a price he knows and at the moment it suits. Therefore, many end investors tend to bid at auctions only when the secondary market is illiquid and/or the amount to buy is so large that it could move the market. As a result, auctions can require time for a bond to reach benchmark size. In the meantime, the issuer pays a liquidity premium.

(iii) Price: the issuer has little control over the price. The flexibility to adjust the size of the issued amount is limited. A target issuance amount has been announced and a funding need has to be met. The auctioned price can be a surprise for both issuer and investors.

(iv) Investor base: the issuer has no control of the investor base. Bidding is often anonymous. In any case, the issuer cannot choose the investor to whom the securities will be allocated.

4.1.2. The advantages of domestic syndications

20 With exception of DMOs paying a commission on customers’ orders submitted by PDs;
A. A domestic syndication allows correcting each of the aforementioned drawbacks of auctions.

(i) **Timing:** syndication takes place out of calendar. Syndications can be done only when market conditions are right. This is a standard and a well-accepted market practice. Syndications, therefore, decrease the execution risk.

(ii) **Size:** syndication enables to issue an amount significantly larger than an auction, thereby providing immediate liquidity. Final investors are attracted by syndications as their investment risk is then minimized: (a) investors know ahead of time the amount of buying orders and a range for the selling price; (b) investors have a greater certainty of being allocated bonds: during the book building process, they can adapt their bid as they get more information on the degree of success of the placement; (c) investors are protected against the winner’s curse (the settlement price is the same as all successful bidders buy the bond at the same price); (d) investors have the assurance that the secondary bond will be liquid thanks to the large size issued, tight quoting obligations and balanced investor base; (e) when syndication is well managed\(^2\), investors have a reasonable expectation of getting a small capital gain. Last, issuers can make a syndication to be a marketing event more easily than for an auction.

(iii) **Price:** the book building process gives the issuer some degree of control over the issuance price. The issuer can adapt the spread range (price guidance) as a function of the quality of the order book. In addition, expert syndication managers are able to create some momentum (“hype”) in the investors’ community by delivering the appropriate market commentary.

In any case, the selling price of a syndicated security is generally higher than the price at which it would have been auctioned, particularly for the size involved, thanks to the direct participation of a larger number of investors and the ensured liquidity of the bond.\(^2\)

(iv) **Investor base:** the issuer can control where the bonds are placed and with what type of investors when it allocates the bonds.

B. Syndications have two additional advantages over auctions.

(i) **Price discovery:** Syndications help in achieving a correct price formation in markets where secondary market prices are not reliable references. Placing the first tranche through syndication gives market participants a clearer idea of how to price the issue in subsequent auctions. In particular, syndications enable DMOs to assess the correct price for issuing a new financial instrument more accurately than auctions do (section 4.2).

(ii) **Firm prices in the secondary market:** The bond allocation process enables the issuer to achieve the optimal mix between buy and hold accounts and trading accounts amongst the investors holding the bonds. In addition, the market making obligation of PDs can be focussed on the joint lead managers who are made specifically accountable for price stability. Issuers who have built a reputation of expert syndication managers benefit from the investors’ corresponding expectation of firm prices in the secondary market with the possibility of issuing at a lower yield.

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\(^2\) Well-advised issuers tend to deliberately set their cut-off price a little below the intrinsic value of the bond, thereby offering investors on the primary market the likelihood of a small capital gain. The cost to the issuer is insignificant as a larger number of investors bid more aggressively as a result;

\(^2\) This does not mean that syndication will always be successful irrespective of market conditions (ex. highly volatile market);
Comparison: syndication vs. auction

<table>
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<tr>
<th>Size:</th>
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<tbody>
<tr>
<td>• bigger participation of end investors</td>
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<tr>
<td>• decreased investment risk: price range</td>
</tr>
<tr>
<td>• book building</td>
</tr>
<tr>
<td>• no winner’s curse</td>
</tr>
<tr>
<td>• more attractive security liquidity</td>
</tr>
<tr>
<td>• firm secondary market prices</td>
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<table>
<thead>
<tr>
<th>Price:</th>
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<tr>
<td>• issuer has better control</td>
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<tr>
<td>• price discovery</td>
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<table>
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<tr>
<th>Investor base:</th>
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<tbody>
<tr>
<td>• wider investor base</td>
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<tr>
<td>• optimal composition (allocation of orders)</td>
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<td>• attracts foreign investors (better information, lower risks)</td>
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<table>
<thead>
<tr>
<th>Timing:</th>
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<tr>
<td>• flexible (no calendar)</td>
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4.1.3. The limitations of domestic syndications

Domestic syndications can show their specific usefulness only in some specific circumstances. To reap the benefits of size, price guidance/discovery and diversification of investor base, a new bond has to be issued and the intention generally has to be to place it both in the domestic market and abroad.

In any case, domestic syndications are complement to, and are not a substitute for, auctions.

4.1.4. The drawbacks of syndications

Syndications have three drawbacks:

(i) Time consuming: syndications are administratively much heavier to put in place than auctions. Completing syndication is a full time job during two or three weeks (Section 4.4.3.).

(ii) Risks: the determination of the selling price is not as straight as it is in an auction. Yet, the securities are unlikely to be sold at a lower price to the detriment of the issuer as a result. The issuer is protected against this risk both by the competition between joint leads and by the scrutiny of the financial press. Admittedly, this protection is not as strong as that secured by the competitive pressure in an auction. To eliminate the risk altogether, the DMO needs some technical expertise in doing syndications. On a comparative basis, a domestic syndication is less risky than an external syndication in countries which have a PD system, due to the existence of a stable relationship.

23 Not necessarily ;
(iii) **Not to be used too often:** syndications are not a level playing field for banks. Large international banks are privileged in granting of joint lead mandates. The recourse to syndications could therefore become detrimental to the well-functioning of a PD group if syndications were used too often. Also, syndications are best done seldom enough to remain a marketing event.

The fact that **syndications entail the payment of a commission** to the syndication managers or selling agents is not listed as a drawback of domestic syndications as the cost of the commission is normally offset by other benefits, in particular a higher selling price and a stronger motivation of primary dealers to perform.

<table>
<thead>
<tr>
<th>Domestic syndications: drawbacks</th>
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</thead>
<tbody>
<tr>
<td>• time consuming</td>
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<tr>
<td>• not entirely riskless</td>
</tr>
<tr>
<td>• not to be done too often</td>
</tr>
</tbody>
</table>

The payment of a commission is not a genuine drawback

### 4.2. Using syndications to launch a new financial instrument

**Auctioning a new instrument is a risky process.** An auction is a one-time process which the issuer cannot influence. The result of an auction is particularly unpredictable when a new instrument is involved. An additional risk is that a wrong start could be hard to correct when the instrument is issued again later on.

**Syndications enable DMOs to assess the correct price for issuing a new bond more accurately than auctions do.** This is due to both the book building process in syndications and the participation of a wider investor base. Both the DMO and the market also benefit from the experience of the lead managers in structuring the transaction.

**The use of syndications to launch a new financial instrument has become a widespread practice.** In 2005, the UK syndicated its first long dated inflation linker; in 2006, Germany syndicated its first inflation-linked bond; in 2006, France syndicated its first OATi (inflation-indexed bond); in 2008, Italy syndicated its first inflation linked floating-rate note (FRN) in 2010. The French DMO has made the point that syndications are an efficient way to “launch a new instrument that requires a learning process for the market”.  

24 The German DMO has stated that “it would use the syndication route again if it was issuing a new type of instrument or entering a new market to have the assistance and experience of the banks”.  

### 4.3. Market survey

The launch of new benchmarks with a “domestic syndication” has been initiated in the EMU by the **Belgian Debt Agency (BDA).** The first Belgian domestic syndication took place in January 1999, a few days after the introduction of the euro. Belgium was then confronted with two issues compounding the problems created by an excessively large public debt. First, over 90% of the public debt was held by resident investors. In the pre-euro days, these investors were somehow captive. They could not invest abroad without incurring a FX risk. With the euro, domestic investors were expected to diversify their holdings. The BDA had therefore an urgent need to develop a nonresident investor

24 France: Travaux Parlementaires, "Pour une gestion consolidée des dettes de l’Etat", July 12, 2005 ;

25 Euroweek, June 26, 2006;
base. The second problem of the BDA was that the introduction of the euro raised the size of the critical mass required to attract liquidity. A minimum amount outstanding of euro 5 billion is a prerequisite for bonds to be quoted on the pan-European electronic trading platform “Euro-MTS”. By contrast, the amount that the BDA could auction without disrupting the market was estimated to be a maximum of euro 3 billion. The BDA inaugurated the domestic syndication technique to overcome these two constraints. Since 1999, the BDA has launched all its new benchmarks with a domestic syndication, i.e., a total of 35 issues for a global amount of euro 105.5 billion as of June 30, 2011.

From 2000 onwards, domestic syndications have been increasingly used in the EU for launching new benchmarks. Today, all the small issuers in the euro zone invariably follow this strategy. In 2005, large issuers started using domestic syndications as well but with the objective of enhancing price discovery (see section 4.2). All issuers in the EU basically follow the same placement procedures, with the exception of the Netherlands.

In June 2003, the Dutch State Treasury Agency (DSTA) innovated a specific domestic syndication procedure (the “Dutch Direct Auction” or DDA). This placement technique reinforces the auction component in the standard domestic auction structure. The DDA is not just followed by auctions. In itself, it is a hybrid between a syndication and an auction. In view of its specificity, the DDA is described in detail in section 4.7.

In 2009, sixteen OECD countries were reported to be using syndications followed later by auctions to increase the size of the initial issuance as an additional way to issue domestic currency denominated debt. Practices range from occasional use to systematic use when launching a new benchmark. Some countries use domestic syndications only when issuing a new financial instrument in the domestic market. Mexico provides an instructive illustration of some innovative uses of this placement procedure (section 4.6.). Poland reports that a domestic syndication is a means of placement it might consider in an emergency situation.

4.4. Procedures specific to domestic syndications

4.4.1. General

The specific features mentioned in this section are basically common to the slightly different procedures implemented by various DMO, with the exception of the Netherlands. The syndication steps are reviewed below in a similar sequence as in section 3.2.

(1) Composition of a syndicate group

Two policies apply in virtually all countries where a PD system exists: (i) a syndicate group comprises only PDs; (ii) subject to all other things being equal, the joint lead mandates are awarded to the best PDs. The best PDs are considered the ones that rank the highest in the appraisal of their performance as a PD. The first policy enhances the attractiveness of the PD status in the banking community. The second policy provides the DMO with a powerful tool to motivate PDs to do

26 “New challenges in the use of government debt issuance procedures, techniques and policies in OECD markets”, Hans Blommestein, 2009;
27 Austria, Slovakia, Sweden;
28 Belgium, Finland, Greece, Ireland, Portugal, Spain;
29 France, Germany, Italy, Korea, UK;
30 That is assuming equal degree of expertise in arranging a successful syndication. The degree of expertise can differ as a function of the business specialization of the bank, its type of customer base, the geographical coverage of its placement, etc. In case an expertise in syndication and a quality performance as a PD receive contradictory evaluations, the expertise in syndication is the criterion that should prevail;
better than just complying with the commitments attached to their status. PDs acquire a vested interest in competing against other PDs in order to be ranked amongst the best performers. In this way, they get on the short list for being appointed as a joint lead.31

The above policies rest on three observations:

(a) PDs assume many duties: to bid at the auctions, to place the issued securities with final investors, to enhance the liquidity of the secondary market with a continuous quoting of prices and to advise the issuer on its debt management policy and on the organization of its market. These efforts deserve compensation.

(b) Issuers can compensate their PDs in various ways for the cost and the effort involved. One way is to select PDs as counterparts in DMO’s debt management operations which offers a profit opportunity to the banks involved32. In mature markets, the PDs’ Agreement almost invariably includes a provision stating that “PDs are the privileged counterpart of the DMO in its debt management operations”.

The appointment as a joint lead manager in a syndication is a reward particularly appreciated by banks. As mentioned earlier, it offers them three benefits: a commission, a closer relationship with customers and a higher ranking in the syndications league tables.33

(c) The motivation of PDs to do the best possible job in carrying out their duties can be strongly supported by allocating rewards as a function of the quality of their performance. This practice is wide spread in the EU since the early nineties. It has yielded significant benefits to issuers, including more aggressive biddings by PDs at the auctions.34

The policy of establishing a connection between the quality of performance as a PD and the granting of a joint lead mandate35 has a wide range of possible implementations. (i) This policy can be applied to external syndications. It is a missed opportunity not to do so. Domestic and external debt should be managed in tandem, not in silos. (ii) This policy can be applied in emerging markets where no international bank with a strong franchise in syndications is active yet. It suffices that at least one such bank has a local office or a participation in a subsidiary which has been appointed as a PD. Issuing a lead manager mandate to a head office is likely to have a favorable impact on the future performance of the relevant PD. (iii) This policy can be even applied in countries with no PDs. Some banks are bound to be more helpful to the DMO (or to the Central Bank) than others. It can be mutually beneficial that, all other things being equal, these banks are considered first when rewards are offered.

(2) Pricing guidance

31 Poland reports that the announcement the DMO may consider syndications as a possible placement mechanism in itself led to improved competition amongst PDs;
32 For example, transactions in the currency or derivatives markets;
33 The latter is a particularly valued reward to the banks due to its snow ball effect. Issuers (both public and corporate) tend to appoint as lead managers the banks with high rankings in the league tables, on assumption that they are the most experienced ones in the field;
34 This process went too far in some EU countries during the mid-2000 as PDs started buying market share in order to be on the issuer’s short list of joint lead candidates. As a result, some securities started being auctioned at prices above the level of the prices in the secondary market, thereby forcing issuers to penalize excessively aggressive bids in order to avoid market distortions;
35 Assuming an equal degree of expertise as a lead manager in syndicated deals between the respective PDs;
The joint leads have a particularly strong vested interest in ensuring that the suggested pricing is fair for both issuer and investors. Domestic syndications are a recurrent procedure. Joint leads are therefore especially careful not to disappoint.

(3) Book building

It is a frequent practice for DMOs to set a global ceiling for the placement with domestic investors and to give some fairly detailed instructions to joint leads with respect to the amount placed abroad (which of joint leads places in which countries and to what type of investors).

(4) Allocation of orders

DMOs typically get more closely involved in the order allocation procedure in domestic syndications than in external syndications. Ultimately, the allocation decisions should rest with the joint leads. They are responsible for ensuring the liquidity of the secondary market. Yet, domestic syndications are a procedure often used recurrently. DMOs get an increasingly expert knowledge of their investor base in the process.

(5) Post syndication market

It is standard practice to make a distinction between two secondary market functions: to support the price of the bonds and to ensure the liquidity of the issue. The former applies specifically to the joint leads of the syndication as they assume the role of “stabilization managers”. The latter applies also to the co-leads.

In countries where a PD system exists, the subscription agreement mentions only the function of stabilization manager. The PDs’ obligations with respect to supporting the liquidity of the market are set in the PDs’ Code of Duties.

4.4.2. Documentation

There are two types of documentation drafted in the framework of syndication: legal and market announcements.

(i) Legal documentation

(a) Information memorandum

The Information memorandum is meant to inform investors about the terms of the syndicated bond. It provides some background information on the domestic government securities market, the clearing and settlement procedures, the taxation regime, the subscription and sale of the bonds, selling restrictions (if any) and the composition of the syndicate.

(b) Subscription and selling group agreement

36 One side benefit of this close involvement by a debt manager is to avoid some potentially awkward situations such as meeting an investor some time before a syndication (e.g., in the framework of a non-deal-roadshow) to entice him to buy bonds and thereafter allocating to him only a very small percentage of the order which he submitted;
37 In practice, a Treasury typically informs joint leads that their compliance with the obligation to make bid and offer prices to support liquidity of the government securities market will be monitored particularly closely in the framework of syndication. The Treasury typically further informs the joint leads that the sanction for their noncompliance with this obligation will be to significantly decrease their chance of being appointed a joint lead again in the future. Both policies are best kept pragmatic, however, and not mentioned in a specific agreement;
This document specifies the commitments assumed by the members of the syndicate (underwriting and selling) and by the issuer (bond issuance and payment of commissions), respectively.

(b) Confirmation to the invitation to participate

When the books are closed and the pricing done, the DMO confirms to each member of the syndicate its underwriting commitment and the amount of its final allocation. The document includes a power of attorney to one joint lead to sign the corresponding subscription agreement.

(d) Signing and closing agreement

All parties sign the final documents prior to the settlement of the transaction.

(ii) Market announcements

Four announcements are made to the market\(^\text{38}\) during the syndication process: (i) intention to issue a syndicated bond (description included) during the course of (period mentioned); (ii) opening of books and a price range; (iii) closing of books and imminent pricing; (iv) pricing and issuance of the bond.

4.4.3. Time investment required for syndication

The syndication process usually takes between 2 and 3 weeks to complete. It represents close to a full time job for at least 2 persons in the DMO during this period for a first syndication. The time investment shortens as experience is gained.

The syndication process is marked by 4 “landmarks”: (i) start of the process (initial meeting with the joint leads); (ii) start of book building; (iii) pricing of the bond and (iv) settlement of the transaction. The DMO and the joint leads monitor the whole process through daily conference calls.

The calendar is:

**Day minus ...:** deal preparation period. The DMO submits to the Minister’s approval the contemplated bond issue (size and a maturity) and joint leads selection.

**Day 0:** the DMO and the joint leads meet to agree upon the terms and conditions of the syndication. At the end of this meeting, the Minister makes the announcement that a transaction is being contemplated and indicates the names of the joint leads.

**Day 0 + approximately 2 weeks:** The DMO sends to the co-leads an invitation to participate. Minister announces that book building begins. The co-leads and selling group members send in their order books using an Excel spreadsheet. The joint leads gradually build their book. They input their orders in an on-line electronic book building system which ranks the orders by price, type (firm, soft, re-offer) and type of investor (central banks, insurance companies, pension funds, hedge funds, etc.). In the euro zone, the book building process takes between one and three days.

**When the books are closed** (= the end of the book building period), the Minister announces the formal launch of the issue and that the bond will be priced. From that point in time, the DMO is legally bound to issue the bond. The bonds are allocated.

**The next business day,** the bond is priced.

\(^{38}\) Through Reuters, Bloomberg, etc.;
4.5. Case study 1: Belgium

The case study outlines the provisions designed by the BDA to govern the composition of the syndicate group, the structure of the syndication, the collection of orders and the allocation of securities.

4.5.1. Composition of the syndication group

All primary dealers and recognized dealers\(^{39}\) are invited to participate. The syndication group is split into three segments:

(i) **Joint leads**: 3 or 4 PDs selected amongst the best performing ones.

The joint leads assume:

(a) **overall responsibility for the success of the placement.** They are the BDA’s advisors for the structure of the syndication, the timing of the launch, the pricing guidance, the allocation decisions, etc. (See Appendix 2).

(b) **primary responsibility for the good performance of the bonds in the secondary market.** The joint leads have a vested interest in building a well-balanced and a diversified order book.

(c) **specific responsibility for some operational duties.** (For example, legal documentation, contacts with the press, launch and pricing announcements, online book building, clearing and settlement instructions.) These duties are allocated between the joint leads (See Appendix 3).

The joint leads are responsible for the largest share of the placement. The size of their share increases when the placement is expected to be difficult. The objective is to then give joint leads a better control over the global order book.

(ii) **Co-leads**: the remaining PDs.

Co-leads are given only a small share in the placement. They are expected to concentrate on bringing small orders from attractive accounts, i.e., primarily investors new or seldom seen so far or located in a target geographical area. The objective is to avoid competing with the joint leads who concentrate on large accounts.

(iii) **Selling group members**: the recognized dealers.

Same mission as the Co-leads, but their share in the placement is smaller and they are paid only a selling commission (no underwriting).

**Note: in theory, the joint leads and Co-leads assume an underwriting risk.** In normal market conditions, this risk hardly exists in practice in view of the book building procedure and of the issuer’s flexibility in setting the date of the launch. Yet, the underwriting risk cannot be totally excluded (ex. if the market becomes difficult during the launching process).

4.5.2. Syndication structure

The amount to be issued is usually split into 3 pools:

\(^{39}\) Recognized dealers are financial intermediaries which have an official status as dealers in government securities. They have fewer commitments than PDs and lower rewards;
(i) “pot” for the joint leads: all joint leads pool their orders together. Every joint lead is paid the same commission irrespective of the amount of orders it has actually collected. The size of the pot is usually between 65% and 80% of the amount to be issued.

(ii) “retention” for the Co-Leads (usually 1% for each). The retention is a guaranteed allocation in the placement.

(iii) “strategic reserve” for the Co-Leads and Selling Group members (usually around 15%). The strategic reserve is an amount set aside that the BDA uses to give at its discretion an additional allocation to the Co-Leads and Selling Group members who have collected orders which the BDA deems to be particularly attractive.

In a few cases, the retention has been eliminated from the structure and incorporated into the strategic reserve, thereby suppressing the guaranteed allocations. This procedure has been applied when the placement was expected to be difficult (e.g., volatile market conditions) and/or requiring a special expertise (e.g., placement of a very long maturity bond).

4.5.3. Pricing guidance, collection of orders and book building

A spread range is announced initially. It is narrowed as the order book grows. One joint lead is responsible for centralizing the orders collected by the joint leads group. The BDA collects itself the orders gathered by the Co-Leads and Selling Group members. The book building period typically takes between one and three days.

4.5.4. Names transparency and allocation decisions

(i) Joint leads: There is a full transparency between joint leads. In principle, joint leads disclose all investor names to one another and to the BDA. In practice, joint leads are allowed to disclose a few names only to the BDA when they deem that transparency would be a leakage of market intelligence. The names in question are then reported as “X” accounts to the other joint leads.

The allocation of orders is discussed between the joint leads and the BDA. In case of disagreement, the final decision is made by the BDA.

(ii) Co-leads and selling group members: partial transparency. They disclose names only to the BDA which does the allocation. This procedure applies to both the retention and the strategic reserve. When allocating the strategic reserve, the BDA checks that there is no duplication with orders in the books of the joint leads and Co-Leads/ Selling Group members respectively. If there is duplication, the order submitted by the Co-Leads and/or Selling Group members does not qualify for an allocation in the strategic reserve.

4.5.5. Securities allocation rules

The allocation rules are discussed by the BDA with the joint leads. The rules are flexible and informal. They are not disclosed officially. The Co-Leads and Selling Group members are only told that “the BDA will give priority to small size quality orders which ideally should be first time purchasers of Belgian Government securities”. Some target geographical areas are sometimes also indicated.

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40 Therefore referred to as “blind retention” to indicate that the names of investors are seen only by the DMO; 41 Co-Leads and Selling Group members are expected to concentrate on small orders from accounts which are not in the joint leads’ customer base;
The allocation rules are set in two stages:

(i) before the start of the book building process

The BDA conveys some general guidelines to the joint leads, usually:

- 80% - real money; 20% - trading accounts. The preferred real money accounts are central banks and stable long term investors such as insurance companies and pension funds. Trading accounts include leveraged money, proprietary trading accounts and traders’ long positions.\(^\text{42}\)
- some guidance on target geographical areas, e.g.: maximum 20% to resident investors, preference for Asian accounts.
- no protected orders, i.e., syndication members are forbidden to guarantee an allocation to any of their customers.

(ii) upon the closing of the books

The percentage actually allocated to each category of investors is a function of the size and quality of the order book, i.e., the extent of the oversubscription and the relative importance of the real money and trading accounts. For example, a significant share might have to be allocated to hedge funds if the book is small and with a large component of trading accounts\(^\text{43}\). Central banks and small orders (< EUR 25 million) are typically allocated 100% in any case.

4.5.6. Post syndication market

The responsibility for quoting prices for the syndicated benchmark rests on the joint leads and all Co-Leads. They are all PDs and the bond is a benchmark subject to a PD’s quoting obligation in any case. Yet, the BDA informally advises the joint leads that their compliance with the obligation to make bid and offer prices to support the liquidity of the bond will be monitored particularly closely.

4.5.7. Syndication fees

The policy of the BDA is to pay whatever the prevailing market rate for the commission is. The BDA never negotiates to lower a commission below that level. This policy rests on the observation that:

(i) the degree of expertise and commitment of the staff assigned by banks to the deal is a direct function of the level of the fee paid by the issuer. Low commissions impair the quality of the service provided and thereby the success of the transaction.

(ii) a correct fee ensures that the banks will support the deal in the secondary market. A firm price in the secondary market gives a positive image of the issuer in the investors’ community. This facilitates the placement of the next syndication.

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\(^{42}\) In principle, joint leads should have no long trading positions. On the contrary, joint leads are expected to keep short positions to support the secondary market;

\(^{43}\) An alternative is to downsize the deal to preserve the quality of secondary market performance;
4.6. Case study 2: Mexico⁴⁴

Mexico did its first domestic syndication with the launch of a 10-year benchmark bond in February 2010. As of June 2011, a total of five benchmarks have been syndicated⁴⁵. Mexico reports that the launching of benchmarks with domestic syndication is currently a standing policy.

4.6.1. Innovative objective pursued

The Ministry of Finance (“MoF”) pursued four objectives when doing its first domestic syndication. Three objectives are common practice. One is an innovation.

As reported by the MoF, the “common practice” objectives pursued by the syndication were: “(i) to reach an adequate outstanding amount at the inaugural issuance; (ii) to place the security amongst a broader investor base in order to ensure the liquidity of the benchmark in the secondary market and (iii) to strengthen the issuance process given certainty of price, amount and broad investor distribution”.

The innovative objective was to have the benchmark become immediately eligible for inclusion in the global fixed rate income indices⁴⁶ used by local and international investors to monitor markets performance. In most global indices, a minimum amount outstanding per bond is required in order to be included in standalone indices. Consequently, inclusion of a bond in an index represents a potential tool to attract foreign investment.

In Mexico, the track record of auctions in 2009 showed two problems: (i) it took about 10.5 months for the outstanding amount of a 10-year benchmark to reach the size of pesos 25 billion which is required for inclusion in most bond indices; (ii) the bond tended to be of uneven liquidity during the interim period and vulnerable to market squeezes at the point in time it integrated the indices.

4.6.2. The results achieved

At the inaugural transaction, the syndicated mechanism allowed to issue debt of 25 billion pesos⁴⁷. This allowed the bond to be included in the global fixed rate income indices from the start. The book building process also diversified the investor base, including 20% placed with nonresident investors⁴⁸. Last, the trading of the new 10-year bond has been greater than the latest 10-year references.

4.6.3. Specific procedures implemented

For its inaugural syndicate transaction, the MoF appointed 4 PDs ranked the best market makers⁴⁹ as joint leads and the next 3 best ones as co-managers.

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⁴⁴ The information below has been sourced primarily from: “10-year M-Bond Syndicated Issuance. A successful placement of government debt through a new mechanism in the primary domestic market”, Secretaria de Hacienda y Credito Publico, Mexico, March 2010;
⁴⁵ Three in 2010 (February, March, April) and two in 2011 (February and March). Maturities range is 5, 10 and 30 years. The syndicated amount has been constant for M-bonds: Pesos 25 billion. M-Bonds are fixed-coupon notes and bonds of the Federal Government with maturities of 3–30 years, which are issued since 2000;
⁴⁶ Such as GEMX, GBI-EM (Morgan), WGBI (Citi), etc.;
⁴⁷ In fact, the book was almost 3 times oversubscribed with over 73 billion in 135 orders;
⁴⁸ 10 % in Europe and 10% in the US;
⁴⁹ Santander, JP Morgan, Bank of America, BBVA Bancomer;
Update of Mexico Case Study (as of March 2013)

In July 2011, Mexico adjusted its domestic syndication procedures by switching from its initial book-building process to an auctioned syndication system. The latter has some similarities with the Dutch Direct Auction System (DDA; see Section 4.7: case study DDA).

Auctioned syndications (AS) in Mexico began in July 2011. Five AS were done between July 2011 and September 2012: two in 2011 (July and September) and three in 2012 (February, March, September). Maturities range is 5, 10, 20 and 30 years. Constant amount for M-bonds: Pesos 25 billion (except in July 2012 when a 5-year maturity was syndicated for Pesos 30 billion).

Comparison of book building syndications (BBS) and auctioned syndications (AS)

1. Common objectives

(i) to increase the amount issued upfront so as to have a liquid issue and a bond eligible from the start for inclusion in global bond indices. Both types of syndications achieve this objective as:

- investors are attracted by the prospect of buying a very liquid bond;
- PDs are motivated to place the bond for a commission; and
- launch of a benchmark can serve as a marketing event.

(ii) to widen the investor base

In both instances (BBS and AS), the share of foreign investors is close to 20%.

2. Common features of BBS and AS

In both BBS and AS, only PDs can participate as (joint) lead managers (and in case of the BBS as co-managers).

3. Specific features of BBS and AS
### Specific features:

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<tr>
<th>BBS</th>
<th>AS</th>
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<tr>
<td>Traditional syndication</td>
<td>Close to Dutch DDA</td>
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<tr>
<td>- small number of lead managers and co-lead managers</td>
<td>- all PDs are joint leads</td>
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<tr>
<td>- issue is underwritten</td>
<td>- two limits are announced upfront:</td>
</tr>
<tr>
<td></td>
<td>(i) max. yield accepted</td>
</tr>
<tr>
<td>- there is a book-building period</td>
<td>(ii) max. amount accepted from any single investor expressed as a % of the amount issued</td>
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<tr>
<td>- selective allocation to investors</td>
<td>- firm allocation rules (= by price up to the max. authorized amount)</td>
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<td>- one hour bidding period</td>
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### Advantages

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<tr>
<th>BBS</th>
<th>AS</th>
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<tr>
<td>- selectively chosen investor base (e.g. to privilege foreigners or stable investors; to enhance secondary market liquidity, etc.)</td>
<td>- more competition in setting the issue price</td>
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<tr>
<td>- commitment of joint leads to ensure price stability and secondary market liquidity</td>
<td>- more level playing field for PDs</td>
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<tr>
<td></td>
<td>- lower commissions</td>
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<td>- confidentiality for customers</td>
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### Drawbacks

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<th>BBS</th>
<th>AS</th>
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<tr>
<td>- less competition in setting the issue price</td>
<td>- potentially optimal investor base</td>
</tr>
<tr>
<td>- higher commissions</td>
<td>- potentially less commitment of the banks to look after the secondary market (liquidity and price stability).</td>
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*The Treasury states, however, that the switch from BBS to AS has not affected the liquidity of the secondary market.*

### Note

In view of a relatively small involvement of international banks in emerging markets, limited attractiveness of AS in the absence of lead managers’ rankings is not considered a drawback for international banks’ participation. Yet, some banks might feel marginally penalized and discouraged.

#### 4. In practice:

- **The Treasury has organized a conference call** with investors for all the BBS transactions.

For the AS, a conference call was likewise arranged when the Treasury switched from BBS to AS (the first transaction) and also for the second transaction.

- **The amount issued** has been identical for both types of syndications (pesos 25 billion for M-bonds with the aforementioned exception in July 2012 for the 5-year maturity of 30 billion pesos)

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50 The average book-building period has been 2 days;
51 In a BBS, the allocation is transparent for all joint leads (“pot”);
52 Auctioned syndications are excluded from the calculation of league tables;
• The range of maturities issued has likewise been the same for both types of syndications (5, 10, 20, 30 years)
• The yield of AS has been on average 7 bps below the maximum yield limit.\textsuperscript{53}
• The bid/cover ratio of AS has been a little lower than for BBS. However, this can be explained by the limit set in AS on the maximum amount accepted per investor. In BBS, investors tend to “balloon” the amount of their bids in successful syndications with a view to offset the impact of the pro rata allocation.
• The share of foreign investors has been marginally higher for AS. However, this can be explained by the fact that the syndication procedure had by then become better known abroad.

4.7 Case study 3: The Dutch Direct Auction system (“DDA”)

In June 2003, the Dutch State Treasury Agency (DSTA) inaugurated a new issuance technique the objective of which is to increase the participation of end investors in the primary market by offering all investors a level playing field with a transparent and objective allocation process.

By contrast with the standard domestic syndication which is an adaptation of the external syndications procedure, the DDA is a hybrid between an auction and syndication.

4.7.1 Differences with the traditional domestic syndication method

Same as in a standard domestic syndication, the appointed managers in the auction are the PDs of the DSTA. However, the DDA includes 5 innovations:

(i) The DSTA acts as the lead manager. It runs the order book. The order book is seen only by the DSTA which does itself the allocation of the orders. The information on the orders and on their allocation is confidential. They are only disclosed as an aggregate.

In order to be supported in this role, the DSTA appoints three PDs as its advisors in (i) determining the timing and the organization of the auction and (ii) setting the range of the spread guidance.

(ii) The PDs do not underwrite the issue. They only collect orders from their customers. Same as in a standard syndication, customers can at their discretion choose one single PD for the whole amount of their order or they can split their order between several PDs.

(iii) The allocation rules are pre-announced and firm. Overall, the allocation process is the same as in a uniform price auction. All bids submitted at a level higher than the cut off price are allocated in full. Investors bidding at tighter levels are thus given priority. Bids at the cut off price are allocated proportionately.

At equal bid level, early bidders are allocated ahead of those coming later and real money accounts are allocated ahead of trading accounts. However, the DSTA reserves the right to allocate any case a certain percentage to trading accounts with a view to enhancing the liquidity of the secondary market.

(iv) The DSTA is in direct contact with the customers as it sends to the successful bidders a “thank you” note for their order. This way, the DSTA can check whether the banks have effectively allocated to their customers the amounts which the DSTA has instructed them to do.

\textsuperscript{53} It is understood that the yield of each issue depends on different variables such as market conditions, e.g., type of benchmark, type of instrument, etc.;
**(v) The commissions paid by the DSTA are lower** than in a standard syndication (management and underwriting commission). The DSTA pays an advisory commission to its advisors and only a selling commission to the other PDs.

### 4.7.2. Analysis

**The DDA claims to have two advantages:** for the PDs, the creation of a level playing field and for investors, the implementation of objective allocation criteria.

**The DDA has also four drawbacks, at least in the context of mature markets:**

**(i) A mechanical allocation may not always be optimal.** For instance, due to priority given to time of orders: some Asian investors are typically slow to move, yet they may be a target; likewise, due to priority for the tightest spreads: a trading account can then get precedence over a target real money account. Issuers may therefore prefer to do tailor-made allocations as a function of what they deem to be best in the circumstances.

There is also a lack of clarity in some of the counterparts’ classification. As an example, the difference between banks, asset managers and fund managers may not be always clear.

**(ii) The procedure can be too transparent for the market.** As an example, in a traditional syndication, the price guidance is discussed by the issuer only with the joint leads. Admittedly, the latter have market sensitive information ahead of the co-leads. However, it offers them the possibility to manage the communication process to the market. In a DDA, there is no external lead manager. Thus, all announcements (book size, changes in the price guidance, etc.) are published on the screens. This is not the most efficient procedure when the placement begins with a slow momentum.

**(iii) The responsibility for ensuring a good performance of the bonds on the secondary market is diluted.** In a traditional syndication, this responsibility rests primarily on the joint leads. In the DDA, there are no joint leads.

**(iv) An advisor’s mandate in the DDA does not count for a ranking in the league tables.** As a result, the DDA is a lost opportunity for the issuer to reward its best performing PDs. The banks are less motivated for the deal and also possibly less committed to the issuer overall.

### 4.7.3. Conclusion

There is currently a consensus amongst DMOs in the EU that issuers are better off to maintain flexibility in deciding about allocations provided the allocation criteria are clear.

So far, the DSTA is the only DMO using the DDA procedure. The DSTA’s expectation that it would be adopted by other DMOs has not been realized.

There is no conclusive evidence that investors are bidding at better prices in a DDA than in a traditional syndication.

### 4.7.4. DDA and emerging markets

Do the DDA drawbacks mentioned in the previous section also apply in markets that have not yet reached maturity?
At first glance, the DDA seems to be an attractive financing mechanism, particularly for an emerging government securities market: (i) the DDA guarantees a complete confidentiality for all orders in the book. This can be valuable for a placement focused on a small local market; (ii) the complete transparency in the allocation procedure can help the issuer in building trust and credibility; (iii) the drawback for the banks that the DDA does not count in the league tables is minimized by the small amount of the syndication.

However, further analysis indicates the rigid allocation procedure in the DDA may actually have three important drawbacks, particularly for an emerging market: (i) the absence of track record can make it risky to lose flexibility in setting allocation rules. The likely composition of the order book cannot be forecasted; (ii) the liquidity of the secondary market is a particular challenge in emerging markets. Getting the right order book to that effect may require exercising judgment on a case by case basis as to the quality of the contribution that can be offered by investors receiving an allocation; (iii) the success of the syndication requires a particularly active support by the sponsor banks. The DDA is a financing method that is generally not favored by banks.

Therefore, a “traditional” syndication method seems to be more efficient in emerging markets. This conclusion is further supported by the perception that it is generally prudent not to accumulate innovations (i.e., in this case, to both do a first syndicated deal and use a syndication method, which is not widely practiced).

4.8. Syndication fees

Fees are normally quoted as a flat percentage of the nominal amount issued and are paid in advance. The level of commissions is a function of several variables. The main variables are the credit rating of the issuer, the maturity of the transaction, the condition of the market and the power of negotiation of the issuer to lower the fee, in case the issuer wishes to do so.

For external syndications, each market has generally accepted levels of commissions for underwriting and selling. Fees tend to be the same across markets for similar borrowers and structures. Fees for domestic syndication tend to align on the levels applicable to external syndications.

A sample of commission levels is appended (See Appendix 4). In Europe, the fees paid by the BDA for domestic syndications have followed a downward trend since 1999 up to 2003. Their level is marginally higher since 2008.

4.9. Factors contributing to the success of domestic auctions

It is important that the DMO clearly communicates to the market the reason why it is planning to do syndication, i.e., the benefits it is seeking to achieve. This should be done after conducting a thorough market research in consultation with PDs and final investors. Syndication may be needed to achieve certain objectives (e.g., size, market liquidity, investor diversification and/or price discovery). Syndication would not be beneficial if these objectives have been achieved already. This is the case in Brazil which has not sought to do syndication for this reason.

The DMO has to be perceived as a credible and skillful issuer. The DMO’s reputation and credibility can play an important role in attracting investors to participate in a syndication.

When the DMO has a PD system, sufficient number of PDs have to master a required technical expertise. A syndication done with banks that are not PDs loses some of its benefits, such as increased competition amongst PDs to better perform in the primary and secondary markets.
Four additional factors play a major role: the selected joint leads, the level of the syndicate fee, the structure of the syndication and the allocation of the bonds.

(i) selection of joint lead managers: joint lead managers should have complementary strengths. They should not be too numerous in order to preserve their motivation and facilitate their coordination by the DMO. The optimal number is a function of the amount and of the difficulty of the placement. Some syndications have been done with up to five or six joint leads. Three joint leads often seem to be the best number.

(ii) commissions: DMOs are advised to pay the market rate as opposed to selecting the banks which charge the lowest commissions (section 4.5.7). Syndication fees are generally a worthwhile investment.

(iii) structure of a syndication: the structures combining a “pot system” for joint leads and a strategic reserve for co-leads seem to be particularly efficient. The equal sharing of commissions enhances the cooperation between joint leads. The possibility to get an additional allocation to attractive orders while preserving confidentiality\(^{54}\) enhances the motivation of the co-leads.

(iv) investor base: the DMO should be actively involved in directing joint leads where to look for orders and in allocating the orders brought by the syndicate group.

4.10. Syndications in the absence of a PD system

There seems to be no precedent so far of a domestic syndication done by an issuer with no appointed PDs.

In the absence of a PD system, the appointment of only 3 or 4 banks may be enough. Ideally, the MoF should appoint as joint leads and co-leads only banks, which are perceived to have a potential interest in it, and the capacity of, playing an active role in the government securities market. If, in practice, the MoF can realistically count on a very limited number of financial institutions to become active participants in the primary and secondary markets, the appointment of only 3 or 4 joint leads to manage the syndication appears to be the correct strategy.

Over time, however, the number of qualified syndication participants will presumably be growing. At this stage, one would recommend not to increase further the number of joint leads beyond 3 or 4 but to appoint co-leads instead. The number of joint leads is best kept small to ensure good coordination and no dilution of responsibility. However, the appointment of co-leads allows to further diversify the investors’ base by instructing the co-leads to concentrate on small “quality accounts”\(^{55}\) (a policy which they should naturally be inclined to follow in any case in view of their small share in the placement). The fact that the identity of the co-leads’ accounts is not disclosed to the joint-leads (blind retention) is a further incentive for the co-leads to offer good quality names. Last, the appointment of co-leads is also a good way to test the placement capabilities of the banks in question. In this way, syndication can pave the way for the future implementation of a PD system.

\(^{54}\) The order book of the co-leads is open only to the DMO;

\(^{55}\) A quality account is usually defined as a stable real money investor who will hold on to the bond for some time and who has the potential to buy more bonds later if he is pleased with the investment. Central banks typically belong to this category. A real money investor, who has the reputation of taking its profit or its loss fast without being a market maker and who enhances the liquidity of the secondary market, is not a quality account;
5. CONCLUSION

Historically, syndications have been used only in issuances of foreign currency denominated bonds in external markets. This has changed since 1999. Many DMOs view domestic syndications as an efficient tool for both small and large issuers whenever the target investor base includes entities located beyond the national borders of the relevant issuer. Small issuers have been attracted by the possibility of issuing larger amounts. Larger issuers have been attracted by a better quality of price discovery. In both cases, syndicated bond issues are more liquid. Prices in the secondary market are usually firmer for syndicated issues. Syndications can enhance a motivation of primary dealers to deliver a good performance in the execution of their duties. In view of the aforementioned benefits, any reasonable syndication commission is a worthwhile investment.

**Domestic syndication has prerequisites, limitations and drawbacks.** In particular, the DMO has to be clear on the objectives to be achieved. These objectives should be communicated to the market. Domestic syndications are a complement to, not a substitute for, auctions. They are a time consuming procedure. They are not as straight a competitive process as an auction is.

**On balance, however, domestic syndication is an efficient securities placement procedure, the use of which is expected to be spreading further across government securities markets.**  

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56 In case a by-law or a decree is needed to allow this new bond placement procedure, a summary of some provisions that could be incorporated in the relevant document is shown in the Appendix 5;
## Appendix 1

### COMPARISON: SYNDICATION VS. PRIVATE PLACEMENT

<table>
<thead>
<tr>
<th></th>
<th>Private Placement</th>
<th>Syndication</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Counterparty</strong></td>
<td>1 or 2 financial institutions</td>
<td>A syndicate group</td>
</tr>
<tr>
<td><strong>Investors</strong></td>
<td>1 or 2 targeted investors</td>
<td>A wide range of investors</td>
</tr>
<tr>
<td><strong>Timing</strong></td>
<td>Bilateral consensus</td>
<td>Market driven</td>
</tr>
<tr>
<td><strong>Size</strong></td>
<td>Relatively small;</td>
<td>Larger;</td>
</tr>
<tr>
<td></td>
<td>Total size pre-underwritten</td>
<td>Gradual build up through book building</td>
</tr>
<tr>
<td><strong>Maturity</strong></td>
<td>Bilateral consensus</td>
<td>Standard</td>
</tr>
<tr>
<td><strong>Commitment</strong></td>
<td>None: both parties can call the deal</td>
<td>Joint leads commit to subscribe;</td>
</tr>
<tr>
<td></td>
<td>off up to last minute</td>
<td>Issuer commits to issue once the deal is launched</td>
</tr>
<tr>
<td><strong>Pricing</strong></td>
<td>Pre-negotiated</td>
<td>Pre-set range;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Refined on basis of investor interest</td>
</tr>
<tr>
<td><strong>Documentation</strong></td>
<td>Issue driven;</td>
<td>ISMA</td>
</tr>
<tr>
<td></td>
<td>Often prepared by counterparty</td>
<td></td>
</tr>
<tr>
<td><strong>Trading</strong></td>
<td>Inactive; buy and hold</td>
<td>Active trading</td>
</tr>
<tr>
<td><strong>Listing</strong></td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Rated</strong></td>
<td>No</td>
<td>Generally yes</td>
</tr>
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</table>

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57 Source: BDA presentation “Syndicated OLO issuance, overview”;
Appendix 2

FIRST MEETING OF DMO WITH JOINT LEADS

USUAL AGENDA

- Rationale for the transaction
- Syndication commissions
- Terms of the new bond (maturity / coupon/ settlement)
- Structure of the syndication
- Time table
- Marketing / targeted investor base
- Pricing process (reference rate, pricing methodology/ first suggested pricing range)
- Duration manager
- Book building process
- Legal documentation
- Clearing and settlement procedure
- Communication to syndicate members
- Wording of Minister’s announcements
- Press
- Listing
- Working party list (= who does what)
- Timing of fist conference call
Appendix 3

ALLOCATION OF DUTIES BETWEEN JOINT LEADS AT THE BDA

The usual duties assigned by the BDA are:

Communication manager

Responsible for delivering all the information intended for a syndicate group. The objective is that all members of the syndicate are informed at the same time.

Press manager

Responsible for organizing contacts of the BDA with the press.

Execution manager

The execution manager is in charge of the book building process. It provides the BDA with a written summary of the strategy suggested by joint leads. It collects and summarizes the information provided by joint leads regarding their target investor list and their qualitative feedback during the book building process. He updates the outstanding order book submitted to the BDA twice a day. After order allocation has been discussed jointly by the BDA and all joint leads, the execution manager submits to the BDA the final allocation and is responsible for their dispatching.

Duration manager

The duration manager is a joint lead designated by the BDA to be a counterparty of the other members of the syndicate for the execution of switch orders of their customers. ⁵⁸

⁵⁸ Customers can submit their orders to the syndicate group either for cash or on a switch basis, in which case, same as in a bond exchange auction, they state their willingness to exchange a certain old bond at a yield of “x” bp over the yield of the syndicated benchmark;
Appendix 4

SYNDICATION COMMISSIONS

*basis points, flat*

EUROPE

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<td></td>
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<td>27.5</td>
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</tbody>
</table>

**DDA**

- advisors: 8 bp (as of 2008)
- others: 5 bp

LATIN AMERICA

- Brazil: usually pays between 25 and 30 bp for any tenor.
- Chile: paid 15 bp for 4-year FRN in 2004.
- Colombia: usually pays between 30 and 40 bp.
Appendix 5

INPUT TO ASSIST IN DRAFTING OF A BY-LAW ON THE RECOMMENDED BOND PLACEMENT SCHEME (if needed)

Whereas

The objective of the Government is to reduce or eliminate the liquidity premium currently paid on the bonds issued in the domestic market until they reach benchmark size;

In order to meet this objective, the MoF has to create a competitive security issuance procedure based on a market mechanism which increases the number of participants to allow for a wider distribution of holdings, decreases the amount of time needed for a bond to reach benchmark size and increases the liquidity of the secondary market;

The syndicated issuance of new benchmark bonds allows issuing larger amounts than in the framework of auctions by attracting a wider number of end investors to the primary market, including nonresident investors. As a result, this issuance method also fosters the development of the secondary market;

The subsequent tapping of bonds in the framework of an auction calendar allows to further increase the outstanding amount issued whilst firmly anchoring benchmark bonds into the domestic market;

This issuance procedure is widely implemented by public debt managers abroad

Therefore

The MoF is empowered to syndicate the issuance of new benchmark bonds in the local market.

The target issuance amount and composition of the syndicate group proposed by the DMO must be approved by the Minister of Finance.

The syndicated benchmark can be subsequently tapped in the framework of the auction calendar published by the MoF.

The bond auction scheduled to take place on the month during which the syndication is carried out can be cancelled.

59 Only as an indication, the Belgian legislation does not refer specifically to the issuance of new benchmark bonds by syndications. Instead, it refers in general terms to “the first tranche(s) of a bond issue” and to “any form of underwriting conforming to market practices”. This allows for more flexibility in adapting to new market developments, if any;

60 The use of “can be” instead of “is” only reflects the writer’s personal view that the best regulations are the ones which leave the maximum flexibility to a public debt manager to do what he/she believes to be the best in the circumstance without needlessly being tied by too precise instructions, sometimes written a long time before! Who knows what the market could be like tomorrow?
REFERENCES

- Gemloc Peer Group Dialogue meetings of September 23 and 29, 2010: “Syndications as an alternative placement mechanism for domestic government debt issues”. A total of 12 countries have participated.61

- “Insights of External Bond Issuance”, slide presentation, Andrea Dore, World Bank, 2010

- “Syndicated OLO issuance, Overview”, slide presentation, Belgian Debt Agency 2005


- “10-year M Bono Syndicated Issuance. A successful placement of government debt through a new mechanism in the primary domestic market”, Secretaria de Hacienda y Credito Publico, Mexico, March 2010

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61 September 23: Brazil, Hungary, Mexico, Poland, South Africa, Turkey
September 29: Costa Rica, Egypt, Morocco, Pakistan, Romania, Uruguay.