GLOBAL FINANCE & MARKETS | GOVERNMENT BOND MARKETS ADVISORY SERVICES

# DOMESTIC SYNDICATIONS

## Background Note

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WORLD BANK GROUP

## Background Note[1]

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

Topics selected have been a key focus in Advisory Services' work area because of their catalytic impact on debt market development. Six notes have been produced so far: Domestic Syndications, Bond Buybacks and Exchanges, Securities Lending and Related Standing Facilities, Primary Dealer Systems, Electronic Trading Platforms, and Repo Markets.

Domestic syndications can be a powerful tool in development of government bond markets by 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 note reviews goals, prerequisites, limitations, and drawbacks of syndications and provides real-life examples in the case studies.

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[1] This background note has been prepared to support World Bank Group technical assistance programs for the development of local capital markets. This note is a work in progress because data intended to show practical examples of country practices are still being collected. Comments to baudouin.richard@live.be, asilva3@worldbank.org, oakcadag@ifc.org, and iraghavan@worldbank.org are welcome.

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# Abbreviations and Acronyms

| | |
|---|---|
| **AS** | Auctioned Syndication |
| **BBS** | Book-Building Syndication |
| **BDA** | Belgian Debt Agency |
| **DDA** | Dutch Direct Auction |
| **DMO** | Debt Management Office |
| **DSTA** | Dutch State Treasury Agency |
| **EMU** | European Monetary Union |
| **FRN** | Floating-Rate Note |
| **MoF** | Ministry of Finance |
| **OECD** | Organisation for Economic Co-operation and Development |
| **PD** | Primary Dealer |


# 1. Introduction

This background note is intended to assist debt management offices (DMOs) 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: (1) a bond is placed in the domestic market denominated in a local currency,[2] (2) a bond is generally placed with both domestic and foreign investors, and (3) the outstanding amount of a bond is intended to be subsequently increased through a calendar of auctions. In practice, domestic syndications are invariably linked to the launch of a benchmark bond.[3]

Domestic syndications were first used in the European Monetary Union (EMU) in 1999. Their usage is now expanding in Organisation for Economic Co-operation and Development (OECD) countries. At first glance, this seems to be an evolution backwards. The end of bank financing extended under the form of "club deals,"[4] and their replacement by competitive auctions in the domestic government securities market has been 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: (1) they provide immediate liquidity, (2) they diversify the investor base by attracting new investors, (3) they are an efficient tool to ensure firm prices in the secondary market, and (4) 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 for the "club deals" done in the past. Third, domestic syndications are also an efficient tool to

[2] Thus, in local format as opposed to a euro or global bond format.

[3] That is, 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 a "bank consortium," means a financing extended jointly by a group of banks that effectively dictate their terms and conditions to the borrower.

launch new financial instruments,[5] because they enhance price discovery. As a result of the above features, domestic syndications lower funding costs 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 the selection of banks managing a transaction.

Domestic syndications have prerequisites, limitations, and drawbacks. In particular, DMOs need to be clear on the objective pursued, because 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 the 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, the Netherlands, and Mexico. Finally, specific topics are briefly reviewed before concluding.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.

[5] Referring to financial instruments that represent an innovation in the domestic market.


# 2. Syndications

## 2.1. Standard Features of Syndications

Syndication is the process of putting together a group of banks that 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 with their customer base. In the event of a lack of demand by customers, however, the banks will keep the securities on their balance sheets. The members of a syndicate earn two commissions: an underwriting commission for committing to provide funding and a selling commission for placing the securities.

Syndication is akin to a private placement where the issuer is ensured of having 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 from one to 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. See appendix 1 for further comparison.

Banks consider syndications to be very attractive business. This applies particularly when a bank is mandated to be the 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 the business reputation of the bank, thereby attracting other mandates. The banks participating in a syndication are also given an opportunity to strengthen their relationship with their customers by being first to offer 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 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 those most sensitive to the detrimental impact on their syndicate desk of unfavorable comments published in the press.

## 2.2. External versus Domestic Syndications

External and domestic syndications share numerous procedures. Yet they pursue different objectives, and each has some specific features.

### 2.2.1. Specific Objectives Pursued

External syndications pursue primarily two objectives: (1) to fund the foreign currency requirements of the government and/or meet funding needs that are beyond the absorption capacity of the domestic market and (2) to diversify the investors' base by familiarizing international investors with the issuer's credit. External syndications raise an issuer's market profile and visibility.

Alternative or additional objectives can be (1) to obtain a lower cost funding than on the domestic market, if achievable by doing a currency swap,[6] and (2) to provide a pricing reference for bonds issued in the international market by domestic agencies or corporations.

Domestic syndications pursue three objectives: (1) to provide immediate liquidity to a new domestic benchmark bond by issuing a large amount, (2) to widen the investor base, and (3) to enhance the good functioning of the secondary market by creating the right mix between real money investors and trading accounts among the bondholders.

The widening of the investor base generally includes an expectation to attract foreign investors to the domestic market. Syndication is a tool that is more efficient than an auction because 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.[7]

An additional (or alternative) objective of a domestic syndication can be to support the launch of a financial instrument that represents an innovation in the domestic market. Syndications facilitate price discovery (section 4.1.2). 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, and the transaction is subject to foreign law.[8] The bond is denominated in foreign currency. It is usually placed primarily—if not exclusively—abroad and is rarely intended to be tapped again in the future. The funding need being met is usually not recurrent. The syndication itself is a placement procedure that is for the most part seldom used.

In domestic syndication, the issued security is a standard domestic benchmark bond of which the outstanding part 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 that tends to be used recurrently. Many DMOs have made domestic syndications an integral part of their debt issuance policy for issuing new benchmark maturities.

Well-managed domestic syndications reduce the issuer's funding cost. The higher liquidity of the security and the larger number of investors potentially allow bonds to be sold at a higher price than in an auction, particularly for the size issued. A domestic syndication also provides additional benefits that jointly further decrease the net cost of the funding (see section 4.1.2 and table 2.1). These advantages generally outweigh the commissions paid.

[6] This assumes that an arbitrage possibility exists between the two markets ("swap window") and that investors can take advantage of it.
[7] As an illustration, Mexico has not mentioned foreign investors as a specific objective nor has it set any target market share for placement abroad.
[8] Generally, U.K. or New York (state) law.

### Table 2.1. Aspects of External and Domestic Syndications

| External Syndication | Domestic Syndication |
|---|---|
| Objectives<br>• To meet foreign currency needs and/or financing needs beyond the absorption capacity of the domestic market<br>• To diversify the investor base<br>• To lower funding cost (if possibility of swap arbitrage) | Objectives<br>• To increase size of issuance (immediate liquidity)<br>• To attract foreign investors to the domestic market<br>• To facilitate the issuance of new instruments (price discovery) |
| Distinctive features<br>• Bonds denominated in foreign currency<br>• Transaction subject to foreign law<br>• Placement abroad<br>• No (or little) recurrent placement procedure | Distinctive features<br>• Domestic benchmark tapped by auctions thereafter<br>• Transaction subject to domestic law<br>• Placement both domestic and abroad<br>• Recurrently used placement procedure |
| Additional benefits<br>• Raises issuer's profile and visibility<br>• Provides a pricing reference for other borrowers | Additional benefits<br>• Decreases funding cost<br>• Ensures firm prices in the secondary market<br>• Supports primary dealers' motivation to perform<br>• Strengthens investor relationships<br>• Can support liability management operations |


# 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 sufficient familiarity with the issuer to submit large and/or aggressive bids. Auctions are seldom used—if at all—for nondomestic issuance by sovereigns. In most cases they would not produce the best prices outside domestic markets.

## 3.2. External Syndication Procedures

Syndications are usually preceded by a marketing campaign. The issuer updates investors on the country credit and government securities market, and 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:

1. Appointment of a syndicate group
2. Pricing guidance
3. Official announcement of the transaction/book building
4. Closing of the books
5. Allocation of orders
6. Management of the market postsyndication

### 3.2.1. Appointment of a Syndicate Group

A syndicate usually comprises a small number (two to four) of joint leads and up to a dozen of co-managers. The joint leads[9] assume responsibility for arranging the transaction, and 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 that have offered the lowest funding cost are appointed.[10] In the second case, some form of competitive process (an interview or "beauty parade" based on formal submissions) may still be used, but the appointed banks are the ones that the issuer deems to be best equipped to achieve the assigned objectives; that is, the qualities considered are the ability and experience of the bank for the transaction, the strength of the bank's relationship with the targeted investor base, and the capacity and resources of the bank to support the syndicated bond in the secondary market.

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), at least for larger transactions.

### 3.2.2. 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 launch.[11] The joint leads informally check[12] with a sample of representative investors in their respective customer base for the price range would attract buying orders and for what amounts. The corresponding price range is expressed as a "spread range" over a reference rate.[13]

### 3.2.3. Official Announcement of the Transaction and Book Building

The announcement of the transaction indicates the target amount to be issued[14] and a spread range for the pricing. The order book lists the orders by price levels and by amounts, in the same way 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.

### 3.2.4. Closing of the Books

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

### 3.2.5. Allocation of Orders

Successful syndications are typically oversubscribed, that is, the amount of orders submitted at the cutoff price or higher is larger than the amount of funding required. The orders then need to be allocated for a certain percentage of their amount. This can be done in different ways: (1) allocation of the same percentage either across all investors or by type of investors, (2) 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, for example, the DMO,[15] or (3) a combination of (1) and (2).

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[9] Also called "book runners."

[10] That is, the highest bond price and the lowest commissions.

[11] Instead, in a "bought deal," the price is set at the level at which joint leads have committed to underwrite the transaction.

[12] The transaction is not yet announced officially.

[13] For example, U.S. 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, or the condition of the market.

[14] For example, "benchmark size."

[15] For example, participation of the investor in bond buyback and exchanges or information given by the investor to the DMO on its portfolio management strategy.

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 their portfolio for some time.[16] The liquidity of the secondary market can be enhanced by granting a certain percentage of allocations to actively trading market participants.[17] The combination of stability and liquidity creates the optimal conditions for 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, for example, investors who are recurrent buyers, active participants in bond exchanges or buybacks,[18] or providers of useful market feedback.

#### 3.2.6. Management of the Market Postsyndication

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.

This section covers the rationale for domestic syndications. It includes a survey of the markets using them and analyzes 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, the Netherlands, and Mexico. 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 primary dealer (PD) system.

[16] For example, central banks, insurance companies, and pension funds.
[17] For example, hedge funds.
[18] Syndications can indirectly support liability management when this allocation strategy is made explicit.


# 4. Domestic Syndications

## 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 generally commission-free process.[19] They represent an improvement on the noncompetitive placement systems that used to prevail in most government securities markets. 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.

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

**2. Size:** Auctions allow only relatively small amounts to be raised. 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 (its bid may not be successful), and (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 it wants at a price it knows and at the moment that suits it. Many end investors therefore tend to bid at auctions only when the secondary market is illiquid and/or the amount to buy in the secondary market is so large that it could move the market. As a result,

[19] With exception of DMOs paying a commission on customers' orders submitted by PDs.

auctions can require time for a bond to reach benchmark size. In the meantime, the issuer pays a liquidity premium.

**3. Price:** The issuer has little control over the price, and 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.

**4. Investor base:** The issuer has no control of the investor base, and bidding is often anonymous. In any case, the issuer cannot choose the investor to whom the securities will be allocated or subsequently sold.

### 4.1.2. The Advantages of Domestic Syndications

A domestic syndication allows correcting each of the aforementioned drawbacks of auctions:

**1. 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.

**2. Size:** Syndication enables the issue of an amount significantly larger than an auction, thereby providing immediate liquidity. Final investors are attracted by syndications because 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 because all successful bidders buy the bond at the same price); (d) investors have the assurance that the secondary bond will be liquid because of the large size issued, tight quoting obligations, and balanced investor base; (e) when syndication is well managed,[20] investors have a reasonable expectation of getting a small capital gain. Last, issuers can turn a syndication into a marketing event more easily than for an auction.

**3. 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 investor 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, because of the direct participation of a larger number of investors and the ensured liquidity of the bond.[21]

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

Two additional advantages of syndications over auctions are the following:

First, 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 do auctions (section 4.2).

Second, 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 among the investors holding the bonds. In addition, the market-making obligation of PDs can be focused 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.

[20] Well-advised issuers usually tend to deliberately set their cutoff 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 usually insignificant because a larger number of investors bid more aggressively as a result.

[21] This does not mean that syndication will always be successful irrespective of market conditions (e.g., highly volatile market).

The following list compares features of syndications and auctions:

| Size | Price | Investor Base | Timing |
|---|---|---|---|
| • Larger participation of end investors<br>• Decreased investment risk: price range<br>• Book building<br>• No winner's curse<br>• More attractive security liquidity<br>• Firm secondary market prices | • Issuer has better control<br>• Price discovery | • Wider investor base<br>• Optimal composition (allocation of orders)<br>• Attracts foreign investors (better information, lower risks) | • Flexible (no calendar) |

### 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 and discovery, and diversification of investor base, a new bond has to be issued, and generally[22] the intention 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:

They are time consuming: Syndications are administratively much heavier to put in place than auctions. Completing a syndication is a full-time job lasting two or three weeks (section 4.4.3).

They have risks: The determination of the selling price is not as straightforward 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 handling syndications. On a comparative basis, a domestic syndication, in countries where there is a PD system and the stable relationship that it offers, is less risky than an external syndication.

They should not be used too often: Syndications are not a level playing field for banks. Large international banks are privileged in the 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 because the cost of the commission is normally offset by other benefits, in particular a higher selling price and a stronger motivation of PDs to perform.

## 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 that the issuer cannot influence, and 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 comes to be reissued.

Syndications enable DMOs to assess the correct price of a new type of bond more accurately than do auctions. This reflects 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.

[22] Not necessarily.

The use of syndications to launch a new financial instrument has become a widespread practice. In 2005, the United Kingdom syndicated its first long dated (50-year) inflation-linked bond; in 2006 Germany syndicated its first inflation-linked bond; in 2006 France syndicated its first inflation-indexed bond; and in 2008 Italy syndicated its first inflation-linked floating-rate note (FRN). In 2005 the Agence France Trésor said that syndications are an efficient way to "launch a new instrument that requires a learning process for the market."[23] In 2006 the Deutsche Finanz Agentur 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."[24]

## 4.3. Market Survey

The launch of new benchmarks with a "domestic syndication" was 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 challenges, compounding the problems created by an excessively large public debt. First, more than 90 percent 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 foreign exchange risk. With the euro, domestic investors were expected to diversify their holdings. The BDA therefore had an urgent need to develop a nonresident investor 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 €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 €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: A total of 35 issues for a global amount of €105.5 billion had been issued as of June 30, 2011.

From 2000 onward, domestic syndications have been increasingly used in the European Union 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 EU issuers 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" [DDA]). This placement technique reinforces the auction component in the standard domestic auction structure. The DDA 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, 16 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 (Blommestein 2009). Practices range from occasional use[25] to systematic use when launching a new benchmark.[26] Some countries use domestic syndications only when issuing a new financial instrument in the domestic market.[27] Mexico provides an instructive illustration of some innovative uses of this placement procedure (section 4.8). Poland reports that a domestic syndication is a means of placement that 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 all the slightly different procedures implemented by various DMOs, with a few exceptions for Mexico and the Netherlands. The syndication steps are reviewed below in a similar sequence as in section 3.2.

[23] France: Travaux Parlementaires, "Pour une gestion consolidée des dettes de l'Etat," July 12, 2005.
[24] Euroweek, June 26, 2006.
[25] Austria, Slovakia, Sweden.
[26] Belgium, Finland, Greece, Ireland, Portugal, Spain.
[27] France, Germany, Italy, Republic of Korea, the United Kingdom.

#### 4.4.1.1. Composition of a Syndicate Group

Two policies apply in virtually all countries with a PD system: (1) the syndicate group comprises only PDs and (2) subject to all other things being equal,[28] 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 better than just complying with the commitments attached to their status. PDs acquire a vested interest in competing against other PDs to be ranked among the best performers. In this way, they get on the short list for being appointed as a joint lead.[29]

The above policies rest on three observations:

1. 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.

2. Issuers can compensate their PDs in various ways for the cost and the effort involved: One way is to select PDs as counterparts in DMOs' debt management operations, which thereby offers a profit opportunity to the banks involved.[30] 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.[31]

3. 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 has been widespread in the European Union since the early 1990s. It has yielded significant benefits to issuers, including more aggressive biddings by PDs at auctions.[32]

The policy of establishing a connection between the quality of performance as a PD and the granting of a joint lead mandate[33] has a wide range of possible implementations: (1) This policy can be applied to external syndications.[34] It is a missed opportunity not to do so. Domestic and external debt should be managed in tandem, not in silos. (2) 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 that 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. (3) This policy can be even applied in countries with no PDs. Some banks might 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.

#### 4.4.1.2. Pricing Guidance

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, and so joint leads are therefore especially careful not to disappoint.

[28] 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. Where a number of competent banks are part of a PD group, the lead might be deliberately rotated to maintain motivation. In case expertise in syndication and quality performance as a PD receive contradictory evaluations, expertise in syndication is the criterion that should prevail.
[29] Poland reports that the announcement the DMO may consider syndications as a possible placement mechanism in itself led to improved competition among PDs.
[30] For example, transactions in the currency or derivatives markets.
[31] The latter is a particularly valued reward to the banks because of its snowball effect. Issuers (both public and corporate) tend to appoint as lead managers the banks with high rankings in the league tables, on the assumption that they are the most experienced ones in the field.
[32] This process went too far in some EU countries during the mid-2000 as PDs started buying market share 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 to avoid market distortions.
[33] Assuming an equal degree of expertise as a lead manager in syndicated deals between the respective PDs.

**4.4.1.3. 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 joint leads place in which countries and to what type of investors).

**4.4.1.4. Allocation of Orders**
DMOs typically become 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 develop an increasingly expert knowledge of their investor base in the process.

**4.4.1.5. Postsyndication 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 because they assume the role of "stabilization managers." The latter applies also to the co-leads.

In countries with a PD system, 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.[35]

### 4.4.2. Documentation
Two types of documentation are drafted in the framework of syndication: legal and market announcements.

**4.4.2.1. Legal Documentation**
Four types of legal documentation are usually found:

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

**2. Subscription and selling group 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.

**3. Confirmation of 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 on behalf of the whole syndicate.

4. Signing and closing agreement: All parties sign the final documents before the settlement of the transaction.

**4.4.2.2. Market Announcements**
Four announcements are made to the market during the syndication process: (1) intention to issue a syndicated bond (description included) during the course of (period mentioned), (2) opening of books and a price range, (3) closing of books and imminent pricing, and (4) pricing and issuance of the bond.

### 4.4.3. Time Investment Required for Syndication
The syndication process usually takes between two and three weeks to complete. A first syndication requires close to a full-time job for at least two persons in the DMO over this period. The time investment shortens as experience is gained.

The syndication process is marked by four "landmarks": (1) start of the process (initial meeting with the joint leads), (2) start of book building, (3) pricing of the bond, and (4) settlement of the transaction. The DMO and the joint leads monitor the whole process through daily conference calls.

[34] One side benefit of this close involvement by a debt manager is to avoid potentially awkward situations such as meeting investors sometime before a syndication (e.g., in the framework of a non-deal-roadshow) to entice them to buy bonds and thereafter allocating only a very small percentage of the submitted order.
[35] In practice, DMOs typically inform 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. DMOs typically further inform 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.
[36] Through Reuters, Bloomberg, etc.

The calendar is the following:

- Day minus …: Deal preparation period. The DMO submits for 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 releases the names of the joint leads.
- Day 0 + approximately two weeks: The DMO sends to the co-leads an invitation to participate. The minister or DMO 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 online electronic book-building system that ranks the orders by price, type (firm, soft, reoffer) 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 (i.e., 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. On the next business day, the bond is priced.

## 4.5. Syndication Fees

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

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

An example of commission levels is shown in appendix 3. In Europe the fees paid to the BDA have followed a downward trend since 2003, although a small increase has been seen since 2008.

## 4.6. 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.

### 4.6.1. Composition of the Syndication Group

All PDs and recognized dealers are invited to participate.[37] The syndication group is split into three segments.

#### 4.6.1.1. Joint Leads: Three or Four PDs Selected among the Best Performing Ones

The joint leads assume the following:

**1. Overall responsibility for the success of the placement:** They are the BDA's advisors for the structure of the syndication, timing of the launch, pricing guidance, allocation decisions, etc. (see appendix 2).

**2. 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.

**3. Specific** responsibility for some operational duties (for example, legal documentation, contacts with the press, launch and pricing announcements, online book building, and clearing and settlement instructions): These duties are allocated between the joint leads (see appendix 4).

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 then is to give joint leads better control over the global order book.

#### 4.6.1.2. 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, that is, primarily investors new or thus far seldom seen or ones located in a target geographical area. The objective is to avoid competing with the joint leads, who concentrate on large accounts.

[37] Recognized dealers are financial intermediaries that have an official status as dealers in government securities. They have fewer commitments than PDs and lower rewards.

**4.6.1.3. Selling Group Members: The Recognized Dealers**

Selling group members have the 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 that, 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 the issuer's flexibility in setting the date of the launch. Yet the underwriting risk cannot be totally excluded (e.g., if the market becomes difficult during the launch process).

### 4.6.2. Syndication Structure

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

**1. "Pot" for the joint leads:** All joint leads pool their orders. 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 percent of the amount to be issued.

**2. "Retention" for the co-leads (usually 1 percent for each):** The retention is a guaranteed allocation in the placement.

**3. "Strategic reserve" for the co-leads and selling group members (usually around 15 percent):** 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 that 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).

### 4.6.3. Pricing Guidance, Collection of Orders, and Book Building

A spread range is announced initially and 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.

### 4.6.4. Names Transparency and Allocation Decisions

**1. Joint leads:** Full transparency is required between joint leads. In principle, joint leads disclose all investor names to one another as well as 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 cases of disagreement, the final decision is made by the BDA.

**2. Co-leads and selling group members:** Partial transparency is required. They disclose names only to the BDA, which does the allocation. This procedure applies to both the retention and the strategic reserve.[38] 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 or selling group members respectively. If duplication is found, the order submitted by the co-leads and/or selling group members does not qualify for an allocation in the strategic reserve.[39]

### 4.6.5. Securities Allocation Rules

The allocation rules are discussed by the BDA with the joint leads. The rules are flexible and informal and are not disclosed officially. The co-leads and selling group members are told only 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.

[38] Therefore referred to as "blind retention" to indicate that the names of investors are seen only by the DMO.
[39] Co-leads and selling group members are expected to concentrate on small orders from accounts that are not in the joint leads' customer base.

The allocation rules are set in two stages. First, before the start of the book-building process, the BDA conveys some general guidelines to the joint leads, usually the following:

- 80 percent, real money; 20 percent, 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.[40]
- Guidance on target geographical areas, for example, maximum 20 percent to resident investors or preference for Asian accounts.
- No protected orders; that is, syndication members are forbidden to guarantee an allocation to any of their customers.

Then, second, 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, that is, 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.[41] Central banks and small orders (less than €25 million) are typically allocated 100 percent in any case.

#### 4.6.6. Postsyndication 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. 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.

#### 4.6.7. 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, first, 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. Then, second, 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 investor community. This facilitates the placement of the next syndication.

### 4.7. Case Study 2: The Dutch Direct Auction (DDA)

In June 2003 the Dutch State Treasury Agency (DSTA) inaugurated a new issuance technique, the objective of which was 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.[36]

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

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

First, the DSTA acts as the lead manager. It runs the order book. The order book is seen only by the DSTA, which itself allocates the orders. The information on the orders and on their allocation is confidential. They are disclosed only as an aggregate. To be supported in this role, the DSTA appoints three PDs as its advisors in (1) determining the timing and the organization of the auction and (2) setting the range of the spread guidance.

Second, the PDs do not underwrite the issue. They only collect orders from their customers. 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.

Third, the allocation rules are preannounced and firm. Overall, the allocation process is the same as in a uniform price auction. All bids submitted at a level higher than the cutoff price are allocated in full. Investors bidding at tighter levels are thus given priority. Bids at the cutoff 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.

[40] In principle, joint leads should have no long trading positions. On the other hand, joint leads are expected to keep short positions to support the secondary market.

[41] An alternative is to downsize the deal to preserve the quality of secondary market performance.

However, the DSTA reserves the right to allocate in any event a certain percentage to trading accounts with a view to enhancing the liquidity of the secondary market.

Fourth, the DSTA is in direct contact with the customers as it sends to the successful bidders a "thank you" note for their order. In this way, the DSTA can check whether the banks have effectively allocated to their customers the amounts that the DSTA has instructed them to do.

Fifth, 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, by comparison with a more conventional syndication:

**1. A mechanical allocation may not always be optimal:** For instance, in relation to the priority given to time of orders. Some Asian investors are typically slow to move, yet they may be a target. Likewise, in relation to priority for the tightest spreads: a trading account can then be given precedence over a target real money account. Issuers may therefore prefer to make tailored 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 always be clear.

**2. 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 of managing 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.

**3. 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. The DDA uses no joint leads.

**4. An advisor's mandate in the DDA does not count in the calculation of rankings 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

Currently consensus among DMOs in the European Union is that issuers are better off maintaining flexibility in deciding allocations, provided the allocation criteria are clear. No conclusive evidence is found that investors are bidding at better prices in a DDA than in a traditional domestic syndication.

So far, the DSTA is the only DMO using the DDA procedure. However, Mexico adjusted its domestic syndication procedure in July 2011 to switch from a book-building system to an auctioned syndication system, which is comparable in many ways to the DDA.

## 4.8. Case Study 2: Mexico

Mexico made its first domestic syndication in February 2010 with the launch of a 10-year benchmark bond.[42] The government then reported that the launching of benchmarks with domestic syndication will be a standing policy.

### 4.8.1. Innovative Objective Pursued

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

As reported by the MoF, the "common practice" objectives pursued by the syndication were "(1) to reach an adequate outstanding amount at the inaugural issuance; (2) to place the security amongst a broader investor base in order to ensure the liquidity of the benchmark in the secondary market; and (3) to strengthen the issuance process given certainty of price, amount and broad investor distribution."

[42] The information below has been sourced primarily from Secretaria de Hacienda y Crédito Público (2010).

The innovative objective was to have the benchmark become immediately eligible for inclusion in the global fixed rate income indices[43] used by local and international investors to monitor markets' performance. In most global indices, a minimum amount outstanding per bond is required 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: (1) it took about 10.5 months for the outstanding amount of a 10-year benchmark to reach the size of Mex$25 billion, which is required for inclusion in most bond indices, and (2) the bond tended to be of uneven liquidity during the interim period and vulnerable to market squeezes at the point when it integrated the indices.

### 4.8.2. The Results Achieved

At the inaugural transaction, the syndicated mechanism allowed debt of Mex$25 billion[44] to be issued. 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 percent placed with nonresident investors.[45] Moroever, the trading of the new 10-year bond has been greater than the previous 10-year references.

### 4.8.3. The Two Different Procedures Implemented by Mexico

Mexico initially implemented a book-building process, similar to that in EU countries (with the exception of the Netherlands). For its inaugural syndicate transaction, the MoF appointed as joint leads the four PDs ranked as best market makers[46] and the next three best ones as co-managers. As of June 2011, five benchmarks had been syndicated. In July 2011 Mexico adjusted its domestic syndication procedures by switching to an auctioned syndication (AS) system. The latter has some similarities with the DDA system (see section 4.7). Five ASs had been completed as of September 2012.[47]

Book-building syndications (BBSs) and ASs pursue the same objectives. The first objective is 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 because

- Investors are attracted by the prospect of buying a very liquid bond
- PDs are motivated to place the bond for a commission and
- The launch of a benchmark can be made a marketing event.

The second objective is to widen the investor base. The share of foreign investors is close to 20 percent in both BBSs and ASs.

The specific features of BBSs and ASs are summarized in table 4.1.

In practice:

- The Treasury has organized a conference call with investors for all BBSs. For ASs, a conference call was arranged only for the first two issues (when the Treasury switched from BBSs to ASs for the second transaction).
- The amount issued has been identical for both types of syndications (Mex$25 billion for M bonds with the aforementioned exception in July 2012 for the five-year maturity of Mex$30 billion).
- The range of maturities issued has likewise been the same for both types of syndications (5, 10, 20, and 30 years).
- The yield of ASs has been on average 7 bps below the maximum yield limit announced upfront by the MoF.[48]
- The bid/cover ratio of ASs has been a little lower than for BBSs. However, this can be explained by the limit set in ASs on the maximum amount accepted per investor. In BBSs investors tend to "balloon" the amount of their bids in successful syndications with a view to offset the impact of the pro rata allocation.

[43] For example, GEMX, GBI-EM (Morgan), and WGBI (Citi).
[44] In fact, the book was almost three times oversubscribed with more than Mex$73 billion in 135 orders.
[45] Ten percent in Europe and 10 percent in the United States.
[46] Santander, JP Morgan, Bank of America, and BBVA Bancomer.
[47] Two in 2011 (July and September) and three in 2012 (February, March, September). Maturities range across 5, 10, 20, and 30 years. Amounts are constant for M bonds: Mex$25 billion (except in July 2012 when a five-year maturity was syndicated for Mex$30 billion).
[48] The yield of each issue depends on different variables such as market conditions, type of benchmark, or type of instrument.

**Table 4.1 Specific Features of Book-Building Syndications (BBS) and Auctioned Syndications (AS)**

| BBS | AS |
|---|---|
| Traditional syndication<br>• Small number of lead managers and co-lead managers<br>• Issue is underwritten<br>• A book-building period is used[a]<br>• Selective allocation to investors | Similar to Dutch DDA<br>• All PDs acting as market makers at the time the auction is taking place are joint leads (no co-leads)<br>• Two limits are announced upfront:<br>  • (1) maximum yield accepted<br>  • (2) Maximum amount accepted from any single investor expressed as a percentage of the amount issued<br>• Firm allocation rules (by price up to the maximum authorized amount: same allocation procedure as in a uniform price auction)[b]<br>• One-hour bidding period |
| Advantages<br>• Selectively chosen investor base (e.g., to privilege foreigners or stable investors or to enhance secondary market liquidity)<br>• Commitment of joint leads to ensure price stability and secondary market liquidity | Advantages<br>• More competition in setting the issue price<br>• More level playing field for PDs<br>• Lower commissions<br>• Confidentiality for customer orders[c] |
| Drawbacks<br>• Less competition in setting the issue price<br>• Higher commissions | Drawbacks<br>• Potentially suboptimal investor base<br>• Potentially less commitment of the banks to look after the secondary market (liquidity and price stability: see note below). |

Note: A joint lead mandate in an AS does not count in the calculation of rankings in league tables. This is considered to be a drawback in the DDA procedure. It is less of a drawback in Mexico because of the comparatively smaller involvement of international banks in the market. However, the MoF states that, in practice, the switch from BBSs to ASs has not affected the liquidity of the secondary market.
a. The average book-building period has been two days.
b. The price of the bid therefore has an impact only on the allocation.
c. In a BBS, the allocation is transparent for all joint leads ("pot")

- The share of foreign investors has been marginally higher for ASs. However, this can be explained by the fact that the AS procedure by then had become better known abroad.

## 4.9. Choosing the Most Efficient Domestic Syndication Structure

The case studies show that domestic syndications can be structured in different ways. The structure originated by the BDA has many features in common with external syndications. It is the procedure currently prevailing in the European Union. The structure pioneered by the DSTA is a hybrid between a syndication and an auction. The Mexican system stands between these two procedures. It has evolved along the way, starting with a book-building process and moving toward an AS system close—but not identical—to the DDA.

A link can be seen between the optimal structure of a domestic syndication and the degree of development of the government securities market. Mature markets prefer the syndication-type book-building procedure. Book building helps in maximizing the size of the order book. DMOs also value the flexibility of the discretionary allocation of orders because it enables them to optimize the composition of the investor base. Finally, the procedure provides the strongest motivation to the banks because a joint lead mandate raises rankings in league tables.

A domestic syndication with some auction features could be more efficient in emerging markets. Four reasons can be given. First, this procedure strengthens competition in setting the issuance price. In mature markets, the scrutiny by the financial press and the attention paid to peers' comments provide safeguards ensuring that the price is technically correct. These safeguards would not be as effective in an emerging market. Second, it guarantees complete confidentiality for all orders in the book. This can be valuable for a placement focused on a small local market. Third, the complete transparency in the criteria for allocating orders can help the issuer in building trust and credibility. The potential for a discretionary allocation of orders is probably limited in any case. The prerequisite for a syndication—a significant oversubscription—could be met only rarely in a developing market. Last, a domestic syndication with some auction features creates a more level playing field for PDs. This could support the development of the PD system.

Irrespective of the selected structure, the government securities market should have a certain minimum degree of development for a domestic syndication to be efficient. Domestic syndications are intended to help in building large lines of which the outstanding will be further increased by auctions. A prerequisite is an already active benchmark issuance policy using reopening of lines as a standard procedure. Domestic syndications are intended also to create a liquid market from day one. There is no point in pursuing this objective if little or no activity takes place in the secondary market even for seasoned issues.

## 4.10. Factors Contributing to the Success of a Domestic Syndication

It is important that the DMO clearly communicates to the market the reason why it is planning to do a syndication, that is, the benefits it is seeking to achieve. This should be done after conducting 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. As an illustration, Brazil is said not to have not sought to do syndications 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, a sufficient number of PDs have to master the required technical expertise. A syndication done with banks that are not PDs loses some of its benefits, such as increased competition among PDs to perform better in the primary and secondary markets.

Particularly for BBSs, four additional factors play a major role:

**1. Selection of joint lead managers:** Joint lead managers should have complementary strengths. They should not be too numerous 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 seems to be the best number.

**2. Commissions:** DMOs are advised to pay the market rate as opposed to selecting the banks that charge the lowest commissions (section 4.10). Syndication fees are generally a worthwhile investment.[49]

**3. 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 of receiving an additional allocation for attractive orders while preserving confidentiality enhances the motivation of the co-leads.[50]

**4. 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.

[49] However, some countries face a problem that the fees are treated above the line in government accounts, not netted off against debt interest.

[50] The order book of the co-leads is open only to the DMO.

## 4.11. Syndications in the Absence of a PD System

No precedent is seen 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 three or four banks may be enough. Ideally the MoF should appoint as joint leads and co-leads only banks that are perceived to have a potential interest in, and the capacity for, 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 three or four joint leads to manage the syndication appears to be the correct strategy.

Over time, however, the number of qualified syndication participants can be expected to grow. At this stage, one would recommend not to increase further the number of joint leads beyond three or four 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 helps the investors' base to diversify further as a result of instructing the co-leads to concentrate on small "quality accounts"[51] (a policy that 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.

[51] 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 it 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 doing nothing to enhance 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 the motivation of PDs 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, and they are not as straightforward a competitive process as an auction.

On balance, however, domestic syndication is an efficient securities placement procedure, the use of which is expected to spread further across government securities markets. [52]

[52] In case a by-law or a decree is needed to allow this new bond placement procedure, a summary of provisions that could be incorporated in the relevant document is given in appendix 5.


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# Appendix 1: Comparison: Syndication versus Private Placement

| | Private Placement | Syndication |
|---|---|---|
| Counterparty | One or two financial institutions | A syndicate group |
| Investors | One or two targeted investors | A wide range of investors |
| Timing | Bilateral consensus | Market driven |
| Size | Relatively small; Total size pre-underwritten | Larger; Gradual build-up through book building |
| Maturity | Bilateral consensus | Standard |
| Commitment | None: both parties can call the deal off up to last minute | Joint leads commit to subscribe; Issuer commits to issue once the deal is launched |
| Pricing | Pre-negotiated | Preset range; Refined on basis of investor interest |
| Documentation | Issue driven; Often prepared by counterparty | International Security Management Association |
| Trading | Inactive; Buy and hold | Active trading |
| Listing | No | Yes |
| Rated | No | Generally yes |

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 and 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 first conference call


# Appendix 3: Syndication Commissions (Basis Points, Flat)

**Europe**

| BDA | 1999 | 2002 | 2004 | 2008 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| 5 years | 15 | | | 10 | 12.5 | 12.5 |
| 10 years | 22.5 | | | 15 | 17.5 | 17.5 |
| 15 years | | 17.5 | | 17.5 | | 20 |
| 25 years | | | | | 25 | |
| 30 years | | | 27.5 | | | |

**DSTA**
Advisor, 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 four-year FRN in 2004

**Colombia:** Usually pays between 30 and 40 bp

**Mexico:** Paid 25 bp for 30-year bond in 2008

Source: Informal sources; indicative figures.


# Appendix 4: Allocation of Duties between Joint Leads at the BDA

The usual duties assigned by the BDA are the following:

**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 in 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. It 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's approval the final allocations, and it is responsible for dispatching the approved allocations to the members of the syndicate.

**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 their customers' switch orders.[53]

[53] Customers can submit their orders to the syndicate group either for cash or on a switch basis, in which case, 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 5: Input to Assist in Drafting of a By-law on the Recommended Bond Placement Scheme

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.

To meet this objective, the MoF has to create a competitive security issuance procedure based on a market mechanism that 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 for 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 facilitates further increasing the outstanding amount issued while firmly anchoring benchmark bonds to the domestic market.

This issuance procedure is widely implemented by public debt managers abroad.

Therefore,

1. The MoF is empowered to syndicate the issuance of new benchmark bonds in the local market.[54]
2. The target issuance amount and composition of the syndicate group proposed by the DMO must be approved by the MoF.
3. The syndicated benchmark can be subsequently tapped in the framework of the auction calendar published by the MoF.
4. The bond auction scheduled to take place on the month during which the syndication is carried out can be canceled.[55]

[54] Only as an example, 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.

[55] The use of "can be" instead of "is" reflects only the writers' personal view that the best regulations are the ones that leave the maximum flexibility to a public debt manager to do what he or she believes to be the best in the circumstances without needlessly being constrained by too precise instructions, sometimes written a long time before! Who knows what the market could be like tomorrow?


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