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Press Release

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Policy of Issuance of Treasury Bonds Through Public Auctions

The Central Bank commenced issuing Treasury bonds only through public auctions from the auction of 30 year Treasury bonds held on 27 February, 2015. In response, several reports published in the media have alleged that the sole reliance on issuing Treasury bonds through auctions conducted since February 27, 2015 has led to additional costs to the government. Accordingly, they appear to support that issuance of Treasury bonds through a mix of private/direct placements method and auctions that have been followed during the past several years should be reintroduced to reduce such costs. The some reports hypothetically calculate the additional costs to the government based on certain assumptions. In this regard, the Central Bank wishes to provide following clarifications for awareness of the general public.

1. In terms of the Operational Manual of the Public Debt Department, issuance of Treasury bills and bonds should be undertaken as much as possible through public auctions based on market conditions and any balance funding requirement could be raised through private/direct placements as per the procedure laid down in the Manual. However, in recent years, nearly 80 to 90 per cent of government funding raised through Treasury bonds was via direct placements method, alternative to auctions, based on strategies followed at that time. The current policy of issuance of Treasury bonds via public auctions only is expected to enable further market development process initiated in the past several years by moving to a full scale auction arrangement for issuance of Treasury bills and international Sovereign Bonds which will be bring more benefits to both the Government and investors in the near future.

2. At the 30 year Treasury bond auction held on 27th February 2015, Rs.10.06 bn. was raised at the weighted average yield to maturity of 11.73%. Prior to this auction, at the previous 30 year Treasury bond auction held on 27th May 2014, Rs. 2 bn. was raised at the yield to maturity of 11.75%. After this auction, further Rs. 77.8 bn. was raised from direct placements of around 30 year maturity Treasury bonds at yield rates ranging from 8.85% to 11.80% as per the prevailing practice and the overall weighted average yield covering the auctions and direct placements was 11.47%. At other previous issuance of Treasury bonds of around or close to 30 years, lower or higher yield rates have been determined.

3. However, the yield rates of Treasury bonds or any security issued at auctions in the market are not directly comparable across the auctions or across different maturities of securities because each auction in the market environment involves different market conditions and factors. Changes in market liquidity, policy interest rates, foreign investors' behaviour and market expectations will have diverse impact along with demand and supply forces on the yield rates. Therefore, commenting on the additional costs or saving to the government from issuance of a Treasury bond at a particular auction compared with the yield rate of a Treasury bond issued at another auction or in a particular period is not acceptable and justifiable.

4. The calculation of additional cost to the government due to the 30 year Treasury bond issuance at the auction held on 27 February, 2015 in some analyses is solely based on the assumption that if Rs.1 bn. as announced for the auction was accepted on bids at the weighted average yield to maturity of 10.38% as per those bids up to Rs. 1 bn and direct placement window was opened after the auction at that auction weighted average yield rate to fund the balance funding as per the prevailing practice. Accordingly, the additional cost to the government as per such calculations is 1.35% being the difference between the yield rate of 11.73% at the auction for Rs. 10.06 bn and the yield rate of 10.38% applicable to Rs. 1 bn at the auction. However, the two issuing options are completely different as the full auction system is market-based whereas the limited auction with direct placements is a funding method combined of market and administratively determined arrangement. Therefore, such additional cost calculation has no practical grounds.

5. Some analysts calculate a further addition to the above additional cost by calculating the increase in yield rates of Treasury bonds of other maturities issued at auctions after 27 February 2015 compared to yield rates of such matures issued at the latest auction or direct placement made prior to the 30 year Treasury bond auction on 27 February 2015. Such analysts update the

total additional cost on an on-going basis as and when a new Treasury bond is auctioned. As the yield rates at different auctions are not comparable due to different market conditions and factors as stated above, the calculation of such additional cost has not justification.

6. The auction based issuance arrangement will contribute to the development of Government securities market in many ways and some are highlighted below.

    a. The benefit of price discovery realized in the market mechanism is not available in the direct placement led issuances. Therefore, it is not possible to gauge whether the yield rate in this system is lower than the yield rate to be realized from the full auction system. In economics, it has been established that market mechanism is more beneficial than administratively managed market arrangements to market participants in terms of the efficient pricing in place of administered prices. In the medium term, when the full auction system comes into place, the funding cost to the government will be determined based on market mechanism with close monitoring by the Central Bank with a mix of debt-raising instruments to reduce the excessive volatility in yield rate or costs. Accordingly, the immediate increase in the yield rates at auction on 27 February 2015 and the aftermath would be corrected by market forces. In addition, removal of special standing facility rate of 5% by the Central Bank on March 3, 2015 also led to the increase in the yield rates which is a factor external to the issuance of the Treasury bond under reference. However, as shown in the subsequent auctions without direct placements, yield rates gradually started adjusting and stabilizing in a market environment. Also, the demand increased across several maturities of government securities from the short to long term. Therefore, the overall cost of borrowing through Treasury bonds has been declining and moderating in general. However, the cost at individual auctions may vary due to changes in market conditions.

    b. The auction process improved tremendously as shown by increased participation by dealers and investors in the primary and secondary markets. As a result, the Government could raise as much as Rs. 316.4 bn through Treasury bonds at auctions since the issuance of 30 year Treasury bond in reference supported with other debt instruments to meet the government funding requirements.

    c. The secondary market of government securities (Treasury bonds and bills) also expanded due to active auctions in 2015. As a result, investors who are not in a position to access the auctions or large institutional investors who fail to secure bids at the action started bidding in the secondary market across the Primary Dealers looking for yields comparable with primary market/auction yields. As a result, an active secondary market has now begun to operate in the country. The active secondary market will improve further competition in the government securities market facilitating the government to raise funds at competitive yield rates.

d. The promotion of the open market mechanism for government securities will attract international investors to the government securities market and the stability in investment flows and investor confidence will improve in the medium term.

e. In addition, the issuance Treasury bills and Sri Lanka Development Bonds will further facilitate the Government to raise funds through the auction system in a market environment.

7. In view of the above, the current policy initiative for issuance of Treasury bonds only at public auctions should be evaluated with a medium to long-term view to understand the benefits of the market mechanism to all participants.