Review of the Spanish Government Securities Market[1]

Purpose and methods

This report summarizes the results of a mandatory Federal Reserve review of the treatment of U.S. firms in the Spanish government debt market. This review is required under the Primary Dealers Act of 1988 because a U.S. bank holding company owned by a Spanish firm sought to acquire a U.S. broker-dealer that is currently designated by the Federal Reserve as a primary dealer of government securities in the United States. The central question of this review is whether Spain grants to U.S. firms the same competitive opportunities to underwrite and distribute Spanish government debt instruments that Spain accords to Spanish firms.[2]

This review draws on public information and confidential communications with market participants and Spanish regulators.[3] More specifically, the review examines the primary dealer system in Spain, auction and syndication processes for debt issuance, central bank transactions in government securities, and access to market utilities for trading, hedging, secured financing, and clearing and settlement.

Executive summary

The Debt Management Office (DMO) of the Spanish Treasury (*Tesoro Público*) manages the government's finances and issues debt securities. A set of twenty financial firms designated by the Treasury as primary dealers (C*readores de Mercado*; literally, "market makers") performs most of the private intermediation activity in both primary and secondary markets. By controlling ownership, four of these primary dealers are U.S. firms (called "U.S.-owned dealers" in this report), six are Spanish, and the others are from France, Germany, the United Kingdom, and Japan.[4] Primary dealers benefit from some exclusive rights, including access to auctions, participation in syndications, and the right to strip and reconstitute coupon securities. In turn,

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[1] December 14, 2021.

[2] Under the Primary Dealers Act of 1988, 22 U.S.C. 5341–5342 (Act), the Federal Reserve may not designate a person of a foreign country as a primary dealer or allow a person of a foreign country to retain designation as a primary dealer, if that person's country does not grant to U.S. companies the same competitive opportunities to underwrite and distribute that country's government debt instruments as that country accords to its domestic companies. A "person of a foreign country" includes any foreign individual or company that directly or indirectly controls a primary dealer. The Board has made determinations under the Act with respect to six foreign countries: Japan (1989), the United Kingdom (1989), Switzerland (1989) Germany (1990), France (1992), and the Netherlands (1998).

[3] In addition, the Federal Reserve requested public comments in a notice published in the Federal Register on October 27, 2021, but none were received.

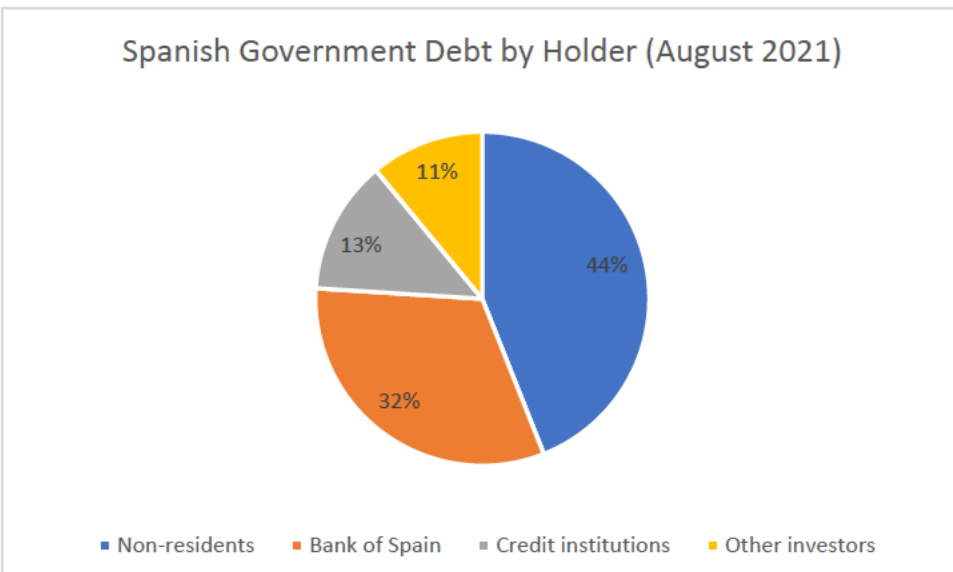
[4] Entities operating as security dealers in Spain must be domiciled and authorized in the European Union (EU). Spain, as a member state of the EU, is subject to Council Directives 89/646/EEC (the Second Banking Directive or "2BCD") and 93/22/EEC (the Investment Services Directive or "ISD"). The 2BCD created a "single passport" for banks authorized in an EU member state by allowing them to branch into, or provide direct services in, host member states without need of a separate authorization from the host state. The ISD created a similar regime for investment firms authorized in an EU member state. Accordingly, (parent) firms domiciled outside the EU conduct primary dealer operations in Spain through controlled subsidiaries that are domiciled and authorized in an EU country. Nineteen firms are primary dealers in Spain for both Treasury bonds and Treasury bills. One Spanish firm is a Primary Dealer only for Treasury bills.

primary dealers are obligated to bid for at least a minimum amount in every auction and to maintain two-sided quotes in secondary markets during most of the main trading hours.

Summarizing the main conclusions of the review, in all aspects of regulation and market access that we examined, the government appears to treat foreign-owned primary dealers (including U.S.-owned firms) comparably to the treatment afforded to Spanish firms. Most DMO interactions with primary dealers are highly constrained by rules that allow little scope for favoritism, and DMO auctions and other operations are perceived to be conducted fairly. For syndications, no national bias is evident in the mandates that have been awarded. U.S.-owned firms are frequently included in underwriting syndicates, commensurate with their success in fulfilling their obligations as primary dealers. Similarly, monetary policy operations that involve secondary-market bond purchases by the Bank of Spain are perceived as fairly conducted, in the sense of not involving any discrimination among primary dealers in their role as counterparties to the trades. In addition, market utilities supporting transactions related to Spanish government debt follow largely mechanical practices that tend to result in comparable treatment of market participants.

<u>Market parameters and investors</u>

As of August 31, 2021, Spanish government debt stood at €1,198 billion, including €1,065 billion in Treasury bonds (*bonos y obligaciones*) and €76 billion in Treasury bills (*letras*). The bonds include inflation-linked securities, ultra-long maturities, and sustainable ("green") bonds.



Investors outside Spain, including those from other euro area countries, have been major holders of Spanish government debt.[5] As of August 2021, non-residents in total held 44 percent, Bank of Spain (*Banco de España*, the central bank) held 32 percent, Spanish credit institutions held 13 percent, and other Spanish investors just 11 percent.

[5] In the latest available Treasury International Capital (TIC) System data, U.S. residents (an aggregate that does not include foreign offices of U.S. financial firms) held only about €20 billion in Spanish government debt.

The yield spread of the 10-year bond over the German bund curve averaged 65 basis points in the first 3 quarters of 2021 but has been much higher at times in the past, exceeding 600 basis points in 2012. The subsequent narrowing in spreads is consistent with the upward trajectory in credit ratings of long-term Spanish government securities since the European debt crisis; these ratings are currently Baa1 (Moody's) and A (Standard and Poor's).

Market utilities for trading, hedging, secured financing, and clearing and settlement

Secondary market trading in Spanish government securities is active. Aggregate daily turnover for the first 9 months of 2021 averaged €14 billion for bills, €71 billion in bonds, and €5 billion in strips, or about 17, 7, and 10 percent of average outstanding amounts, respectively.[6] Most of the trading is conducted on anonymous and rule-driven dealer-to-dealer platforms such as SENAF, Brokertec, and MTS, that have little or no scope for any discrimination by country of ownership.

In principle, Spanish bond positions can be hedged with futures that are listed on Eurex, however these contracts are very illiquid. This market also has little scope for any discrimination by country of ownership.

For secured financing, repo (repurchase agreement) markets are liquid and active and include significant participation by U.S.-owned dealers. Total repo volumes averaged approximately €30 billion per day over the last year, based on data from various interdealer platforms.[7] Roughly 95 percent of Spanish repo trading volume is executed against specific collateral sought by lenders, rather than general collateral.[8] More than half of the volume is cleared through LCH SA, which applies haircuts to collateral following a pre-announced schedule (expressed as a percent of collateral value), which thus allows no scope for discrimination against particular market participants.

Market members (including primary dealers) are required to settle their transactions with the Treasury on Iberclear and dealers also use Euroclear for other transactions. These systems do not appear to discriminate by country of ownership in any way.

Designation of primary dealers and their obligations

Since 1999, credit institutions and broker/dealer firms licensed in any European Union (EU) jurisdiction have been eligible to apply to the Spanish Treasury for primary dealership status. All the U.S.-owned primary dealers are German subsidiaries, but prior to Brexit, U.S.-owned primary dealers had been licensed in the United Kingdom. In contrast to the 1988 Primary Dealers Act in U.S. law, which considers the nationality of a controlling owner, no provision in

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[6] Based on figures reported in the Spanish Treasury's monthly *Central Government Debt Statistics* compiled from activity on Iberclear and electronic trading exchanges, including transfers associated with repurchase agreements.
[7] At this level, the Spanish repo market is about half the size of German market and one-third the size of the Italian market.
[8] Primary dealers with bank licenses can also fund positions in Spanish Treasury securities in European Central Bank (ECB) facilities that are administered by the Bank of Spain.

either EU or Spanish law that we are aware of calls for different treatment for U.S.-controlled primary dealers relative to other primary dealers licensed in Germany or in another EU country.

An applicant for a primary dealership in Spain must demonstrate that it has a sufficient workforce, balance sheet, and technical capacity to provide market liquidity and distribute securities on a significant scale. Approval for a new applicant may be awarded by the Treasury after the successful completion of a probationary period.

To fulfill their obligations in primary markets, all primary dealers must bid for at least 3 percent of the amount offered at each Treasury auction at credible prices. In secondary markets, primary dealers must post two-sided quotes at a competitive bid-ask spread for at least five hours per trading day.

The DMO evaluates primary dealers' performance on a monthly basis through an evaluation based mostly on objective and quantitative criteria. There appears to be no difference in the performance criteria applied to U.S.-owned and Spanish primary dealers. Two U.S.-owned firms were ranked as top-five performing primary dealers in bonds for 2020.

Similar to the function of the U.S. Treasury's Treasury Borrowing Advisory Committee (TBAC), the Spanish Treasury convenes meetings with its primary dealers. Failure to attend such meetings with the Treasury may count as a penalty factor against a primary dealer in their evaluation by the Spanish Treasury.

Poor performers risk losing primary dealer status. A broader set of entities (mostly smaller Spanish banks) that also have been designated as "market members" may bid directly in Treasury auctions, but these additional firms do not have the other rights and privileges of primary dealers.

Auctions

The DMO conducts regular auctions of Treasury securities typically on the first and third Thursdays of the month. Only primary dealers and other market members may bid directly in auctions.[9] Primary dealers can submit bids until 10:30, but the cut-off for other market members is 10:00.

In a "green shoe" second round held the following Monday, only available to primary dealers, each primary dealer may subscribe for up to 24 percent of the amount it was awarded at the previous week's auction. These additional allocations are entirely at the dealer's discretion, and the price is set at the average auction outcome (the same price at which non-competitive bids were filled), so that an increased secondary market price for the recently auctioned bond confers an immediate arbitrage opportunity to primary dealers.

[9] Other Spanish residents (including individuals) can acquire newly issued Treasury securities through direct accounts (*cuentas directas*) administered by The Bank of Spain, a program similar to Treasury Direct in the United States. This arrangement works best for investors who expect to hold to maturity, because securities acquired in these direct accounts would have to be transferred to a dealer account before they could be sold on the secondary market.

The auctions are rule-driven in essentially every respect, leading to the same competitive opportunities for U.S.-owned and Spanish primary dealers.

Syndication

The DMO's financing programs also include syndications of securities with a narrower investor base, such as longer-dated tenors and green bonds, including about €58 billion of debt issued in 2020.

Syndicated issues are underwritten by primary dealers, for which they earn a fee from the issuer. As is common in other countries, we find that the Spanish DMO typically chooses lead managers mainly from among the dealers with the highest performance in the previous calendar year.

Syndication mandates for 2016-2021 deals are summarized by the nationality of dealers' ownership in the table. The four U.S.-owned dealers collectively were awarded a total of 26 percent of the co-leads over this period. This share is very close to the frequency with which the U.S.-owned dealers were reported as top-five performers during the 2015-2020 period, both for bond markets and bill markets, broadly consistent with mandates being driven mainly by recent dealer performance rankings.

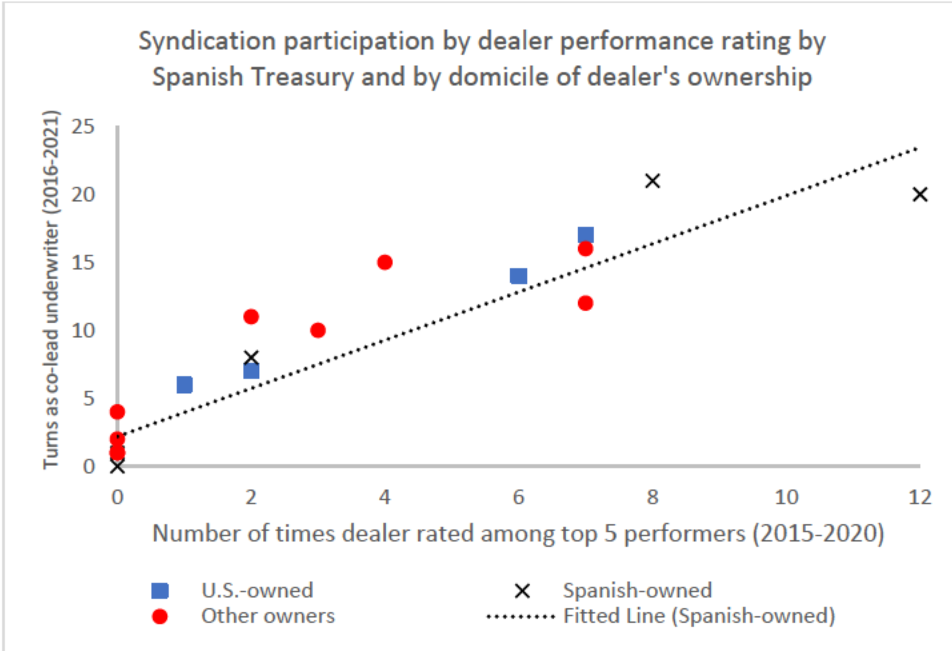
Table: Primary dealers, syndication co-leads, and performance ratings by owner domicile

	period	Spanish owners	U.S. owners	Other owners
Primary dealers in Treasury bonds (number)	current	5	4	10
Co-leadership in syndications (share)	2016-2021	30%	26%	44%
Top-five annual ratings in bonds (share)	2015-2020	29%	29%	42%
Top-five annual ratings in bills (share)	2015-2020	43%	23%	33%

Notes: A 6th Spanish firm that is a primary dealer only in bills is excluded from the statistics reported in the table. Dealer counts totaling 167 co-lead mandates for 28 syndications are from Dealogic. The Spanish Treasury lists the top-five performing primary dealers for the previous calendar year at **www.tesoro.es**. Six dealers were listed in the top five for bonds for 2015.

The importance of dealer performance rankings for underwriting participation is further supported by dealer level analysis shown in the figure below as a scatter plot. Syndication participation turns during 2016-2021 among the 19 current primary dealers in bonds are generally increasing in the frequency with which a dealer places in the top five on the Treasury's performance rankings during 2015-2020. In addition, there is no evidence that foreign owned firms (represented by the blue squares and red circles) are chosen less often as co-leads than similarly rated Spanish-owned firms (the black crosses and dashed fit-line).[10]

[10] Furthermore, formal regression analysis did not find any statistically significant national differences in the relationship. A caveat is that the analysis is less precise than what would have been possible using the exact performance rankings of each dealer instead of the frequency of top-five rankings.



<u>Central bank transactions involving Spanish government debt</u>

The Bank of Spain is a major buyer of domestic government debt, including bonds acquired on the secondary market in the context of the European Central Bank (ECB) asset purchase programs, specifically the Public Sector Purchase Programme (PSPP) and the more-recently established Pandemic Emergency Purchase Programme (PEPP). We did not find any evidence of discrimination against U.S.-owned primary dealers in trades with the Bank of Spain.

The Bank of Spain also accepts substantial quantities of Spanish sovereign bonds as collateral for ECB credit facilities. Predetermined rules for rates and haircuts ensure that favoritism by country of ownership for eligible borrowers (which include all Eurozone-domiciled credit institutions) is not possible.