**A Review of Evaluation of Primary Dealers in Government Securities**

**I Introduction**

1.1 Issuance of government securities and trading activities on them are exclusively routed through a Primary Dealer (PD) system in Armenia. Currently, a network of 7 Primary Dealers operate in the government securities market, which are all commercial banks.

1.2 As a PD, it plays the role of a sub-custodian to investors and provides investment services by (i) receiving and transferring assignments from clients regarding transactions with securities; and (ii) make and execute transactions with securities on its behalf and on behalf of the clients. The primary role of the Primary Dealers is defined in the Government Decree on Regulation of Government Securities.

1.3 For performing its role, a PD is required to – (i) have a separate unit consisting of specialists implementing activities in the primary and secondary security markets, with qualified staff; (ii) have an internal control unit, which also implements control over the custodian activities; (iii) act as a subdepositary; and (iv) have a right to provide services in the securities market in accordance with points (1), (2) and (4) of Article 25.1, and Article 26.1 of the RA Law on Securities Market.

**II. Privileges and Obligations of Primary Dealers**

2.1 The framework of exclusive access to the primary market through closed auctions for PDs inherently provides them with captive fees from their onward sale to final investors (clients) in addition to a spread derived between the selling price in the secondary market and the allocation price in the primary market. Another element of privileges provided to the PDs under the current framework is additional allocation of government securities in the primary market equivalent to 20 percent of their successful allocation in the auction at the weighted average auction price. A final source of income for the PDs is the fees charged for secondary market transactions with its clients.

2.2 As a reciprocation for providing exclusive access to the PDs in the primary and secondary market for government securities they are obligated to provide a two-way quote on government securities on a daily basis through the electronic dealing system of NASDAQ OMX.

**III. Recent Activity of Primary Dealers in the Government Securities Market**

3.1 Based on the outstanding stock as at the end of June 2018, primary dealers currently hold 35.0 percent of the total government securities (Figure 1). The share of holdings by PDs has declined in recent years. Along with the non-dealer banks, the total share of bank holdings stood at 68.4 percent of total government securities reflecting the dominance of the banking sector in Armenia’s financial system.

Figure 1: Share of Holding of Government Securities by Investor Type on 30 June 2018 (percent)

Source: Statistical Bulletin, June 2018, PDMD

3.2 In recent years, PDs have exhibited a growing demand to bid for clients as part of intermediation role to place securities to final investors. Allocation of securities for “investment account” increased from 5.5 percent of their total allocation in 2013 to 29.5 percent in 2016 before receding to 15.9 percent in the first four months of 2017 (Figure 2). This suggests that although declining, more than 70 percent of their demand for bids by the PDs is driven by their own investment needs. This can be acting as an impediment in the role of PDs to be an efficient securities distribution mechanism to their customer base.

Figure 2: Allocation of Government Securities in Primary Auction by Purpose (percent)

3.3 Reflecting the dominance of securities purchase for own investment need, the share of “held-to-maturity” (HTM) classification of holdings by PD banks stood at 37.4 percent during the first five months of 2018, increasing steadily from 15.5 percent in 2016 (Figure 3). While the share of “held-for-trading” (HFT) holdings remained insignificant at less than 2 percent, the share of “available-for-sale” (AFS) declined from 83.2 percent to 60.9 percent during the same period. The increasing trend of HTM holdings of PDs (or the declining share of AFS holdings) could be a cause of concern for the fulfillment of the main role of PDs to place securities to final investors.

Figure 3: Share of Holdings by Accounting Classification for PD Banks (percent)

3.4 Another contrasting feature is that the share of HTM holdings of non-PD banks is less than PD banks while the share of its AFS and HFT holdings are greater than PD banks (Figure 4). This raises issues about the effectiveness of PDs in its primary duties vis-à-vis the non-PD banks.

Figure 4: Share of Holdings by Accounting Classification for non-PD Banks (percent)

**IV. International Practice for Evaluation of Primary Dealers[[1]](#footnote-1)**

4.1 PDs are generally assigned six duties: (i) to bid on the primary market, (ii) to place government securities with final investors, (iii) to enhance the liquidity of the secondary market, (iv) to be the counterpart of the debt management office (DMO) for certain debt management operations, (v) to advise the DMO on its debt management strategy and to develop the debt market, and (vi) to report on their activity in the secondary market. While all of these duties are related to the funding of the government, they are connected to its amount, its stability, its cost and its management. Two duties in particular which are considered to be most important to the DMO include the obligation to bid at auctions and the commitment to quote prices on the secondary market and tend to have some country specific features.

4.2 By bidding at the auctions, PDs function as a channel between the DMO and final investors. They build a portfolio of securities that they will sell in the secondary market. The obligation of PDs to participate in auctions decreases the execution risk of the issuer. The obligation to bid at auctions generally includes the obligation for PDs to submit a certain minimum amount of bids and/or successful bids. In both cases, the minimum amount is generally expressed as a certain percentage of the total amount auctioned. In both cases, the minimum bidding commitment can be quantified, either as a percentage discretionarily set by the relevant DMO or as a function of a certain reference, such as the number of appointed PDs, the relative size of the PD’s balance sheet, or the amount of the PD’s trading activity in the secondary market.

4.3 To enhance liquidity in the secondary market, PDs in most advanced and some emerging markets are committed to provide firm two-way quotes continuously. In many emerging markets, PDs are committed to quote indicative prices only. Prices must usually be quoted for some minimum amounts, with some maximum spreads and for a certain minimum number of hours. The ability to offer firm quotes depend on the characteristic of the bonds: benchmark and “on-the-run” bonds and access to hedging instruments by PDs.

4.4 The size of the maximum spread can be expressed either as a number or as an order of magnitude.

This price quoting obligation generally applies both to prices quoted to customers and to prices quoted to other dealers. The objective of obliging dealers to quote to other dealers is to enhance price transparency by ensuring that the market is well arbitraged. Generally, the market making program covers all maturities issued. However, securities are allocated amongst PDs so that every dealer is committed to quote only a certain number of maturities and every security is quoted by at least a certain number of market makers.

4.5 PDs that are committed to quote firm prices are often also obliged to make a certain minimum turnover in the secondary market. The latter obligation tends to be adapted as the market develops. The minimum amount is expressed first as a percentage of the total turnover in the market, then as a percentage of the aggregate turnover done by all PDs, and finally, the minimum amount requirement tends to disappear as trading is well established and when the main benefit of a market making commitment transforms from liquidity to price transparency. Thus the quality of the prices quoted matters more than the volume done.

4.6 As a reciprocation to the duties of PDs envisaged, DMOs provide PDs with certain privileges. Such privileges are extended especially to help PDs perform in the absence of efficient supporting market structures and to motivate them to perform in the most effective manner possible by rewarding good performance. The mix of privileges and supporting arrangements depends on the overall market architecture. Such privileges could be of a general nature, or apply specifically to the primary or secondary markets.

4.7 Some of the PDs’ privileges which are of a general nature and uniformly apply is the exclusive right to carry the title of PD and privileged treatment in getting information from, and in consulting with, the relevant DMO. Another privilege includes granting PDs the status of exclusive or privileged counterpart of the DMO for profitable debt management operations. Typical examples are the award of a mandate of lead manager in a syndication or the DMO’s decision to deal only with PDs in the derivatives market. Regular publication of league tables listing the PDs (e.g., the first three or the first five PDs) that have been top performers in the primary and in the secondary market, respectively is another emerging privilege being extended to PDs.

4.8 Privileges that are provided in the primary market (i.e., principally auctions), constitutes: (i) recognizing the exclusive right of PDs to be direct bidders at auctions, (ii) allowing extra time for PDs to submit bids when other market participants can also be direct bidders at auctions, (iii) paying PDs a commission on successful bids, or (iv) increasingly, granting PDs the right to submit non-competitive subscriptions either at or after the auction.

4.9 The most important privilege provided to PDs in the secondary market is the exclusive access to a securities lending facility. Other privileges can also apply to PDs related to central banks’ operation. This could include special privileges to borrow from the central bank, the exclusive right to be a counterpart of the central bank for its open market operations, or the exclusive right to trade in the call market.

4.10 Designing a PD appraisal procedure is a three steps process. The first step is to make an inventory of the various components of the PD’s expected performance (evaluation criteria). Some components will be quantitative. They can be expressed as a certain amount of currency (e.g., sum of the bids submitted by a PD at an auction). Others will be of a qualitative nature (e.g., quality of the advice provided by a PD to the DMO). The second step is to weigh each activity as a function of its importance to the DMO. The third step is to make three policy decisions. These refer to the disclosure of the mechanics of the appraisal procedure, the disclosure of the results of the appraisal procedure and the impact of the appraisal result on the allocation of rewards.

4.11 The quantitative criteria include all the components of the PD’s activity that can be expressed in terms of volumes, market share or prices (e.g., the amount of successful bids at the auctions, trade turnover or spreads of quotations). Business volumes are increasingly duration weighted in order for the appraisal procedure to use comparable figures when calculating aggregates. This is easy to implement in the primary market as the maturities are known to the DMO. On the secondary market, however, a duration weighting is technically possible only if PDs report their transactions by maturity ranges. It is technically possible to refine the appraisal of PDs’ behavior at auctions by including in the analysis the quality and the stability of their performance and the quality of their price discovery.

4.12 A variety of qualitative criteria are used in practice. This includes market information, trade execution, advice, research, promotion of the issuer, and overall relationship. Some DMOs use customer surveys to gauge investors’ satisfaction, etc.

4.13 The main issues involved in assigning weights relates to the relative importance between primary and secondary market, type of instruments and between quantitative and qualitative indicators. DMOs provide a larger weight to the primary market where the availability of funding (primary market) is ultimately more important than its cost (secondary market). Other DMOs assign either the same or larger weight to the secondary market. In respect of instruments, weights increase when maturities lengthen. Long-term funding is more valuable to the DMO and more risky for the PD to provide than short-term funding. Weights on qualitative assessment are generally restricted to within 20%.

4.14 DMOs are advised not to establish a completely mechanical link between the results of the appraisal procedure and the allocation of rewards. Allocating incentives requires DMOs to exercise judgment. It is counterproductive to reward only the few best performing PDs. While the best performers should be rewarded more than the good performers but the good performers should obtain some reward also. PDs sometimes have different fields of expertise which the debt manager must try to take advantage of in the most efficient way.

**V. Assessment of the Evaluation Framework**

5.1 The regulatory framework for PDs is indicated in the Ministry of Finance Decree on Primary Dealers which also provides the basis for the evaluation of PD activity. Based on the evaluation framework, the lowest ranked PD is replaced from the highest ranked entity within a potential list of PDs which also includes investment companies. The potential participant willing to become a PD will be required to present to the PDMD its program of activities in bond market for the upcoming two years including its volume and structure of bonds portfolio; and the availability of investors and the policy for involving new investors. The evaluation framework is implemented in a transparent manner by the PDMD.

5.2 The activities of the PDs are evaluated based on its participation in the primary market, activity in the secondary market and its work with the issuer with a weight of 40 percent, 50 percent and 10 percent respectively. While the first two parameters are quantified based on an objective metrics, the latter parameter is quantified based on a subjective assessment. The detailed analytical framework of the three indicators is provided in Appendix 1.

5.3 The index on primary market participation is based on competitive allocations in primary auctions on issuance and buybacks. The index on primary market participation includes two indicators: share of allocation for a PD in the total allocation; and the share of allocation for a PD in the total bid submitted by the PD (inverse of bid-cover ratio for a specific PD). The weights applied are 75 percent and 25 percent for the first and second indicators respectively. The evaluation therefore places a significantly greater weight on “relative” participation in the global allocation than the aggressiveness of “individual” participation. A sub-weight is applied on these two indicators based on the remaining maturity of securities allocated, with short-term, medium-term and long-term securities accorded weights of 20 percent, 40 percent and 40 percent respectively. Information on the primary market metrics is provided by the NASDQ-OMX to PDMD on a quarterly basis.

5.4 The index on secondary market activity is a weighted average index of the share of the exchange (NASDAQ-OMX) and OTC trading operations of a particular PD in the total daily volume of trading activity. Secondary market activity in the NASDAQ exchange is given 60 percent weight while the OTC market is assigned a weight of 40 percent. The information on this metrics is provided by the Central Bank of Armenia (CBA) to PDMD on a quarterly basis.

5.5 The ranking on the value of work with the PDMD on developing the government securities market is assessed by 5 officials within PDMD to ensure that the assessment is based on objective considerations and no personal opinions influence the ranking.

5.6 The final ranking of the PD is determined by deducting a score based on the number of violations of the quotation obligation as required from the PDs. PDs will be required to provide on a daily basis a continuous two-way quotation of prices for the designated benchmark bonds as indicated by the PDMD. The quotation should be provided within 10 minutes of the opening of the trading session till the closing of the session. In case of matching purchase / sale order, the PD will be required to provide a new two-way quotation within three minutes of the matching order.

5.7 The two-way quotations will be subject to a price margin (spread) and a minimum volume of quotation. The price should be within a spread of 500 basis points of the maximum sale price and minimum purchase price for a specific bond. The minimum quotation volume should be 0.1 percent of the nominal outstanding bond in circulation. Violation of this obligation will take place for a PD if it is unable to restore the quotation price or volume within three minutes in the trading system. A PD will not be subject to this obligation on a given issue, if on that day it executes a trade of 0.2 percent of the nominal value of the outstanding bond in circulation.

**VI. Implementation of Assessment**

6.1 The PDs are individually evaluated on an annual basis for their activities implemented between October 1 of the previous year and October 1 of the current year. A quarterly system of evaluation is undertaken during this period on a rolling over basis. The publication is in the form of a league table for all the PDs and potential participants. From the quarterly scores, an annual score is aggregated across the four quarters (Table 1).

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| --- |
| **Table 1: Annual Assessment of Agents and Potential Participants Behavior \* for 2017** |
| Agent | 2016-IV | 2017-I | 2017-II | 2017-III | **Annual assessment** |
| ARARATBANK OJSC: | 6.2 | 7.0 | 5.8 | 5.0 | **24.0** |
| Ardshinbank CJSC: | 2.8 | 6.0 | 5.0 | 5.0 | **18.8** |
| Armswissbank CJSC: | 5.2 | 3.6 | 6.0 | 3.6 | **18.4** |
| VTB-Armenia Bank CJSC: | 5.8 | 3.2 | 5.2 | 3.0 | **17.2** |
| Converse Bank CJSC: | 3.0 | 2.6 | 2.2 | 5.2 | **13.0** |
| Ameriabank CJSC: | 3.6 | 3.4 | 2.4 | 2.2 | **11.6** |
| HSBC Bank Armenia CJSC: | 1.4 | 2.2 | 1.4 | 4.0 | **9.0** |
| \* Assessment of the performance of the agents from October 1, 2016 to October 1, 2017, is made only on the results of the primary market participation and the secondary market performance indicators. Quarterly assessment is calculated by adding 40% of the unit's primary market participation to 60% of the active unit in the secondary market. |
|  |  |  |  |  |  |
| Potential participant | 2016-IV | 2017-I | 2017-II | 2017-III | **Annual assessment** |
| Evocabank" CJSC: | 7 | 7 | 6 | 7 | **27** |
| ALPHASECURITIES LTD | 5 | 6 | 0 | 5 | **16** |
| Armeconombank OJSC: | 1 | 3 | 5 | 6 | **15** |
| Inecobank CJSC: | 0 | 4 | 7 | 0 | **11** |
| FUTURE CAPITAL MARKET LTD | 0 | 5 | 2 | 3 | **10** |
| Byblos Bank Armenia CJSC: | 4 | 1 | 4 | 0 | **9** |
| Mellat Bank CJSC: | 2 | 2 | 1 | 2 | **7** |

6.2 Based on the annual assessment, a new PD is selected from the potential list replacing the lowest ranking PD from the existing list. The quarterly evaluations are published in the website of PDMD within 7 working days of the completion of the reporting period. Scores on primary market participation and secondary market activity for individual PDs along with an aggregate score is provided in the league tables of PD assessment. For potential participants, individual scores are provided only for the secondary market activity. On publication of the annual assessment by the middle of October every year, discussions on the replacement of the lowest ranked PD with a new one from the potential participants list effective from January in the following year is undertaken by PDMD thereafter.

6.3 PDMD has so far implemented a transparent process in the assessment of PD performance which is in accordance with sound international practice. This has been supported by specific reporting provided by NASDAQ-OMX and CBA as required for the defined indicators on primary market participation and secondary market activity respectively. The PDMD has recently decided after consultation with PDs to increase the volume of quotation required on the two-way quotes for secondary market trades.

6.4 Under the current framework, the weight provided to the share of successful allocation in the overall bid by the PD is provided a weight of 25 percent. It is considered that there is more room to increase the weight of this indicator to promote more aggressive budding by PDs which would translate into lower funding cost for the government.

6.5 For the minimum trading volume required, it is proposed that the threshold 0.1 percent of the nominal volume of outstanding bonds in circulation will be increased. Similarly, for providing exemption on such quoting obligation, the threshold 0.2 percent of the nominal volume of outstanding bonds in circulation will be increased.

6.6 It is proposed that the privileges could be enhanced by considering the top ranked PDs to provide participation as a lead arranger through syndications or through limited role in the issuance of Eurobonds.

6.7 With respect to the obligation of a PD to provide two-way quotes on designated benchmark bonds, PDMP will initiate further reducing of spread of 500 basis points at the next stage of reforms.

6.8 With respect to selection of a new PD from the potential list of PDs, it is proposed that PDMD initiates a pro-active channel of communication. PDMP intends to organize a meeting with potential participants included in quarterly evaluation list.

**Appendix 1: Analytical Framework for Evaluation of Primary Dealers**

The indicators for evaluating the activities of the dealers are as follows:

1) **Participation in the primary market = I1 \*0.75 + I2 \*0.25**

The indicators characterizing the dealers’ participation in the primary market are as follows:

a. Indicator for the share in the allocation and buyback volume:

**I1 = STB\*0.2 + MTB\*0.4 + LTB \*0.4**,

where:

STB, MTB and LTB are the ratio of the satisfied volumes of the bids of the dealer at each primary allocation and buyback auction in the reporting period and each volume of the short-term, medium-term and long-term bonds allocated and bought back,

b. Indicator for effective participation:

**I2 = STB\*0.2 + MTB \*0.4 + LTB \*0.4**,

where:

STB, MTB and LTB are the ratio of the satisfied volumes of the competitive bids of the dealer at each primary allocation and buyback auction in the reporting period and the volume of the competitive bids submitted by the dealer.

For the calculation of indicators I1 and I2 the allocation and buyback term shall be taken as the maturity term, moreover the bonds with maturity term of up to 365 days inclusive are considered as STB, from 366 to 1826 days inclusive – MTB, and more than 1826 days – LTB.

2) **Indicator for activity in the secondary market:**

Indicator of the share in the volume of operations:

**I3 = ∑ N i = 1 (ET \* 0.6 + OET \* 0.4)**

where:

n is the number of working days in the given quarter,

ET and OET are the share of the exchange and off-exchange trading operations in the total daily volume of operations.

I3 indicator is calculated by the Central Bank of RA and provided to the issuer within five working days upon the end of each quarter.

3) **Work with the issuer** - (I4)

I4 is the indicator for provision ten days before each quarter of reports by the dealer to the issuer through “CBA-Net” network for the upcoming quarter about consulting, analysis, forecasts regarding the capital market, and for evaluation of recommendations and comments presented during the meetings with the dealers.

For the purpose of determining the quarterly score of each dealer, an indicator for the number of violations of the quotation rules of the dealers is applied. For the dealer with the most violations, a point equal to one tenth of the total number of dealers operating as of the last day of the evaluated quarter is deducted from the sum of the weighted points received for each indicator, whereas 0.1 points less is deducted from each subsequent dealer in the violations list. No points are deducted from the dealer, which has no violations.

The evaluation of the quarterly activities of the dealer is done by the following stages:

1) Calculation of the sum of the indicators for the participation in the primary market

2) Calculation of the indicator for the activity in the secondary market

3) Calculation of the indicator for the work with the issuer

4) In accordance with the results for each indicator mentioned in sub-points 1, 2 and 3 of this point, the dealers are given corresponding points in descending order, according to the following scale:

|  |  |
| --- | --- |
| Maximum result | 7 point |
|  | 6 point |
|  | 5 point |
|  | 4 point |
|  | 3 point |
|  | 2 point |
| Minimum result\* | 1 point |

 \* in case of 7 primary dealers. In case of n number of primary dealers, the maximum result shall equal to n, and every next result shall be 1 less.

5) The score for each indicator of a dealer shall be weighted with the share of the relevant area,

6) The total score shall be reduced with the indicator of the number of violations of quotation rules.

**Appendix 2: Evaluation Framework for Potential Participants**

The activities of the potential participants are evaluated by the indicator characterizing the activity of the participant in the secondary market:

**indicator for the share in the volume of operations:**

**I5 = ∑ N i = 1 (ET \* 0.6 + OET \* 0.4)**

where:

n is the number of working days in the given quarter,

ET and OET are the share of the exchange and off-exchange trading operations carried out by the potential participant in the total daily volume of operations.

I5 indicator is calculated by the Central Bank of RA and provided to the issuer within five working days upon the end of each quarter.

1. This section has been drawn upon from “Primary Dealer System”, GEMLOC Advisory Services, World Bank, 2010. [↑](#footnote-ref-1)