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Is the primary dealer system a gateway to information transfers? Evidence from the eurozone

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Abstract

The primary market for sovereign debt in the EU is organized as an auction with a selected number of participants, i.e. primary dealers, serving as underwriters. We observe a great degree of primary dealers' interconnections across sovereign issuers. At the same time, the number of primary dealers in Europe has decreased in the last few years, mainly due to regulation and competition. A limited number of auction participants not only comes at a cost for the issuing countries, but also inhibits information production about the economic prospects of the issuing sovereigns by primary dealers themselves, and information transfers to other market participants. Therefore, maintaining a stable primary dealer network has important implications for financial stability and market integration. Policy recommendations for the short-term future include proposing financial incentives for members to remain in such a network.

Keywords: primary dealer, sovereign debt, financial integration, financial stability, information transfers.

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Introduction

The funding strategy for European sovereign debt, including the current European Commission's Next Generation EU programme (€800 billion), relies on structured relations between countries and financial institutions via a primary dealer system. Primary dealers are authorized entities that support the issuance and the liquidity of sovereign debt. Recently, this selective network model has been put under scrutiny, with members complaining of increased regulation, fierce competition, and steep costs. As a result, several primary dealers started to withdraw from such network over the last few years.[1] A reduction in the number of participants indicates a weakening in the entire primary dealer system, which could impair the liquidity of the European sovereign debt market and result in higher borrowing costs for sovereign issuers. Moreover, primary dealers' exits may influence investment decisions of other market participants, undermine the process of financial market integration, and exacerbate frictions in the capital markets.

The primary dealer system was first introduced in the United States in 1960 (Preunkert 2023). Since then, most developed economies worldwide adopted this model, thereby regularly appointing financial institutions to buy, promote, and distribute sovereign debt on the primary and secondary markets. In a recent working paper (Grazioli and Mazzola 2024), we explored the multiple facets of the role of a primary dealer in the wholesale markets of sovereign debt. Acting as a primary dealer entails both benefits and costs. Through this analysis, we argued that the decision to act as a primary dealer could be reduced to such cost-benefit analysis. Then, we investigated the recent ramifications of the primary dealer system in the eurozone over the 2018-2023 period. The number and composition of primary dealers exhibit both cross-country and within-country variations. In the past six years, the total number of European primary dealers has declined from 230 to 217, i.e. a 6% decline. Also, the composition has changed, as numerous exits from European banks have been only partly compensated by entries from non-European primary dealers, especially banks from the United States. Our study sheds further light on recent challenges raised by European primary dealers.

Finally, the framework we proposed in Grazioli and Mazzola (2024) focuses on the spillover effects stemming from a primary dealer system. More precisely, we developed a systematic research agenda to explore whether and how the benefits of a solid primary dealer system could spread beyond the members of such network. Primary dealers have access to sovereign issuers and could exploit their comparative advantages in information production for their portfolio allocation. Building on this, we expected plausible information transfers unfolding from primary dealers to other market participants, such as other financial institutions that are not in this privileged position. In this vein, we provided a set of research questions that have not been explored in the literature.

To conclude, a deeper knowledge of the primary dealer system would contribute to our understanding of the development of financial market integration in a monetary union such the Eurozone. An integrated financial system is of paramount importance as it permits a smooth transmission of monetary policy across the whole area. Moreover, there

[1] See also for more details https://www.omfif.org/2023/05/eu-primary-dealer-exits-underline-pressure-facing-smaller-banks/#:~:text=Four%20banks%20have%20exited%20the,market%20makers%20for%20the%20EU.

are considerable financial stability benefits associated with financial market integration, such as allocation efficiency, risk-sharing, and diversification.

Primary dealer system

Sovereign issuers adopted a primary dealer system “to guarantee the placement of their debt on the primary markets and facilitate the liquidity of their secondary markets” (Ecofin 2000). As of December 2023, 23 out of the 28 members of the European Union (EU) have a primary dealer system in place, thus confirming its broad adoption (Preunkert 2023). A primary dealer is a financial institution that commits to purchasing a certain portion at each sovereign debt auction and to act as market maker in the secondary market. On the one hand, supporters argue that this system allows sovereign issuers to reduce borrowing costs and enhance financial resources, which, in the end, is deemed to improve the overall economy. In a cross-country survey, sovereign issuers showed a positive attitude toward such view (Arnone and Iden 2003). On the other hand, primary dealers recently complained about the challenges of this system. Regulatory burden, fierce competition, and lower margins are all elements that cast doubts on the sustainability of the primary dealer system. Therefore, it could be argued that “acting as a primary dealer is usually regarded as a loss-leader” (Dunne, Moore, and Portes 2006). In sum, research that contributes to this debate is of value to both practitioners and scholars.

Primary dealers include banks and other types of financial institutions, such as brokerage houses and investment firms. The appointment process of dealers varies across countries, with respective Ministries of Finance and State Treasury Agencies setting a list of selection criteria. Primary dealers must guarantee satisfactory and consistent operational performance, including the ability to achieve targets set by sovereign issuers and the possession of an adequate distributional and organizational structure (AFME 2017; 2020). Notably, in primary dealer systems, members are not directly remunerated or compensated for their activities by sovereign issuers (Preunkert 2023).

The role of primary dealer entails several benefits such as exclusive access to additional tranches of sovereign debt actions, privileged hearings in matters related to the management of sovereign debt, preferred counterparty status in derivatives transactions, specific repo facilities, and appointment as lead managers of syndicated issuances (see AFME 2017; 2020 for more details). On top of such contractual privileges, primary dealers earn access to sovereign issuers. Therefore, they can develop relationships with sovereign issuers and could exploit their comparative advantages in information production for their portfolio allocation in multiple ways including trading, investment, and lending decisions.

Among their contractual obligations, primary dealers must actively participate in sovereign debt auctions, submit bids for a minimum amount, promote price discovery in the secondary market, inform sovereign issuers of developments in the primary and secondary markets, and maintain certain level of regulatory capital coupled with a suitable organizational structure (see AFME 2017; 2020 for more details). The first requirement is particularly costly. In fact, they might be forced to hold suboptimal levels of sovereign debt exposures and to keep such holdings if market demand is missing. In sum, primary dealers’ liquidity and profitability could both be at risk.

Empirical findings

We examine the composition of primary dealer (PD) systems in the eurozone over the 2018-2023 period. More precisely, we focus on countries that have a primary dealer system in place exclusively (13 sovereign issuers): Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Slovakia, Slovenia, and Spain. For the historical membership list of the primary dealer systems of each sovereign issuer, we contacted State Treasury Agencies. We complement this information with other public sources such as the Ministry of Finance websites and AFME handbooks (AFME 2017; 2020). This process yields a final sample of 58 distinct primary dealers incorporated in 17 different countries. Non-European actors refer to Canadian, Japanese, and US financial institutions (10 primary dealers). The remaining primary dealers (48) are headquartered in European countries.

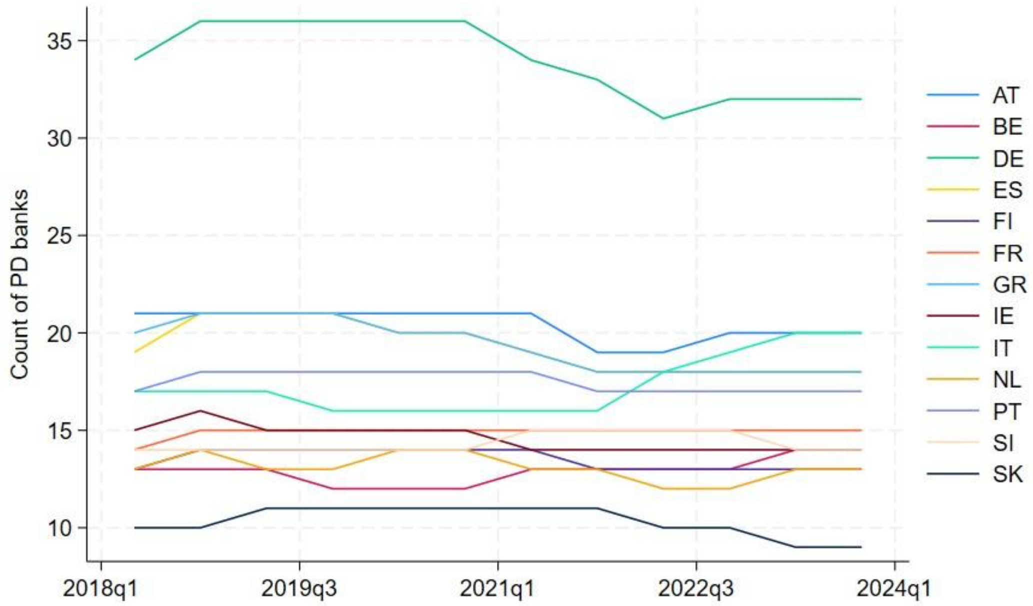
Figure 1 depicts the number of primary dealers by sovereign issuers and by year. We observe a net reduction in the size of the PD network in several countries since 2021. A potential explanation for this decline is that sovereign issuers increased emissions of sovereign debt to cope with extraordinary policies related to the Covid-19 pandemic and to take advantage of the loose monetary policies in place in the eurozone. As a result, primary dealers experienced unprecedented pressure to absorb such newly issued sovereign debt, which led to withdrawals in some cases. A case in point is the European bank NatWest that pulled out from its role in five countries in 2021. Kerr Finlayson of NatWest Markets, when asked comment on the decision stated:

"It's become increasingly more competitive since sovereign borrowing programmes increased due to Covid-19 but what has triggered banks to leave primary dealerships is the expensive cost to run the infrastructure. So our view was to pick our battles and use the finite resources of the bank to sharpen our European government bond offering and deliver value to customers in areas where we had the scale to compete".[2]

We also document a modest increase in the composition of primary dealer systems toward the end of the time window investigated. This trend analysis shows two important features. First, mainly European primary dealers stepped down from their role, while new members refer to non-European ones. This is consistent with practitioners' argument that a huge scale is needed to perform the task in a profitable and sustainable way. Second, increases in the number of primary dealers are more common among peripheral countries with a lower sovereign credit rating such as Italy. It follows that the reduction in membership refers to countries with higher ratings and lower sovereign yields. This evidence suggests that primary dealers may be eager to enter more volatile markets which are characterized by higher margins.

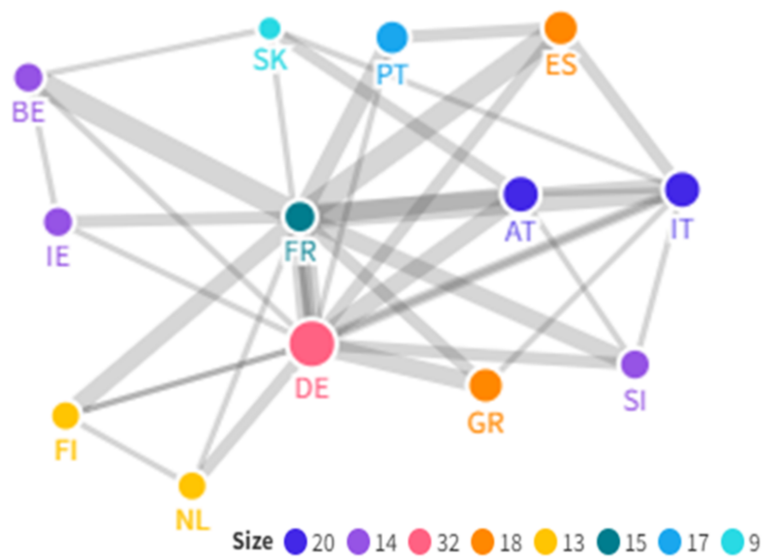
[2] See also for more details https://www.thebanker.com/Is-Europe-s-primary-dealership-model-fit-to-last-1643031147#:~:text=So%20what%20does%20the%20future,%2C%E2%80%9D%20says%20ING's%20Mr%20Delcour.

Figure 1: Number of primary dealers by sovereign issuers and by year



We also perform a network analysis to map the interconnections within and across primary dealer systems in the eurozone. The German primary dealer system is the largest one as it comprises more than 30 primary dealers in the period investigated. Notably, primary dealers in Germany are connected to every other country in the eurozone in terms of PD network overlap. This is consistent with the role of German government securities (*Bund*) as key interest rate in the entire eurozone. Moreover, our evidence is consistent with a "home" bias, namely the tendency of primary dealers to cover neighboring countries. This is the case of Italy whose primary dealers are actively involved in neighboring countries (Austria, France, and Slovenia) as well. We also observe similar patterns in other countries such as Austria and Spain. We report the network analysis in Figure 2.

Figure 2: Network of primary dealers within the eurozone (as of December 2023)



Conclusion and discussion

Sovereign debt holds a central position within the European financial markets. Its primary function is to fund public goods and services, a role that has grown in significance alongside increasing debt levels, making it a notable political issue amid European financial integration and the adoption of the euro. As sovereign debt is primarily financed through bond issuance, these government securities are actively traded in financial markets, with their yields providing valuable information. Furthermore, government bonds have been utilized extensively by the ECB in unconventional monetary policy efforts aimed at controlling inflation and shaping inflation expectations.

Studying the structure and functioning of the primary and secondary markets for sovereign debt is crucial for understanding its broader economic and financial impacts, which can extend well beyond sovereign debt markets and even across national borders. Although these connections might not be apparent at first, their significance becomes evident when considering the essential role sovereign debt markets play in the European financial system.

The information generated by primary dealers could become an indicator (by means of disclosure) of the economic outlook of sovereign issuers. While this information is valuable for making investment choices in sovereign debt, it might also influence decisions on the allocation and pricing of corporate credit within the issuer's country (Grazioli and Mazzola 2024; Grazioli and Prencipe 2024). Interestingly, although a primary market relying on a primary dealer system and compulsory disclosure is beneficial for financial integration by lessening information imbalances, particularly across borders, such transparency might detrimentally impact financial stability. Even seemingly unfounded negative information concerning a sovereign could trigger repercussions like a credit squeeze for the corporate sector within that country. Do disclosures of primary dealers' allocations function as an alternative mechanism for aggregating information, or do they encounter limitations? Is information aggregation through a primary dealer network immune to impairments and noise generated under non-conventional monetary policies such as Quantitative Easing? Further research is needed to answer these empirical questions.

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