1. Definition, characteristics and advantages of a Primary Dealer System

2. Selected countries’ experience

3. Primary Dealers System in Mexico
Definition, characteristics and advantages of a Primary Dealer System

What is a Primary Dealer System?

- A primary dealer system is an agreement between a debt management office and a group of institutions to pursue a common strategy in support of the functioning and development of primary and secondary markets for government securities.¹

- Generally, with their status of Primary Dealers, institutions gain specific privileges and are subject to certain specialized functions or obligations within the government securities market.

Main objectives of a Primary Dealer System

1. Building a stable source of demand for securities in the primary and secondary markets.
2. Providing liquidity in the secondary market, fostering efficient price formation.
3. Building distribution channels and expanding the investor base, as primary dealers often act as intermediaries.
4. Promote public confidence in the integrity of the government securities market.

Potential advantages and disadvantages of implementing a Primary Dealer System

Disadvantages

1. Can potentially limit competition, as primary dealers acquire certain rights or advantages over other institutions.
2. Requires regular measuring and monitoring to ensure compliance.
3. Possible misconception of debt manager guaranteeing creditworthiness.

Advantages

1. Increases and ensures coverage at primary auctions.
2. Improves secondary market conditions.
3. For markets in an early development stage, a PD system can help ensure the development and proper functioning of the secondary market.
4. Can improve government access to financing as it can foster efficient price formation in the secondary market.
5. In some cases, it facilitates the implementation of monetary policy.
1. Definition, characteristics and advantages of a Primary Dealer System

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Selected countries’ experience: Development of Primary Dealer Systems

Year of Establishment of a Primary Dealer System

Source: Finance ministries, central banks and other national authorities.
Note: If the country appears more than once it is because there were important changes in their primary dealer system. The size of the circle represents the number of primary dealers in each country.
The selection criteria for primary dealers is related to their role in the primary and secondary markets for government securities, it also depends on the development of the country’s domestic financial market.

Rights are arrangements that should allow the primary dealers to perform efficiently and obligations are the commitments they make to perform certain activities.

<table>
<thead>
<tr>
<th>Country</th>
<th>Sufficient balance sheet capability</th>
<th>To be approved by a regulatory agency</th>
<th>Minimum market share</th>
<th>Staff and technological resources</th>
<th>Viable business plan</th>
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<thead>
<tr>
<th>Obligations</th>
<th>Country</th>
<th>Minimum participation in every auction</th>
<th>Participate in every auction</th>
<th>Provide information and data</th>
<th>Maintain a minimum market share</th>
<th>To avoid distortion to auction prices</th>
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<tr>
<th>Rights</th>
<th>Country</th>
<th>Preferred counterparty status</th>
<th>Consultation meetings</th>
<th>Securities lending facilities</th>
<th>Exclusive access to auctions</th>
<th>Access to exclusive electronic trading systems</th>
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Source: Finance ministries, central banks and other national authorities.
The arrangement between primary dealers and authorities must be transparent and responsibilities clearly defined. A continuous flow of communications among the ministry of finance, the central bank, and primary dealers is essential.²

Selected countries’ experience: Relationship with the authorities

- The arrangement between primary dealers and authorities must be transparent and responsibilities clearly defined. A continuous flow of communications among the ministry of finance, the central bank, and primary dealers is essential.²

Institutions Responsible for Supervision and Enforcement

<table>
<thead>
<tr>
<th>Country</th>
<th>Supervision</th>
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<tbody>
<tr>
<td>United Kingdom</td>
<td>Debt management agency</td>
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<tr>
<td>United States</td>
<td>Central Bank</td>
</tr>
<tr>
<td>India</td>
<td>Central Bank</td>
</tr>
<tr>
<td>Japan</td>
<td>Ministry of Finance</td>
</tr>
<tr>
<td>Brazil</td>
<td>National Treasury</td>
</tr>
<tr>
<td>Mexico</td>
<td>Central Bank and Ministry of Finance</td>
</tr>
</tbody>
</table>

Source: Finance ministries, central banks and other national authorities.

Recommendation of a Primary Dealer System

- Strongly recommended 55%
- Recommended 32%
- Weakly recommended 5%
- Not recommended 5%
- Uncertain 3%

Note: A survey questionnaire on primary dealers was sent by the IMF to 47 countries. Of the 39 respondents, 20 were advanced economies, 13 were emerging markets, and 6 were developing countries.


1. Definition, characteristics and advantages of a Primary Dealer System

2. Selected countries’ experience

3. Primary Dealers System in Mexico
Primary Dealers System in Mexico

- As a further step to develop Mexico’s debt markets and promote the liquidity of the secondary market, the Mexican Ministry of Finance established in 2000 a market-making program for government bonds.

- The program was initially established for MBonos and Cetes (nominal instruments). It was until 2008 that the program was also extended to Udibonos (Inflation-linked bonds).

- Throughout the program, 13 institutions have acquired a market-maker status. This number has diminished as some institutions have merged and others left. The maximum amount of institutions with such status at the same time has been of 10 from 2007 to 2008, and the minimum has been 5 in 2001 and 2002.

- Currently, there are seven market-makers for Cetes and MBonos that represent around 75% of the total market share. There are also four market-makers for Udibonos that account for 55% of the total market share.

### Market maker participants (2000-2019)

<table>
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<tr>
<th>Current</th>
<th>Previous</th>
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<tbody>
<tr>
<td>BBVA Bancomer*</td>
<td>Chase Manhattan Bank**</td>
</tr>
<tr>
<td>Banco Santander*</td>
<td>Citibank**</td>
</tr>
<tr>
<td>HSBC</td>
<td>Credit Suisse</td>
</tr>
<tr>
<td>Banamex*</td>
<td>Deutsche Bank</td>
</tr>
</tbody>
</table>

**Udibonos market maker**

**Merged with a current market maker**

Source: Banco de Mexico
## Primary Dealers System in Mexico: Characteristics

### Selection Criteria

- Declare their interest in participating in the program
- Active participation in primary and secondary markets
- Market share ≥ 7%

### Obligations

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>Primary Market Participation</td>
<td>Commitment to participate in primary auctions.</td>
</tr>
<tr>
<td>Secondary Market Participation</td>
<td>Provide two-way quotes for each of the securities they are market makers of, in all their maturities.</td>
</tr>
<tr>
<td>Comply with the Code of Conduct</td>
<td>Comply with the Code of Conduct for the money and fixed income market.</td>
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</table>

### Privileges

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Greenshoe” option</td>
<td>The right to buy up to an additional 20% of the Fixed-rate securities offered in the primary auction.</td>
</tr>
<tr>
<td>Securities lending facility</td>
<td>Borrowing privileges with the Central Bank.</td>
</tr>
<tr>
<td>Syndicated auctions</td>
<td>Exclusive access to syndicated auctions where they act as distributors.</td>
</tr>
</tbody>
</table>
Primary Dealers System in Mexico: Characteristics

Market Maker Index (Zero-coupon and MBonos) = Activity Index + Incentives - Penalizations

Market Maker Index (Inflation Linked Bonds) = Activity Index + Incentives - Penalizations

The Market Maker Indexes are calculated every month with a six month period.
Primary Dealers System in Mexico: Characteristics

“Greenshoe” Option

- Market makers are obligated to participate in primary auctions, by providing a minimum amount of bids. By complying with this obligation, market makers gain access to a “greenshoe” option.
- In the “greenshoe” option, market makers have the option to buy, in total, up to 25% of every issue offered in the primary auction a day before (depends of the type of instrument they are market makers of), at the same allocation price.

Advantages for issuer

1. Allows the debt manager to increase the allotted amount of debt.
2. The additional debt is allotted at the same price of the primary auction, eliminating any risk related with less competitive pricing dynamics.
3. Makes the program more attractive.

Advantages for market makers

1. Depending in market conditions, the market makers have the opportunity to buy an additional amount of instruments at a lower price than the one in the secondary market.
2. Allows market makers to meet large demand from clients that could not be fulfilled through the primary auction.
Primary Dealers System in Mexico: Characteristics

“Greenshoe” Option

For Zero-coupon bonds, **94.3%** of the times the option is partially or completely exercised.

*Data since 2001

For Mbonos, **60.3%** of the times the option is partially or completely exercised.

*Data since 2001

For Inflation-linked bonds, **49.6%** of the times the option is partially or completely exercised.

*Data since 2008

Source: Banco de México.
Primary Dealers System in Mexico: Characteristics

Participation in the Secondary Market

- Another obligation for market makers is being active in the secondary market by providing competitive two-way quotes through brokers.
- Market makers must present competitive quotes for each of the securities they are market makers of, in all their maturities.
- If market makers comply with a minimum amount of quoted amount, they are granted with a basis points incentive (maximum 90bp) which will be added to their market share. In the contrary, if they fail to comply with the minimum amount, they are penalized with basis points that will be subtracted from their market share (maximum 30pb).

**Competitiveness** ➔ Competitive quotes, measured by the difference between the quoted rate and the rate in the two adjacent trades, weighted by the time elapsed between the quote and the trades.

**Minimum Lifespan** ➔ Quotes live for more than 1 minute.

**Minimum amount** ➔ More than 20 million pesos in quotes for every issuance of the instruments the institution is market maker of, in a daily basis.

Incentives are defined by the daily average of the percentage of issuances that comply with the 20 million pesos requirement, in a monthly period.
Primary Dealers System in Mexico: Characteristics

Participation in the Secondary Market

- **Daily quoted amount for Mbonos by type of institution**
  - Millions of pesos (Moving average 20 days)
  - Source: Brokers

- **Daily average of the quoted amount for Mbonos in 2019 by maturity**
  - Millions of pesos
  - Source: Banco de México

- **Intraday Quotes in August 19, 2019 for the Mbono maturing in Dec-24**
  - Percentage
  - Note: The size of the sphere represents the amount quoted.
  - Source: Brokers

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**Source:** Brokers
Primary Dealers System in Mexico: Characteristics

Participation in the Secondary Market

**Daily quoted amount for Udibonos by type of institution**

Millions of pesos (Moving average 20 days)

- **Market Makers**
- **Other Institutions**

![Graph showing daily quoted amount for Udibonos by type of institution.]

**Daily average of the quoted amount for Udibonos in 2019 by maturity**

Millions of pesos

- **Market maker**
- **Other Institutions**

![Graph showing daily average of the quoted amount for Udibonos in 2019 by maturity.]

**Intraday Quotes in August 19, 2019 for the Udibono maturing in Jun-22**

- **Percentage**

![Graph showing intraday quotes for the Udibono maturing in Jun-22.]

Note: The size of the sphere represents the amount quoted.

Source: Brokers
Primary Dealers System in Mexico: Characteristics

Securities lending facility

• Market makers have borrowing privileges with the Central Bank. They have access to a Mbonos, zero-coupon bonds and inflation-linked bonds lending facility even if they act as market makers of that particular instrument or not.

• The right to the securities lending facility is suspended for those market makers with positions for a single issue of Bonos or Udibonos that exceed 35% of the amount placed in each issue.

• In order to foster the development of securities lending in the secondary market, in October 2007, the cost for the securities lending facility was adjusted and established as a function of each market maker’s securities lending activity in the market, with different participants than the Central Bank.

• The cost of Cetes and Bonos lending for market makers varies by participant:
  • For a market maker in a particular instrument, the cost of lending is a percentage of the government funding rate. The cost represents between 3% and 7% of the government funding rate.
  • For an institution that is not a market maker of that particular instrument, the facility is also an option but the cost is 100% of the funding rate.

Advantages for market makers

1. Immediate disposition of any government security.
2. Possibility of fulfilling a client’s demand for Mexican securities immediately.
3. Ease in compliance with the duty of continuously quoting purchase and sale prices for fixed-rate government securities in the secondary market.
Primary Dealers System in Mexico: Characteristics

Securities lending facility

Government securities lending costs
Percentage of funding rate

- Average lending cost in private market (moving average 20 days)
- Average lending cost in Mbono market makers facility (moving average 20 days)
- Average lending cost in Udibono market makers facility (moving average 20 days)

Source: Banco de México.

Securities lending facility as percentage of the limit by instrument (capacity)
Percent

Foreign investors bond flows and securities lendings bond flows for MBonos
Millions of pesos (20-day moving average)

Source: Banco de México.
Primary Dealers System in Mexico: Characteristics

Incentives for operations in Mexican Derivatives Market

• Within the eligibility criteria in the Market Maker Index for Mbonos and Cetes, is the operations in the Mexican Derivatives Markets (MexDer), which is the institution authorized by the Mexican Ministry of Finance in charge of providing the facilities and services needed so the derivative contracts are quoted and negotiated.

• The points for activity in the derivatives market are calculated as follow:

  \[ \text{Points for competitive quotes + Points for operated contracts} \]

  • Up to 70 basis points for competitive quotes in Mbonos and zero-coupon bonds future contracts.
  • Up to 40 additional basis points if the institution operates 40,000 or more future contracts.
Market makers have contributed both to make the primary market of securities more efficient and sophisticated and to develop the securities’ secondary market. When the Market Maker Program was first implemented in 2000, the government domestic financing revolved around short-term instruments and floating-rate coupon bonds. Likewise, the level of domestic debt placed through market instruments accounted for only 8% of GDP.

At the beginning, the Market Maker Program considered only Cetes and 3-year fixed rate nominal bonds created in January of 2000. In May, a 5-year bono was placed. In tandem with the development of the Market Maker Program, the maturities of fixed rate placements extended to 10, 20 and 30 years, respectively. At the end of 2013, and having the entire fixed rate yield curve developed, these instruments accounted for 53% of the total amount of government securities and 23% of GDP.

Yield Curve development

![Graph showing yield curve development](Source: Banco de México.)

Evolution of Mexican yield curve

![Graph showing evolution of Mexican yield curve](Source: Banco de México.)

Average maturity of Government securities

![Graph showing average maturity of government securities](Source: Banco de México.)
Market makers have reinforced the primary placement of securities. Ever since there are market makers for each type of instrument, no auction of Cetes, Bonos and Udibonos has been declared void.

Source: Banco de Mexico.
Market makers have played a key role in the new way of placing domestic government debt.

Traditional primary auctions have an average amount of 5,000 million pesos (MoP) for Bonos and 500 million udis (MoU) for Udibonos and take place at a staggered frequency (not less than every four weeks).

As of 2010, and with the purpose of increasing more rapidly the size and relative liquidity of the new issues of Bonos and Udibonos, the Ministry of Finance began carrying out syndicated placements, where market makers acted as primary and secondary underwriters.

In July 2011, this scheme was modified to a syndicated auction, where market makers act as distributors presenting their clients’ bids. In any of the two modalities, in this novel way of placing new issues, such issues reach a higher outstanding amount (up to 30 billion pesos in the case of Bonos and 3.5 billion udis in the case of Udibonos) in a single exhibition.

Source: Banco de México.
Primary Dealers System in Mexico: Development and Contributions

**Broadening of the investor base**

- Syndicated auctions favored the inclusion of Bonos in FTSE World Government Bonds Index (WGBI) as one of the conditions to participate in this index is that issues must have an outstanding amount equivalent to 10 billion pesos, at least.
- In October 2010, Mexico became the first Latin American country to be considered in this index.
- This event, coupled with a more developed market, attracted a more diverse investor base, specifically non-resident investors.

**Non-residents’ holdings of government bonds in local currency**

*As percentage of total outstanding debt*

Note: Average by region of the percentage of ownership of local bonds denominated in local currency by foreigners from the following countries: Mexico, Peru, Colombia, Brazil, Indonesia, Malaysia, Thailand, Poland, Turkey, Israel, Russia, Hungary, South Africa and South Korea (enters since December 2009). The vertical black line represents the moment when Mexico became part of the WGBI.

Source: Finance ministries, central banks and other national authorities.

**Non-residents’ holdings of government bonds of selected countries in local currency**

*As percentage of total outstanding debt*

Note: *Mexico enters the WGBI in October 2010. **On October 31, 2018, JP Morgan increases Colombia’s participation in the GBI-EM index.*

Source: Finance ministries, central banks and other national authorities.
Trading volumes

- Market makers have contributed both, to make the primary market of securities more efficient and sophisticated and to develop the securities’ secondary market.
Primary Dealers System in Mexico: Development and Contributions

Market operation conditions and price formation

- The program has contributed to building efficient and sound market conditions. A liquid and deep market, coupled with an increase in the number of market players, have fostered an efficient price formation.

MBonos bid-ask spread for selected maturities
Basis points (10 days moving average)

MBonos Amihud’s depth index for selected maturities
Basis points (20 days moving average)

Mexican government Bonos’ monthly turnover
Monthly operations/average outstanding amount

Source: Banco de México.
Primary Dealers System in Mexico: Development and Contributions

Derivatives market development

- The development of the fixed income market laid the groundwork for other markets, such as the derivative market.
- The interest rate swap market in Mexico is one of the most traded compared to other emerging markets.

Traded Volume of Mexican interest rate swaps
Millions of Mexican pesos

Traded Volume of Interest Rate Swaps (IRS) for selected countries
Millions of US dollars

Source: DTCC.
Primary Dealers System in Mexico: Development and Contributions

**Derivatives market development**

- A liquid and deep IRS market is paramount, as implied information regarding monetary policy can be obtained from these instruments.

### Implied target rate in the TIIE swap curve

<table>
<thead>
<tr>
<th>Percent</th>
<th>Rest of period</th>
<th>Reference rate</th>
<th>Last monetary policy decision</th>
<th>Last data</th>
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</table>

Source: PIP with calculations from Banco de Mexico.

### Implied target rate in TIIE interest rate swaps and Mexican peso

<table>
<thead>
<tr>
<th>Pesos per dollar and percent</th>
<th>Aug-19</th>
<th>Sep-19</th>
<th>Dec-19</th>
<th>Jan-20</th>
<th>Mexican Peso</th>
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Source: PIP with calculations from Banco de Mexico.
Market intelligence

- With the purpose of having a more “complete picture” of market conditions, the Central Bank of Mexico maintains regular communication with market makers.

**Daily**
- These consultations are usually done by telephone or chat.
- Promote a direct information exchange with market makers.
- The Central Bank of Mexico is kept informed about relevant developments in the market.
- Market color provided by market makers complements Central Bank’s analysis of the market dynamics.

**Examples of the type of information provided by Market Makers**
- What types of counterparts the market makers have been dealing with
- What kind of securities they have traded
- The depth of market liquidity
- Prices at which the investors are willing to subscribe
- Volumes, the number of sellers and buyers.

**Quarterly**
- Face-to-face meetings that allow the Central Bank of Mexico to learn the practical and detailed experience of the market makers.
- The objective is to improve the structure of the program by discussing:
  - Market structure and development
  - Enhancing transparency in the market
  - Protect investors
  - Reducing systemic risk
  - Design of the obligations and privileges
Primary Dealers System in Mexico: Challenges

Securities Lending

- Securities lending operations are a key fundamental factor to develop the depth of fixed income and equity markets, and are commonly used in developed markets around the world.
- Market makers in Mexico have access to a securities lending facility as a privilege.
- As a result of implementing differentiated cost for the securities lending facility, from being practically inexistent at the beginning of 2008, the amount outstanding in securities lending has increased considerably.

Amount outstanding in Securities Lending (Mbonos and Inflation-linked bonds)

Source: Banco de México.
Primary Dealers System in Mexico: Challenges

Securities Lending

- However, data shows that securities lending activity is still on initial stages in the local market, as the outstanding amount of loans with government securities represents only between 1% and 2% of the outstanding amount of government debt.
- Private market participants are still reluctant to engage in securities lending activity among each other, and they prefer to perform this activity with the Central Bank. Pension Funds are the most active participants, although their lending activity is far from what they are capable of.

Securities Lending Daily Volume among private participants (Mbonos and Inflation-linked bonds)

Pension Fund’s Holdings and Securities Lending (Mbonos and Inflation-linked bonds)

Source: Banco de México.
Further development of the inflation-linked bonds market

- As mentioned before, inflation-linked bonds (Udibonos) were included to the Market Makers Program in 2008. For many years, the status of market maker of Udibonos was conditioned by being a market maker for Bonos. In 2018, this condition was removed, allowing different institutions to participate in the Udibonos program.
- Since inflation-linked bonds were included in the Market Makers Program, we have seen important improvements and development in this market.
- However, trading volume, market conditions and investor base for inflation-linked bonds still have room for improvement compared to the nominal bonds market.

Primary Dealers System in Mexico: Challenges

### Further development of the inflation-linked bonds market

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<th>Market Makers</th>
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<td>14.8%</td>
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<td>Market Share</td>
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<td>76.2%</td>
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### Daily Turnover of Bonos and Udibonos

- Daily operations/outstanding amount (20-day moving average)

### Holdings of government securities by sector

- Inflation-linked bonds
- Bonos
- Udibonos

Source: Banco de México.