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FINANCIAL SECTOR DEVELOPMENT PROJECT

USAID/MOROCCO

SECONDARY MARKET FOR SHORT-TERM DEBT INSTRUMENTS

FINAL REPORT

July 12, 1991

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Price Waterhouse

July 12, 1991

Mr. T. Mark Kraczkiewicz
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Dear Mr. Kraczkiewicz:

Re: AID/PRE Financial Sector Development Project
Contract No. PDC-2206-Z-00-8191-00
USAID/Morocco - Secondary Market for Short-Term
Debt Instruments

Enclosed please find 2 copies of our Final Report (English version) regarding the creation of a Secondary Market for Short-Term Debt Instruments in Morocco. Two copies have been forwarded to Sandra Frydman, AID/PRE/PD and an additional 20 copies are being sent to you by surface mail. The French version of the report is under preparation and 50 copies will be sent to you shortly.

It has been a pleasure working with USAID/Morocco on this important assignment. We look forward to further collaboration with you in the future.

Very truly yours,

Mr. J. Richard Breen
Project Director, FSDP

Attachments

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EXECUTIVE SUMMARY

Since 1983, the Government of Morocco has pursued a financial sector reform program which impacts virtually all segments of the economy. As a part of the reform program, USAID, on behalf of the Ministry of Finance, contracted with Price Waterhouse to study the creation of a secondary market for short-term debt instruments. The study was conducted in September and October of 1990. Presented below are the principal findings and conclusions related to the creation of a secondary market, followed by recommendations for its development.

The Moroccan Financial Sector

In addition to the Bank Al-Maghrib (the Central Bank) and the Treasury, the Moroccan financial sector consists principally of fifteen commercial banks, five specialized financial institutions (SFIs) and twenty insurance companies. The two largest banks, Credit Populaire du Maroc (CPM) and Banque Marocaine du Commerce Exterieur (BMCE), controlled 51% of bank assets at year-end 1989. The six medium-sized banks held 42% of bank assets and the seven smaller banks accounted for the remaining 7% of the total bank assets of 87.6 billion Dh at year-end 1989.

The banking system is generally characterized by stability, high profitability, risk aversion and low loan losses. Competition is limited mainly because of stringent government regulation. Banks are extremely selective in lending, and in 1989 about 81% of all credits were short-term.

Until 1990, most lending and deposit rates were government controlled. As of January 1990, the short term borrowing rate was freed and only the three month deposit rate remained controlled.

Under the system of credit ceilings, known as "encadrement", in effect at the time of the field work, the Central Bank set an annual limit for the net increase in certain loans made by the commercial banks.[1] Several types of credits were non-restricted, such as export credits, medium-term loans and grain and cereal credits. In 1989, 25% of all loans were outside the encadrement system.

Another important aspect of bank regulation concerns the mandated purchases of low yielding government bonds in an amount equal to 35% of sight deposits. This "plancher" requirement, combined with reserve and credit allocation requirements, result in over 60% of the banks' sight deposits being obligated in some way. In addition, banks have daily liquidity requirements which, if a shortage occurs, may only be met through the interbank market or by rediscounts or advances from the Central Bank.

Commercial paper has become a popular means for banks to arrange financing for customers outside of the credit ceilings and to generate fee income. The volume of commercial paper rose rapidly from 1986 to 1989, but a ceiling was placed on its further growth last year.

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[1] In early 1991, the Moroccan authorities announced that this system would be replaced. This report does not attempt to explain the impact of these announced changes which were made following completion of the team's field work.

Other Financial Organizations

The five specialized financial institutions (SFIs) held 35 billion Dh of consolidated assets at the end of 1989, about equal to 40% of the size of commercial bank assets. The Caisse de Dépôt et de Gestion (CDG) receives the deposits of the Caisse Nationale de la Securite Sociale (CNSS), and the Caisse d'Epargne Nationale, as well as other deposits and consignments. It utilizes these resources essentially on the Moroccan financial market.

The insurance industry consists of twenty companies with combined assets of about 9.5 billion Dh. The companies are tightly regulated by the Ministry of Finance and are required to invest 60% of technical reserves in bonds issued or guaranteed by the Government.

Treasury Instruments

When the Government began issuing short-term debt instruments about three years ago, the banks could buy them at rates set by the Government.

In October 1989, the Treasury began auctioning 3, 6 and 12 month instruments at market rates. Subsequently, auctions were held weekly for the 1, 3, 5, 13, 26 and 52 week Treasury bill issues.

As of August 1990, there were 24 types of domestic Government debt outstanding, including 10 short-term, 9 medium-term and 5 long-term. Short-term domestic debt totalled 29,209 million Dh or approximately 50% of the total. Of this short-term debt, 6 billion Dh is owed to the BMCE and 14,184 million Dh is low yielding paper held by the banks to satisfy the "plancher" requirement. Included in the medium-term debt are Treasury notes known as Emprunts Nationaux ("EN") which are sold to individuals and non-financial institutions. Banks and insurance companies may buy these from third parties the day after issue.

The Role of a Secondary Market

When a secondary market works well, it provides a competitive, free, private market for the distribution of securities, permitting institutions, corporations and private individuals to purchase or sell them in small or large volumes at market-determined prices.

Importantly, it allows banks to adjust their liquidity positions without borrowing from the Central Bank - a key element in making the transition from direct to indirect control of the money supply. Furthermore, it provides a vehicle for the monetary authorities to influence bank liquidity positions, bank willingness to extend credit, and the general structure of interest rates. In developed economies, this is accomplished through the use of open market operations.

Finally, it is the role of a secondary market to establish a reference rate from which all other rates can be measured in order to make decisions concerning investments or sales of securities over the full range of maturities. Secondary markets are usually organized around primary dealers who operate in the auction market, underwriting issues of government securities and holding significant inventories of such securities. The primary dealers are normally the largest banks who have accepted the benefits, responsibilities and special capital and supervision requirements associated with being a dealer.

To function effectively, secondary markets need extensive publicity on the volumes traded, the range and average rates for transactions in both the primary and secondary markets, and the types of issues and maturities traded.

Why Create a Secondary Market in Morocco?

Overall, a secondary market would provide significant benefits to the Treasury, the Central Bank, public investors and business borrowers. Specifically, assuming the public is adequately informed, the market provides a place where Treasury debt can be sold to a broader number of purchasers in increased volumes with immediate liquidity. It creates a means to marshal new savings because competition brings better prices and improved services.

Over time, it may encourage the realignment of tax, maturity, and rate relationships and could be a basic source for new short-term business borrowings, supporting economic growth. It also provides another way for banks to adjust liquidity without borrowing at the Central Bank and supports the concept of financial sector reform.

Why Not Just Use the Interbank Market?

The interbank market suffers from several deficiencies. Most notably, it furnishes only a small volume of credit compared to Central Bank advances and provides no rate leadership. By its very nature this market accesses mainly bank liquidity and does little to tap liquidity from elsewhere in the economy. It appears that liquidity is largely provided by banks with low loan ratios - mainly the public and quasi-public financial institutions.

The secondary market meets all of the deficiencies in the interbank market and more. In particular, it: 1) provides a base from which trading in Treasury bills can evolve into trading in securities of even the longest maturities; 2) raises the level of competition between banks, and among banks and non-bank financial firms; and 3) contributes rate information to the private investor.

Finally, without a secondary market, control of the money supply will remain very difficult: if restraint is applied to the volume of money and credit, then the interbank market could not cope with the demand for credit and banks would continue to rely on access to the Central Bank. Moreover, little credit could be supplied to the private market diminishing the announced goal of private sector development and injections of private capital into the Moroccan economy.

Recommendations

It is recommended that a secondary market for short-term Treasury bills of 3, 6, and 12 months maturity be created in Morocco in 1991.

Recognizing that the legacy of a tightly controlled environment under encadrement entails some resistance to change, the recommendation is for a small step toward the implementation of reform at this time. Trading in other products, such as commercial paper or bankers acceptances, might be considered in a later phase of market development.

The greatest changes recommended encompass the designation of dealers for the primary (or auction) market to underwrite new short-term Treasury bill issues and the concomitant steps to link those dealers to a secondary market. Toward that end, the authorities will need to establish the criteria and process for selecting dealers and to clearly define the dealer's responsibilities and supervisory requirements.

Similarly, the monetary authorities will need to decide such issues as when and to what degree they will use discount rates as a reference rate or to communicate policy messages to the banks, and when to begin the phase-out of all Treasury bill issues except the 3, 6, and 12 month maturities so that sufficient trading volumes can develop. Timing the transition to indirect control procedures and effectively communicating the changes and the resulting rate information must be handled. Certain operational issues must also be addressed. In this regard, book entry is already available through the Central Bank and reserve accounts can be used for settlement and record keeping.

Among the benefits to be achieved through the development of a secondary market, in addition to those cited above, are several tied to the financial sector reform program. In particular, a secondary market encourages increased competition in the banking sector, an increased supply of funds to finance private sector development and reduced costs of intermediation. The new market would enable greater indirect control of the money supply by creating a place where open market operations could be developed by the Central Bank.

Commercial bank decisions on whether or not to seek dealer status and their degree of participation in the secondary market will call for a careful analysis of such issues as their financial and managerial strengths and likely success in a more competitive banking environment.

I. INTRODUCTION

A. Background

As a part of the overall program of financial sector reform begun by Morocco, USAID, on behalf of the Ministry of Finance, contracted with Price Waterhouse to provide technical assistance under the Financial Sector Development Project. A report entitled "Technical Assistance for Financial Sector Reform," dated March 7, 1990, was submitted to USAID and the Ministry of Finance. That report suggested various studies be conducted in three separate phases, beginning with the creation of a secondary debt market for short-term debt instruments (or "money market") and revitalization of the Bourse. Both studies were completed in October, 1990.

This study on a secondary market for short-term debt instruments analyzes the alternatives, operational problems and means of creating such a market in Morocco. Among the questions that this study is intended to answer are the following:

- What would be the benefits to Morocco of establishing such a secondary debt market?
- What conditions are necessary for a secondary market for debt instruments to function successfully in Morocco?
- How would the establishment of a secondary market affect monetary policy and debt financing? Which administrative controls might need to be modified or eliminated to make a secondary market effective?
- Who are the potential suppliers and demanders of credit in the secondary market?
- What institutions might serve as primary dealers?
- To what extent are the banks, non-bank financial institutions and private companies interested in the development of a secondary market? How can their participation be encouraged?
- What would be a feasible plan for the development of a secondary market in Morocco? What are some key issues which will need to be addressed?

B. Project Management and Staffing

The services of Dr. Philip E. Coldwell, as Senior Financial Markets Expert and team leader, and Mr. Edward K. Dey, as Money and Banking Economist, were engaged to carry out this work. Technical support was provided by Ms. Julia J. Philipp of Price Waterhouse. The field work started in mid-September and was completed at the end of October, 1990. The consultants conducted interviews with senior officials representing the Ministry of Finance, Bank Al-Maghrib, the banking sector, specialized financial institutions, insurance companies and private companies. A list of those persons interviewed is contained in Appendix F.

II. THE MOROCCAN FINANCIAL SECTOR

Since 1983 the Government of Morocco has pursued a program of financial sector reform, including gradual deregulation of the financial sector. These reforms impact virtually every sector of the economy and condition the environment within which a secondary market for short-term debt instruments could be established. In order to assess the feasibility of creating a secondary market in Morocco, therefore, it is important to understand how the financial sector is structured, managed and regulated and the nature of the important reforms which are taking place.

The following section presents an overview of the Moroccan financial sector, focusing on banks, non-bank financial institutions, and private investors and borrowers. It describes the system of bank regulation in light of past practices and expected reforms, and it provides background information on public financing and the debt auction system.

This section is not meant to provide an exhaustive study of the Moroccan financial sector and reform program. This subject has received considerable attention in the reports of other organizations, such as the World Bank and the International Monetary Fund. Instead, it highlights key aspects of the financial sector and the reform program of relevance to the creation of a secondary market in short-term debt instruments.

A. Commercial Banks

In addition to the Bank Al-Maghrib and the Treasury, the financial sector consists principally of fifteen commercial banks, five specialized financial institutions (SFIs) and twenty insurance companies. As in many developing countries, the banking system dominates the financial sector.

The two largest banks are the Banque Marocaine du Commerce Extérieur (BMCE) and the Crédit Populaire du Maroc (CPM). Together they controlled 51% of bank assets at year-end 1989. The six medium-sized banks accounted for 42% of bank deposits and the seven smaller banks held approximately 7% of bank assets at year-end 1989. Nationwide, total assets of the banking system on a consolidated basis were 87.6 billion Dh at year-end 1989.

Most banks are privately owned. The three banks belonging totally or partially to the Government (the BMCE, the CPM and the BNDE) are on an official list of organizations to be privatized. Several banks have minority foreign participation. With the exception of Citibank, which is 75% foreign owned, all banks are majority owned by Moroccans.

The banking system is generally characterized by stability, high profitability, risk aversion and low loan losses. Competition among the banks is limited, mostly due to stringent government regulation. Capital requirements were increased recently to 100 million Dh per bank due to the undercapitalization of many banks. The monetary authorities acknowledge the need to gradually increase bank capital requirements in the coming years. Increased bank capital will become especially important if Morocco is to follow up on its program of stimulating increased competition in the banking sector.

Credit ceilings on loanable funds allow banks to be extremely selective in their lending decisions. Most bank lending tends to be to the larger, well-established clients and is heavily backed by collateral and/or personal guarantees. Although there has been some increase in medium and long-term lending in recent years, most banks prefer short-term loans. In fact, in 1989, approximately 85% of bank lending was short-term.

1. Regulatory Framework

Until very recently, most deposit and lending rates were controlled by the Government. On July 1, 1990, controls on all deposit rates were lifted except for the three-month deposit rate; the Government has not yet set a date for the deregulation of the three month deposit rate. On October 1, 1990, ceilings on medium and long-term lending rates were lifted. Beginning in January 1991, the short-term borrowing rate was freed.

Under the system of credit ceilings, known as "encadrement", in effect at the time of the field work, the Central Bank sets an annual limit for the net increase in certain loans made by the commercial banks. Each bank is given a ceiling for the amount by which its own portfolio of controlled credits may increase. The fact that banks must fall within their credit ceilings by the end of each month leads to a peculiar situation in which banks work furiously toward the end of each month to adjust their portfolios, as the penalties for exceeding the credit ceilings are quite severe. Several types of preferred credits are not subject to the credit ceilings. These are export credits, medium-term loans (2-7 years) and grain or cereal credits. In 1989, 25% of credits were outside of the encadrement system or 9 billion Dh out of a total of 36 billion Dh in credits.

A certain portion of bank credit is channelled into priority sectors. The banks must extend credit representing 11.5% of the total of their sight deposits to the financing of housing and tourism (6%) and to medium-term and investment credits (5.5%). If a bank does not manage to satisfy this requirement, it must buy and hold bonds of the specialized finance organizations pertaining to these sectors. In addition, the banks must subscribe 3.5% of their deposits to Caisse Nationale de Credit Agricole (CNCA) bonds.

In addition, the banks must invest 35% of sight deposits in government bonds yielding 4.25% (known as the "plancher" - in essence a low cost loan to the Treasury). An additional 12% of

sight deposits are held in non-remunerated accounts at the Central Bank as reserve requirements. All together, over 60% of sight deposits are obligated in some way, giving the banks limited discretionary resources and reducing the amount of credit available to finance non-targeted private borrowers.

The banks also have liquidity requirements that must be met daily, and because a large proportion of lending is by overdrafts, liquidity must be kept relatively high. A bank that finds itself short of liquidity has three options. First, it can rediscount eligible paper at the Central Bank at extremely favorable rates. For example, a bank can rediscount a medium-term loan on which a customer might pay 12% and get a loan from the Central Bank at a rate of 7% - a benefit of 5%. Banks also get very attractive rediscount rates on export credits. Such rediscounts irrevocably transfer the loan to the Central Bank.

Not all banks are in a position to take advantage of the rediscounting facility. Banks must have export credits in excess of 4% of their sight deposits before they can rediscount their surplus loans. A formula also determines what portion, if any, of investment credits can be rediscounted.

A second option for banks who are short of liquidity is to phone the other banks directly and arrange to borrow in the interbank market. Unlike the industrialized countries, where interbank rates are widely known and quoted and where well-run banks are able to arrange financing through brokers, the Moroccan interbank market depends on an expectation that one will be able to find or place the necessary liquidity with another eligible institution. The interbank market operates in a relatively small way compared to the liquidity provided by the Bank Al-Magrib. Unless there were a major enlargement of the interbank market, both in terms of participants and volume, the banks would not be able to rely upon that market to meet their shortages of liquidity and would have to continue to borrow from the Central Bank. This would complicate control over the money supply.

According to one banker, interbank rates vary from 8-9% when there is a lot of liquidity in the system to 12% when there is very little liquidity. There is little variation in rates from bank to bank on any given day. Several banks said that the one week Treasury bill auction rate serves as an approximate reference rate in setting interbank rates, but there is no commonly accepted or published reference rate.

A third and less desirable option is to get an advance at a more expensive rate from the Central Bank. In order to get such an advance (for either one, three or seven days), a bank must have a portfolio of voluntarily acquired short-term treasury bills equal to at least 80% of the amount being borrowed. Every fifteen days, the Central Bank notifies the bankers' association of the rates in effect for the next fifteen day period. The bankers' association then notifies the banks by telex.

In order to discourage the banks from borrowing frequently from the Central Bank, the banks are charged several percentage points more than the interbank lending rates. The Central Bank

advance rates went as high as 13.25% in 1989 and ranged from 11-11.25% from September 26 to October 9, 1990. There is no publicly defined limit as to how much or how often the banks can borrow from the Central Bank. As we understand it, if a bank waits until after 4:00 PM to request Central Bank credit, it is charged the "hell rate" (taux d'enfer) which at the writing of this report was 18%.

A number of bankers were asked what they do when they have excess liquidity and want to invest it for a short time period. When possible, they said, they lend in the interbank market which is the most flexible and liquid. Sometimes, however, all of the banks are flush with cash and there are no interbank borrowers. In this case, the banks might buy short-term treasury bills (described below). Because of the credit ceilings, they are not able to provide additional loans.

2. Treasury Instruments

When the Government began issuing short-term debt instruments about three years ago, the banks could buy them at any time by telephoning the Central Bank. Several maturities of debt were available at rates that were fixed by the Government. This type of market is sometimes referred to as a tap market because it can be accessed at almost any time.

In January 1989, the Treasury began auctioning 3, 6 and 12 month instruments at market rates.[2] The banks were still able to buy the one month bill in the tap market. At first, auctions were held twice a month, whereas they are now held weekly. The introduction of the auction system resulted in just a slight increase in the Treasury's borrowing rates (0.5% over the earlier rates - see Appendix A).

In addition to the auctions, the Central Bank made special issues to the Credit Populaire du Maroc (and now the BMCE) to meet any additional financing needs of the Treasury. The rate on these issues was set at the rate for short-term advances to the banks by the Central Bank, discouraging the Government from borrowing too much or too often from the BMCE. The monetary authorities set targets for reducing the amount of the BMCE debt to 6 billion Dh by end-December 1990 and 5 billion by the end of 1991.

At the present time, auctions are held each Wednesday at 11:00AM. On Tuesday of each week the banks submit their sealed bids to the Central Bank, indicating the amount and rate requested for each maturity. The official minimum amount for each bid is 5 million Dh. The bids are accepted according to a dutch auction process, with those banks offering the highest price to the Treasury being satisfied first. Settlement by book entry at the Central Bank occurs on Thursday. If the Treasury considers the bids for a particular maturity to be excessive, it may not issue the

[2] Then and now, if the banks' bids are viewed to be too high, the Treasury will not issue paper.

bills. The Central Bank then sends out a telex to the bankers' association indicating the amount of paper sold and the maximum rate accepted for each maturity, as well as the amount it originally proposed to sell of each maturity. The Central Bank does not reveal the range of rates at which the paper was sold.

In July 1990, the Government discontinued the tap market for 1 month Treasury bills and increased the range of maturities available through the auction to include the 1, 3 and 5 week bills. At the current time, instruments available through the weekly auction include the 1, 3, 5, 13, 26 and 52 week treasury bills. In addition, it was announced that the auctions would progressively be opened to a larger number of participants. Whereas previously only the banks and the SFIs (the CDG, CNCA, and BNDE) were allowed to participate, the insurance companies, and soon private enterprises, can also participate.

As of August 1990, there were 24 categories or types of outstanding public debt (see Appendix B). Of these various types of debt, 10 are short-term (one year or less), 9 are medium-term (two to five years) and 5 are long-term (six years and over).[3] Short-term debt totalled 29,209 million Dh. Of this amount, approximately 6 billion Dh is owed to the BMCE and 14,184 million Dh is low-yielding paper held by the banks to satisfy their 35% "plancher" requirements. An additional 2,432 million Dh is three month paper in certificate form that is typically rolled over for a final maturity of 6 months.[4] Consequently, the amount of short-term debt that could potentially be traded in a secondary market is 9,025 million Dh.

Included in the medium-term debt category are treasury notes referred to as Emprunts Nationaux ("EN"). These are available to individuals (including foreigners) and non-financial institutions. Banks and insurance companies are eligible to buy EN, but only from third parties beginning the day after the issue. Medium-term EN are quoted on the Bourse and account for a major portion of trading activity.

An EN issue occurred on September 28, 1990. The one year bond was offered at 10.5%, the three year bond was offered at 12% and the five year bond was offered at 13%. These ENs have a minimum denomination of 10,000 Dh and are available at over 1000 locations through the Treasury, the Banque Al-Maghrib and the banks.

The banks earn what they view as a small commission (0.4%) on the sale of government debt. Several banks said they make little to no effort to market treasury paper because of the lack of incentives and, in particular, because customers might reduce their bank balances in order to purchase treasury debt.

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[3] The Treasury defines short, medium and long-term differently. By their definition, short-term refers to debt with a maturity of 1 week to 3 years, medium-term refers to debt with a maturity of five years, and long-term refers to debt with a maturity of 10 to 15 years.

[4] The 3/6 month certificate, or "bons du Trésor á 6 mois sur formule," has an unusual feature in that it is issued at a discount, reaches par at the end of 3 months and bears interest on the face value for the remaining 3 months. The 3/6 month certificate debt is available in the denominations of 100, 500, 1000, 5000 and 10,000 Dh.

Interest on the Government securities is exempt. That on private organizations is included either in the corporate tax or in the general revenue tax.

Several bankers were asked their opinion on why there is no trading in Treasury bills. The most frequent response given was that it pays more to hold them to maturity. If a bank buys a three-month Treasury bill yielding, for example, 9.5% and collects three-month bank deposits on which it pays 8.0%, it makes a risk-free profit of 1.5%. Furthermore, if a bank suddenly needs liquidity, by having Treasury bills in its portfolio it is able to get a 1, 3 or 7 day advance from the Central Bank.

Although there is apparently no law forbidding the sale of government debt, some banks questioned whether the authorities would allow it since there is no law specifically permitting trading in government debt. Since most government debt held by the banks exists as a book entry at the Central Bank, little trading could take place without the explicit approval of the Central Bank.

3. Commercial Paper

Commercial paper has become a popular means for banks to arrange financing for customers outside of the credit ceilings and to generate fee income. The volume of commercial paper grew from 847 million Dh in 1986 to approximately 5,700 million Dh in 1989. Because of their concern over the rapid increase in commercial paper outstandings, the authorities announced that the volume in the second half of 1990 should not exceed the year-end December 1989 level. All issues of commercial paper must carry a bank endorsement and each bank has a ceiling for the amount of paper that can carry its endorsement.

Following a change in the regulations, the minimum maturity for commercial paper was increased from 10 days to one month and the maximum maturity is six months. By increasing the minimum maturity to one month, the banks can no longer get around the credit ceilings by arranging commercial paper that matures before month-end. Trading in commercial paper is allowed, but the banks cannot hold it in inventory for even a few days. Consequently, if a customer wants to sell some commercial paper, the banks must call around and find a purchaser first.

Caisse d'Epargne Nationale. Related to the banks is the Caisse d'Epargne Nationale (CEN) which is a semi-autonomous arm of the Office National des Postes et Télécommunications and subject to the financial oversight of the Ministry of Finance. It is similar to the postal checking system in France and, in fact, used to be part of the French postal system before independence. The CEN gathers deposits through a network of 600 post office branches, covering 85% of the communes in the country. It is a major repository of foreign workers' remittances.

In contrast to a commercial bank account paying 8.5% on deposits (taxable), the CEN pays 9% on deposits, free of VAT and withholding tax. At the end of 1989, the CEN held about 1.4 billion Dh in deposits. The drawback to the CEN is that it offers only one product, passbook savings, and service is said to be less efficient than that of the commercial banks. A proposal was approved by Parliament to modernize the system and possibly increase its range of products.

B. Specialized Finance Institutions

At 35 billion Dh at the end of 1989, the consolidated assets of the five specialized finance institutions (SFI) equalled about 40% of the size of the assets in the commercial banks. The Caisse de Dépôt et de Gestion (CDG), the biggest SFI, had 11 billion Dh in assets at year-end 1989. The CDG has for its purpose the centralization of funds of multiple origins, such as the deposits of the savings banks and social insurance program and administrative and judicial security deposits and consignments. Similarly, the CDG is charged with the management of certain services. The funds deposited at the CDG are essentially transformed, through the financial markets, into Government assets or guarantees by it and if necessary into shareholdings in the different economic sectors.

Other SFIs include the Banque Nationale pour le Développement Economique (BNDE) which provides long-term finance for industry and the Crédit Immobilier et Hôtelier (CIH) which finances housing and tourism. Both the BNDE and the CIH have been authorized for sale to the private sector. Finally, the Caisse Nationale de Crédit Agricole (CNCA) provides agricultural credit and the Caisse Marocaine des Marchés finances enterprises which are successful bidders on public markets.

C. Insurance Companies

The insurance industry consists of twenty companies with combined assets in 1990 of approximately 9.5 billion Dh. Five companies are reportedly undergoing reorganization due to financial difficulty. According to official published sources, insurance premiums grew from 906 million Dh in 1977 to 2,656 million Dh in 1987 (the latest year for which such information was available.)

Insurance companies are regulated by the Ministry of Finance. At least 60% of their technical reserves must be invested in either government bonds or those issued with a government guarantee. The remaining resources are restricted to investments in real estate, mortgages and securities listed on the Bourse, and only two percent may be invested freely (although individual transactions must be approved). In 1987, technical reserves for the industry totaled 9,631.6 million Dh.

The insurance companies put their liquid assets essentially into Government bonds or bonds guaranteed by it, at rates fixed by the Ministry of Finance.

Insurance companies are required to have a certain amount of liquid assets in order to pay out policyholders. As such, they could become major participants in a short-term debt market. At the present time, however, only 5% of their technical reserves may be held in short-term government securities. Insurance companies are frequent investors in commercial paper, primarily due to the attractive yields on CP.

D. Corporate Investors

While the investment preferences of corporations differ across companies and industries, certain anecdotal evidence underlines the need for a secondary market in short-term debt instruments. The following is a sampling of some of the problems facing corporate investors with excess liquidity in Morocco.

- A corporate investor said that in principle his company would like to purchase commercial paper as a short-term investment. His concern, however, was that without a liquid market in CP, he would not be able to sell it back prior to maturity if he discovered he needed cash. Under the current system, he would purchase CP only if the banker who acted as the intermediary would assure him that his company could re-sell it immediately if needed. The banks, however, are unable to inventory commercial paper even for a few days, as previously mentioned.

- One major company said it used to buy CP before the minimum maturity was changed to 30 days. Unable to forecast his company's cash needs for a full 30 days, he feared tying up his money for that length of time with no reliable market for re-selling it.

- One specialized financial institution told us that his organization was planning to purchase 120 million Dh of government paper at a date one week away. In the meantime, he had 120 million Dh that he wanted to invest. Interbank rates at that time were only 6-6.5% whereas his company was used to lending in the interbank market at much higher rates. Rather than create a situation in which certain borrowers in the interbank market might come to expect lower rates from him, he preferred to let his funds stay idle as he saw no other alternatives for investing his money. This situation, he said, exists frequently under encadrement.[5]

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[5] In a more developed economy, this company ("Company A") might have entered into a repurchase agreement. Another company in need of short-term liquidity ("Company B") might

E. Corporate Borrowers

As in the previous section, below are some comments made by corporations on their current borrowing practices and their problems in attaining short-term liquidity.

- One major company used to issue commercial paper to raise cash but now relies primarily on overdraft financing. This company is able to forecast its borrowing needs at the beginning of the year for the full year with less than a 10% margin of error which should enable it to take great advantage of the commercial paper market. Most of its domestic borrowing is in the form of bank overdrafts, however, because of the greater flexibility involved.

- One bank had a corporate borrower who wanted to raise 300 million Dh by issuing CP but had not been able to find an investor. One reason for the bank's inability to find an investor was the fact that the Treasury had just made a special bond issue to the insurance companies which had soaked up all of their liquidity.

- Another major company said it has never issued commercial paper because of a fear it might be sold to a rival company. It tends to borrow using a bank overdraft facility in the absence of other alternatives.

F. Reform of the Financial Sector

As part of its medium-term macroeconomic adjustment program, the Moroccan Government intends to implement reforms relating to monetary policy and the financial sector. Of particular importance to the establishment of a secondary market for short-term debt instruments, the authorities announced the end of the system of encadrement on January 1, 1991 and their intention to pursue a monetary policy based on the use of indirect controls. The main tools of monetary policy were to be the adjustment of discount rates, reserve requirements and ratios on assets, deposits and capital. (The adequacy of these tools to effect monetary policy and the problems that might arise are discussed in Section III.) Debt financing of the Treasury would take place increasingly through the auctioning of Treasury bills, and interest rate controls would be removed.

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have sold some securities worth 120 million Dh to Company A for the one week period. At the end of one week, Company A would return the securities to Company B, and Company B would pay Company A 120 million Dh plus interest. To guarantee the return of the 120 million Dh in cash, Company A would have temporary possession of 120 million Dh (or more) of Company B's securities.

While such reforms are desirable, the concern of many bankers was that the system of encadrement would be replaced by controls placing similar limitations on their lending practices and other operations. Rather than preparing eagerly for the "brave new world" of post-encadrement, the banks were waiting to see what new controls the authorities would put in their place and the degree of stringency of such controls. As these changes were made following completion of the team's field work, this report does not assess the impact of the announced reforms.

III. THE ROLE OF A SECONDARY MARKET

A. Description

Securities markets are normally divided into two components: the primary market and the secondary market. The primary market is the market for new issues of securities, as distinguished from the secondary market where previously issued securities are bought and sold. Dealers in the primary market have responsibilities to underwrite new issues at competitive rates, maintain large inventories in order to perform the role of marketmaker and keep larger capital positions to support their greater risks and market exposure.[6] In addition, the dealers are supervised to insure that they are performing their assigned functions in an equitable and efficient manner. In return, the special benefits provided to primary dealer organizations may include fees on underwriting government securities and sympathetic consideration of particular needs related to the carrying of large inventories.

The primary dealers are usually the largest banks who have accepted the benefits, responsibilities, and special capital and supervision requirements associated with being a primary dealer. There are often other dealers in the secondary market including stock brokers, investment bankers, and other large financial firms. (For more information on primary dealers in the U.S., see Appendix D: Federal Reserve Bank of New York - Primary Dealers Defined. A list of primary dealers in the U.S. appears at the end of Appendix E.)

When a secondary market works well, it provides a competitive, free, private market for the distribution of securities, permitting institutions, corporations, and private individuals the opportunity to purchase or sell in small or large volumes. In advanced countries, products sold and purchased include all maturities of government securities, commercial paper, tax anticipation certificates, repurchase agreements, bankers acceptances and specialized instruments meeting the needs of private borrowers (such as securitized credit inventories and stripped bonds).

If the secondary market is performing its designated functions, it permits banks to adjust their liquidity positions with reduced borrowing from the Central Bank either by selling or buying securities in the secondary market or participating in the interbank market. **Reducing the banks' access to Central Bank borrowing is a key element in making the transition from direct to indirect control over the money supply.** Of course, if the bank were severely short of liquid funds or unable to meet its reserve requirement, emergency access to Central Bank funds would be necessary.

In addition, the secondary market allows investors to purchase or sell securities at competitive free market prices, and companies offering new securities are able to adjust their positions on

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[6] To underwrite is to purchase a new issue of securities from the government, usually in a competitive bidding process, and to assume the risk of reselling them to investors, either directly or through brokers, at a spread.

a daily basis at current rates. Prices in the secondary market generally reflect the trend of interest rates but also specific factors such as the liquidity positions of banks, unusual market conditions resulting from excess supplies of saleable securities or shortages thereof, tax date considerations, and even the influence of holidays.

Another role of the secondary market is to provide a vehicle for monetary authorities to influence bank liquidity positions, bank willingness to extend credit, and the general structure of interest rates. This is accomplished by injecting or withdrawing reserve funds into or out of the market through the purchase or sale of securities from the Central Bank's own inventories. Such activities by the Central Bank are called open market operations and are a very important tool of monetary control.[7]

In addition to the direct impact of such operations on bank reserve positions, there is a psychological effect on participants in the secondary market. Moreover, there is an announcement impact if large volumes are undertaken or if the transactions are consummated at unusual times of the day or on unusual days such as just before or after a Central Bank policy meeting.

Finally, it is the role of a secondary market to establish a reference rate from which all other rates can be measured in order to make decisions concerning investments or sales of securities. Thus a reference rate for one year Treasury bills can, in a normal upward sloping yield curve, form the base for deciding the rates on other securities right up to the longest bond maturities. These judgments will reflect the appraisals of buyers and sellers as to the time value of money for the longer time periods in a continuum of rates against maturities.

To function effectively, secondary markets need extensive publicity on the volumes traded, the range and average rates for transactions in both the primary and secondary markets, and the types of issues and maturities bought and sold. In some countries this publicity is achieved by press attendance at the auctions and reports to the financial press about the results of the day's trading. Dealer associations or an aggressive press can provide the needed impetus to this publicity. In other situations, especially where such organizations do not exist and where the press is not sensitive to the need for public dissemination of this information, the responsibility for information releases falls on the monetary authorities or government press agency. Without this information, buyers and sellers would be unable to make informed judgments about the rates they should pay or receive.

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[7] The existence of a broad and active treasury debt market in the United States is very important to Federal Reserve policy implementation. The Federal Reserve uses open market operations as its primary tool in making adjustments to the volume of money and credit quickly. This report will not attempt to explain the complex system that has evolved in the United States. That subject is explained in full in a publication of the Federal Reserve Bank of New York entitled U.S. Monetary Policy and Financial Markets, available through U.S. A.I.D. or the Ministry of Finance.

B. Why Create a New Secondary Market in Morocco?

Overall, a secondary market could provide significant benefits to the Treasury, the Central Bank, public investors and business borrowers, and to the realization of financial industry reform. It improves liquidity adjustment procedures, increases the potential for reducing access to central bank credit, and supplements the interbank market. Moreover, it widens private sector participation in financial sector activities. Presented below are some of the specific benefits of a secondary market.

- Assuming that the public is adequately informed about it, a secondary market creates a means of marshalling new savings and provides a place where Treasury debt can be sold to a broader number of purchasers and in increased volumes. New government security purchasers will be attracted to a secondary market because competition tends to offer better prices. A well-run promotion campaign and a network of convenient offices will draw even greater numbers of investors to the market.

- A secondary market provides a place for investors to buy or sell securities with the assurance of immediate liquidity. Over time, it should develop into a broader market where new borrowers can obtain short-term business credit through primary issues.

- A secondary market offers an additional means for banks to adjust their liquidity outside direct central bank credit because the market permits use of the non-mandated portion of Treasury bill inventories as a source of liquidity. Moreover the secondary market provides a vehicle through which banks can gradually sell holdings of Treasury bills when the mandated purchase requirements are reduced.

- It should encourage a realignment of tax, maturity, and rate relationships over the spectrum of Treasury debt instruments as free market prices set the rewards for the time value of funds tied up over the longer maturities and adjust for the taxable or tax free status of the securities.[8]

- A secondary market assists in fulfilling another of the goals of the financial sector reform program which is to encourage greater competition in the banking sector. Banks with less recourse to the Central Bank for liquidity would increasingly compete for low-cost funds in the interbank and secondary markets. The banks then offering the lowest cost loans to customers would be able to increase their market share and earn potentially higher profits relative to their competitors. These rewards should stimulate bank managements and stockholders to become more innovative. These actions, in turn, should strengthen the move toward competitive rate determination and eventually establish a new channel for credit extentions to business.

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[8] See Appendix C on recommendations for the Treasury Debt Maturity Mix.

- Financial sector reform also would be assisted by the fact that limiting both routine and automatic access to Central Bank credit will improve control over the money supply and allow the Central Bank to truly perform the role of lender of last resort.

C. Why Not Just Use the Interbank Market?

Reliance on the interbank market as the sole source of liquidity outside of the Central Bank presents a number of problems. The interbank market suffers from several deficiencies as follows:

- It has provided a relatively small volume of credit in relation to the size of the banks involved (averaging only 388 million Dh per month in 1989 compared to 8,100 million Dh in average monthly variable rate advances and 3,900 million Dh in average monthly fixed rate advances from the Central Bank) and has provided no rate leadership except as a possible base comparison rate for the discount rate.

- As with any interbank market, liquidity is provided by competitors and routinely places some banks at the mercy of those competitors. For the small interbank market in Morocco, this feature is especially difficult because it appears that liquidity is largely provided by the BMCE, the CPM and the CNCA.

- The interbank market, by its very nature, trades only liquid funds of the banks and SFIs rather than attracting liquidity from elsewhere in the economy.

- There is no current publication of interbank volumes traded nor any rate information which might be used to benefit savers and borrowers. Sketchy information is published in the Bank Al-Maghrib's annual report and in the reports of the Comité du Crédit et du Marché Financier which has a very limited distribution.

The secondary market could remedy most of the interbank market deficiencies and holds the promise of much more:

- The secondary market will provide a base from which trading in short-term debt (i.e. Treasury bills) can evolve into trading of even the longest term securities, whereas the interbank market is confined to the shortest maturities (i.e., overnight funds).

- It also provides the possibility of eventually extending credit to private businesses, whereas access to the interbank market is limited to banks and a few specialized finance institutions. Increasing the financial resources available to private business would support the Government's goal of encouraging economic growth.

- Competition is not strong in the interbank market but could be a major force in the secondary market because more buyers and sellers would compete for securities on the basis of risk, price, and profit.

- The secondary market offers the possibility of releasing current information on rates and volumes and would encourage revitalization of the Bourse des Valeurs, another part of the financial sector reform program, by demonstrating effective trading of short-term securities.

- With no other safety valve for liquidity besides the interbank market, there is a constant threat of discount window borrowings, but the secondary market offers a second line of defense against such repetitive borrowings at the Central Bank.

- While the creation of a secondary market constitutes a small but important step toward financial reform, relying on the current interbank market is almost no step at all.

If the monetary authorities are relying only on the interbank market, that reliance may be misplaced because the volume of adjustment credit supplied in a single day may prove to be inadequate to meet the needs of the banks. In contrast, the secondary market, by supplementing the interbank market, could deliver a larger volume of such credit without recourse to the Central Bank.

Control over the money supply is a key ingredient in the restraint of inflationary pressures in a market economy. As Morocco moves toward financial reform including indirect rather than direct controls, the monetary authorities will need to determine the desirable rate of money supply growth and tailor their policies to achieve that rate. If such policies are directed toward money supply rates of growth substantially above those needed as an equilibrating and stabilizing force for the GNP growth, then tight controls and forced investment will be required. But such policies will only confirm the skeptics' position that little will change even under the promised financial reform and the system of encadrement will just live on under a new name of indirect controls. Liquidity will still be protected by central bank credit and control over the money supply will be less than desired.

If, on the other hand, the monetary authorities aim toward money supply rates of growth in balance with the GNP growth rate, such restricted liquidity might cause a decline in the discretionary purchases of Treasury securities and interest rates would increase. Moreover, the interbank market might not be able to meet the demands for liquidity and the Central Bank would be forced to inject reserves by the discount window, thus again giving up a measure of money supply control.

Therefore, whichever basic approach is adopted, if total reliance is placed only on the interbank market, there will be only minor changes from the old system of direct controls and the authorities will make little progress in developing better control over the money supply. Either way, monetary control would make only a minimal contribution to financial sector reform. One can understand the desire to maintain tight control over the banking system and the reluctance to move too quickly to an unknown method of control, but if Morocco is to progress to a more open and market-influenced financial system, then some controlled risks are necessary, even in the handling of monetary policy.

IV. RECOMMENDATIONS: THE DEVELOPMENT OF A SECONDARY MARKET FOR SHORT-TERM DEBT IN MOROCCO

A. Treasury Bills

It is recommended that a secondary market for short-term Treasury bills of 3, 6, and 12 months maturity be created in Morocco during 1991.

The restricted scope of the recommendation reflects recognition of the major changes that could occur as a result of lifting encadrement and the importance of maintaining stability in the financial system throughout implementation of the financial sector reform program. Of particular importance in this transition period are the responses of the monetary authorities and commercial bank managements. Both groups now face a critical action phase of financial sector reform.

At the Central Bank and Ministry of Finance, given the conditioning history of encadrement, with its direct and strict controls over bank asset allocation and interest rates, the change to indirect controls creates new uncertainties which must be considered in establishing a new regulatory framework.

For bank managements, the history of good profits, low loan losses, and little responsibility for most asset allocation has bred both a resistance to and skepticism of change. To suddenly confront the banks with a major change in controls and potential leeway to begin their own allocation of credit as well as the beginnings of market determination of some interest rates may seem almost a revolution in the way of doing business. It is, therefore, not surprising that bank managements are somewhat skeptical of actually seeing all these changes take place, even though many of them were announced in the original plan of reform and some of the changes in direct controls have already occurred over the past twelve months.

In view of the above conditions and special circumstances, it is recommended that the Moroccan Government move with considerable caution in establishing the new secondary market. Similarly the selection and degree of stringency of the new indirect controls should be approached with caution. Such caution should continue until bank managements are brought along into the new world of financial sector reform and demonstrate their willingness and capacity to handle their new responsibilities. This is not to say that the new programs should not be developed but only that small steps seem prudent. Thus the recommendation is for the creation of a secondary market of limited scope.

The greatest changes recommended encompass the creation of dealers for the primary (or auction) market to underwrite new short-term Treasury bill issues and the concomitant steps to link those dealers to a secondary market. Underwriting by primary dealers requires that they subscribe to their proportionate share of each Treasury offering and use their best efforts to sell such securities to final investors or hold them in the primary dealers' own portfolios. Implicit

in the recommendations are the regulation, examination, and supervision necessary to protect the market from abuse, to insure control over excessive credit extensions, and to insure the effective and efficient functioning of the secondary market. Also recognized is the need to ensure capital adequacy, sufficient loan loss reserves and effective central bank control of the money supply.

For the primary dealer, the special responsibilities and willingness to assume the burdens of underwriting result in giving them potential profits in distribution. After initial distribution in the primary market, other financial firms may participate in sales in the secondary market. The dealers in the secondary market continue to have access to large sales potentials to final investors with commensurate fees but without the burdens of underwriting. This differentiation between dealers in the primary market, dealers in the secondary market, and non-dealer participants will need to be handled with great care and openness. Assuming smaller reserve ratios are introduced at some later date, the secondary market may be organized as shown in Figure 1.

For an efficient and effective secondary market, there will need to be sufficient volumes traded and thus a limitation on the maturities offered in the primary market so that the secondary market deals with only a small number of maturities. Trading in a limited range of securities should continue until the participants gain experience in the market and the Central Bank is assured that controls are adequate to insure the safety and soundness of banks and sufficient control over the money supply.

Of key importance to the success of the secondary market is the action of the Central Bank in handling the settlement and record keeping for the primary dealers and the activity records of the secondary market. Use of the book entry system is critical to a smoothly operating market and should be encouraged. Settlement and evidence of ownership by non-banks and private purchasers will need to be addressed perhaps by special subaccounts in banks. Furthermore, the Central Bank should assume the role of publication of rates, volumes, and prices for both the primary auction and the secondary market. Adequacy of information is a critical ingredient in the success or failure of both markets.

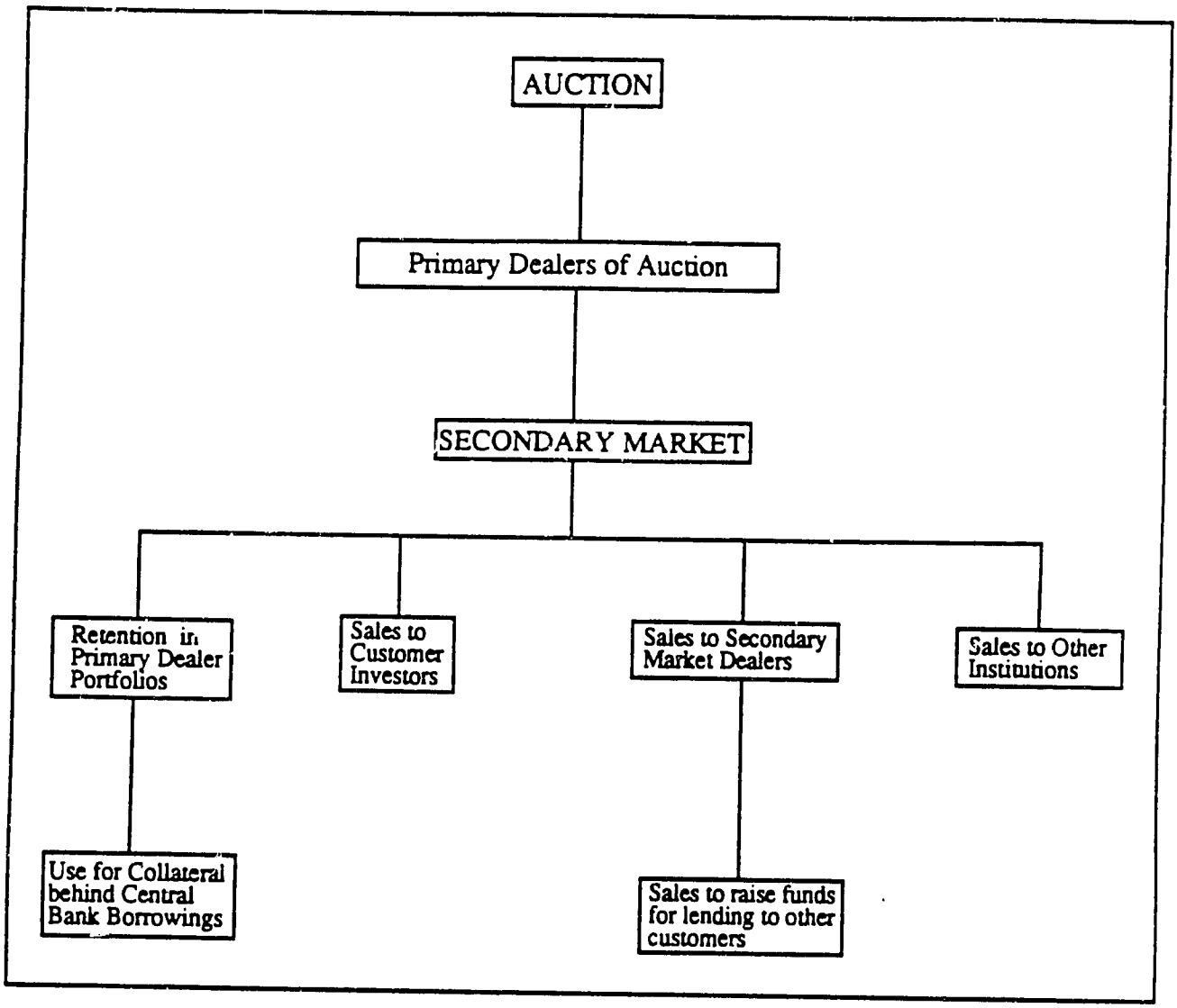
In addition, the Central Bank will need to consider carefully the types of control and supervision needed under this more open banking system. It is assumed that more intensive examinations will be required and that close supervision by ratio analysis will be developed. With judicious application of reserve requirements and greater limitations on discounting, the Central Bank should be able to maintain its restrictive monetary policy and regain control over the money supply. The monetary authorities should announce their plans for changes in regulations, controls and requirements as early in 1991 as possible. Especially important would be the announcement of specific policy guidance on the following:

- Retention or phase out of mandated purchases of government securities and the timetable thereof

- Any retention of interest rate controls, such as for the three month maturities

Figure 1

POTENTIAL ORGANIZATION OF SECONDARY MARKET



- Discount window access and rate information, including planned frequency of announcements, and

- Retention or phased out removal of ceilings on commercial paper issuance and rules on bank holding for later sale.

Also important to the implementation of a secondary market would be a Treasury announcement on the timing of a phase out of all T-bill maturities except the 3, 6, and 12 month bills. Simultaneously, it would be very helpful if the Treasury were to announce its plans for the volumes of such issues for the rest of 1991.

Of course, an early announcement that a secondary market will be created in the fall of the year would be of great value. Such an announcement should contain as much data and information about the market as possible, including the planned organization and process of implementation. Even preliminary announcements indicating that the Treasury has under consideration the establishment of a secondary market for short-term securities would alert the banks, other financial institutions and even private investors that further change is possible.

B. Commercial Paper

The addition of trading in commercial paper on the secondary market is recommended for somewhat later implementation.

After the secondary market for Treasury Bills is functioning and the benefits begin to flow to the Treasury, the Central Bank, businesses and private individuals, the market could be opened to trading in commercial paper. In the meantime, banks should be permitted to continue to broker commercial paper with their endorsement on it. The monetary authorities should experiment with gradual relaxation of the ceiling using a percentage of capital as the principal control feature.

A commercial paper market is a complex matter requiring a high degree of both technical and financial understanding. It is basically an unregulated market where discipline is enforced by rating agencies and investors. This is especially true in the unsecured commercial paper market where company paper relies totally upon the financial strength of the issuing company. There are companies which issue paper with a bank line of credit supporting it, and for the lesser known companies this is the only realistic way of participating in that market.

In financially sophisticated countries, investors in commercial paper include money market mutual funds, pension funds, stock market companies, and private individuals. Since it is an unregulated market, bank participation is more limited than in the regular bank lending market.

For Morocco, it is suggested that this market be used sparingly until financial sophistication increases and private financial sector growth develops. Certainly for the large, well-known companies, this commercial paper market should be available, but for the smaller, less well-capitalized businesses, regular bank loans with adequate collateral should be the primary borrowing market. As the private market expands and bank lending to private businesses expands, there could be an enlargement of the commercial paper market with concommitant regulation of an SEC type.

Consideration should be given to permitting commercial banks to trade such paper during a short holding period, for example five days, while reporting trades on a daily sheet or computer report to the Central Bank. Such a trial period would permit the dealer and non-dealer banks to become familiar with the characteristics of this specialized market and gain experience in general trading of non-Treasury products.

C. Broadening the Secondary Market to Other Products

As experience grows with the use of a secondary market, consideration should be given to additional products such as tax anticipation notes, repurchase agreements, and bankers acceptances. Although these instruments are not likely to be added until a year or more after the inception of the original market, regulatory consideration should be given to their ultimate trading.

V. BENEFITS AND FEASIBILITY OF SECONDARY MARKET DEVELOPMENT

A. Benefits to Morocco

The development of a secondary market would produce substantial benefits to the Moroccan economy. The reform of the financial sector would be advanced by a secondary market in the following ways:

- Encourage competition by supplementing the interbank market to increase availability of funds to finance private sector development as well as reduce costs of intermediation. Interbank market sources of funds to finance private sector development must come from reduced bank retention of public issues in their portfolios and increased sales in the secondary market. To meet liquidity needs, banks must be forced to look internally rather than borrowing from the Central Bank. Internal sources include liquidation of securities, interbank borrowing, and sales of other assets.

- Further the private sector influence on interest rate determination by creating a market-led reference rate.

- Tap new sources of savings and broaden sales of Treasury debt to a wider group of investors who seek the liquidity offered by the market.

- Facilitate the elimination of encadrement by creating another source of bank liquidity, thus permitting a reduction in Central Bank credit advances and better money supply control.

- Improve opportunities for more effective indirect controls by the Central Bank by creating a place where open market operations can be developed to transmit policy direction to the banks.

Widespread publicity concerning interest rates in the primary and secondary markets should make buyers and sellers more cognizant of alternatives in the secondary market against bank loan terms and interest rates. Moreover, the innovative banks should begin to offer new products to their customers, forcing other banks to meet the competition. If foreign banks are eventually permitted to enter the markets in Morocco they will be less dependent on domestic banks for funding and thus could compete more aggressively.

B. Feasibility

Based on discussions with the authorities, it appears that a secondary market is feasible under the current set of laws but that new regulations and guidance will be needed. Banks already participate in the auction, and they have sizeable portfolios of Treasury bills though a heavy proportion is in mandated purchases. Their appetite for bills should increase as the Central Bank moves to restrict discounting and direct advances as it must if it is to regain control over the money supply while giving up direct ceilings and rate determination. Bank investment in Treasury issues should increase if the secondary market performs its role to permit the distribution of Treasury bills to investors. This will enable banks to obtain funds for lending and investors to find an outlet for short term fund utilization.

Secondary trading is not totally foreign to the banks since they are participating in an interbank market for daily adjustment of positions. Thus creation of a secondary market would be an extension of that market. A few banks have tried to introduce new products and services but apparently have been restrained by the ceilings and regulations. There is a small spark of competitive spirit and this will need to be nourished and spread to the other banks if the broader secondary market is to flourish.

Other evidence of the feasibility of such a secondary market is the fact that sales of Treasury bills to the general public are already taking place with good results. Even without an organized secondary market and virtually no publicity, such sales rose by almost a quarter in 1989. Similarly, in just a few years, commercial paper outstandings rose quickly after initial authorization. Developing a secondary market could increase demand for both products.

Finally, much of the infrastructure necessary to create a secondary market is already in place. The development of book entry accounting at the Central Bank and the acceptance of the use of reserve accounts for settlement provide a starting point for operation.

VI. ISSUES TO BE ADDRESSED

A. Selection of Primary Dealers

In order to develop a secondary market as recommended, the authorities will need to select the institutions to be designated as primary dealers. Several considerations must be faced in that selection process. First is the development of criteria for selection. It is presumed that the authorities would screen out any organization which evidences pronounced weaknesses in its current loan or investment portfolio or is grossly undercapitalized. Other weaknesses in present structure or management should also call for concern in the nominating and selection process.

One can easily imagine the authorities setting up criteria which would screen out institutions which were of insufficient size or management strength to carry out the primary dealer's role, but other criteria must be established with a view toward obtaining the best organizations to take the lead in this very important area of financial sector reform. Among such criteria might be the following:

- Diversity of ownership
- Extent and coverage of branch locations (or access to a comparable network)
- Technological advancement in operations
- Past history of compliance with regulations and other government programs
- Evidence of willingness to provide new types of credit and service to customers

and of course:

- Financial strength to carry out the functions of a dealer, including capital adequacy.[9]

The next step in the process is likely to be selection of the incentives which the authorities would consider appropriate to reward the dealers, such as fees for underwriting, and the degree to which the cost of carrying the inventories needed to function effectively as a dealer would be supported by special central bank credit or reduced reserve requirements until the dealers have demonstrated their internal capacity to handle the costs themselves.

Along with such incentive decisions should come decisions as to the supervision requirements for dealers and their subsidiaries. The cost in time and special record keeping along with the

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[9] For information on the criteria used in selecting primary dealers in the U.S., please see Appendix E.

acceptance of such closer supervision should be emphasized to the potential dealer institutions. Of course, the authorities will need to clearly delineate the role and responsibilities of a primary dealer so that potential dealers know what is expected of them.

While it is possible that sufficient numbers of banks and other financial organizations will qualify for the role, it is also possible that too few institutions would be willing to accept such a role and that some degree of pressure will be necessary. Implicit in any decision to use government pressure is a decision as to the precise number of dealers to manage the secondary market. Given the size of the financial industry in Morocco, this number would probably be at least four but no more than seven dealers. Sufficient volume needs to develop in order to ensure a profitable arrangement for the dealers and their ability to act as market makers.

Another significant decision in the selection should be the determination of whether other organizations beyond banks could be considered for the role of dealer. Given the general lack of competition among banks and some enlightened views encountered among insurance companies and the Caisses, these types of organizations could be considered if this is deemed sufficiently advantageous to resolve problems related to their relationship with the Central Bank and their investment and operational authority. If the CDG or insurance companies qualify as primary dealers, there would have to be some agreement on regulation and operational control procedures.

The authorities will also need to consider the best way to communicate the new program to the financial sector. This matter is sufficiently important that a special conference should be held for the senior executives of the potential dealer organizations, followed by working sessions involving both operating and policymaking personnel. Once decisions are made on the criteria for selection and institutional interest has been generated, written proposals should be sent to each potential dealer organization. Clear communications and consultation must be stressed if cooperation and an atmosphere of understanding is to be achieved.

Finally, the new program will need to be communicated to all financial institutions, potential investors and borrowers once the "rules of the game" have been finalized. Here the widest publicity is needed to reach all those who might be participants in the new market.

B. Regulation and Control

Integral to the development of a secondary market is the question of regulation and control. While there are many decisions concerning monetary policy that will need to be made and communicated to the banks and others in the financial sector, there are several regulatory and control policies which directly affect the ability to create an effective secondary market. As banks are given greater leeway to finance private sector developments, there will be more capital needed as protection against loan risks. Similarly, loan loss reserves should be emphasized. For both capital and loan loss reserves, well understood and publicized ratios should be announced. Decisions will need to be taken and communicated to the banks on the length of

time a bank is permitted to borrow at the Central Bank in the normal course of business and the rate to be paid for those borrowings. Similarly, the conditions for borrowing at penalty rates should be clearly described, while the emergency borrowing conditions and rates may be less well defined.

The monetary authorities will need to decide whether to use the discount rate as a potential reference rate or to restrict its use to communicating Central Bank policy concerning credit extensions and general financial conditions. If the latter role is chosen, then less frequent changes in the discount rate should be made to accentuate its announcement and psychological impact. As the secondary market develops, there will probably be less reason for using the discount rate as a reference rate as the auction rates and secondary market trading rates should become the free market reference rates. The development of a secondary market will enlarge private sector influence on interest rates rather than relying solely on government determination. Only by ceding such influence to the private sector can the Government determination of interest rates be reduced.

Also of considerable importance is the decision concerning the control over mandated Treasury bill holdings by banks and others as to their use for discounting and approval or rejection for market trading. Especially important is the decision concerning future mandated holdings and whether these are to be frozen at existing levels; required, as before, as a percentage of new deposits; or phased out according to a schedule. Whatever decision is taken on the mandated holdings, it is essential that it be communicated to the potential secondary market participants to avoid any uncertainty on this matter.

C. Potential Concerns of the Commercial Banks

The authorities should be aware of a number of issues that are likely to be raised by the commercial banks. As each bank considers the new program for a secondary market, it will be faced with a decision as to whether to support the creation of a secondary market or to resist its establishment, as well as whether to be an active dealer, an active participant or a reluctant participant. For each bank, there will be a complex variety of positions throughout the bank each bearing on its ultimate decision. In any bank, an assessment of its competitive position and potential vulnerability to other banks and non-bank financial firms will weigh heavily in its decision. For instance, the present balance of its portfolio of investments and credits compared to that of the competition would be important. Similarly, the bank's branch locations and the strength of its funding sources compared to other banks is likely to influence its view. Another issue that will be raised by each bank is the present mix of its retail, wholesale, specialized and general business compared to its competitors.

Questions are likely to be raised concerning such issues as the following:

- Degree of reliance upon several large customers and whether their business might be lost or threatened in a competitive environment
- Historic liquidity position
- Exposure to heavy drains on liquidity from corporate tax liabilities
- Capital position, both currently and if it becomes a dealer
- Possibilities for raising new capital
- Reserve position, both in relation to present growth rates and projected reserve requirements
- State of technological development
- Strength of its directorate
- Perceived strengths and weaknesses of the managements of other banks
- Past relations with the Central Bank.

These and a host of other questions will influence each bank's position concerning support for the market and whether to become a dealer bank.

Each potential dealer bank will need to study its position vis-à-vis other banks as to its likely success, net income and market share as a dealer bank. If the bank believes there is a potential gain in market share from becoming a dealer and if its management is willing to take the risk, then the decision may be to seek dealer status. Finally, each bank has its own perception of the likelihood of full financial sector reform and its own degree of resistance to change brought on by the Government. These factors will certainly influence a bank's willingness to take the risks necessary to become a dealer.

Furthermore, a secondary market will stimulate competition among banks as individual firms seek new customers and increased market share. Such competition would be on a rate basis as well as on services, and availability of loans or other funding by financial institutions. The old way of tied relationships to borrowers by owners or other strategically placed individuals would be reduced by this new competition. Similarly, the role of the Government in determining the allocation of credit would be minimized.

D. Issues Relating to Risk

Risks abound in the financial sector of any country, some of which are predictable and others, unpredictable. The Moroccan banks have lived in a relatively predictable environment and are suddenly being asked to take on some of the competitive risks which they have largely avoided. Their heavy investments in government bonds is a virtually risk-free business. The banking industry should be encouraged, however, to provide better service to the private sector and to be a stimulus for the country's economic development.

In the new world of banking sector reform, the banks will be asked to take the risks of extending credit to a broader segment of the economy and to seek out deposits and savings which were formerly neglected. How the banks will respond to this challenge is unknown.

Similarly, giving up the system of direct credit ceilings and interest rate controls presents a risk to the monetary authorities. They will have the risk of maintaining control over the amount of credit compatible with non-inflationary growth and the risk of controlling the over-aggressive banker in a timely manner. Failure to make progress on the promised financial system reform program, however, is another significant hazard for the authorities. Although caution is undoubtedly important for this set of changes, making progress on the reform program does entail some risk.

In particular, the authorities will need to devise their system of indirect controls in such a way as to provide increased freedom for the banks. Otherwise, the indirect controls will be just as binding as the old system of encadrement. Progress toward a more competitive and responsive financial sector, as well as the market determination of interest rates, will require the authorities to ease some of their restrictions.

Financial reform always carries some risks and it is important that moves be made with a critical eye toward avoiding upsets of a systemic nature. If the reforms cause financial intermediaries such concern that they cease to function effectively or if depositors become so concerned with the safety and soundness of their banks as to withdraw deposits, then the reforms are excessive and detrimental to the Moroccan economy. Obviously, no one recommends such drastic reforms. The official attitudes and judgements on regulatory control must always keep a close look out for risks of systemic failure. It will take the careful and judicious resolution of these conflicting factors to achieve an appropriate degree of risk without giving up good control over the system.

E. Product Issues

Finally, certain issues related to the products to be offered on the secondary market should be addressed. By launching the secondary market with only Treasury bills, some may argue that the needs of the private sector with respect to new credit offerings are not immediately served.

A lobby may develop for the introduction of trading in long-term securities. Others may seek immediate approval for trading in commercial paper on the secondary market. An approach involving only Treasury bills in the initial phase is undoubtedly the most conservative and cautious approach that could be taken, allowing the market to develop and mature at a reasonable pace.

In order to create a viable secondary market, however, sufficient volume needs to develop in a relatively small range of instruments to insure both a profitable arrangement for dealers and a smoothly functioning liquidity adjustment system. Failure to obtain either one of these objectives would undoubtedly cause the market to wither and thus to lose its ability to make a significant contribution to financial sector reform.

APPENDIX A

OUTSTANDING DOMESTIC PUBLIC DEBT

OUTSTANDING DOMESTIC PUBLIC DEBT

BY MATURITY

(IN MILLION DIRHAMS)

	Dec. 1988	Dec. 1989	Aug. 1990
Short Term	27,010	28,388	29,209
(1 Year or less)	(53.7%)	(49.8%)	(49.4%)
Medium Term	13,335	16,655	17,423
(2 to 5 Years)	(26.5%)	(29.2%)	(29.5%)
Long Term	9,997	12,013	12,446
(Over 5 Years)	(19.8%)	(21.0%)	(21.1%)
TOTAL	50,342	57,056	59,078

Source: Ministry of Finance
Internal Debt Service

OUTSTANDING DOMESTIC PUBLIC DEBT

BY SUBSCRIBER

(IN MILLION DIRHAMS)

	1985	1986	1987	1988	1989
Commercial Banks	16,734	23,482	26,930	30,481	34,907
(Percent)	(65.4%)	(63.3%)	(60.2%)	(61.2%)	(61.2%)
Bank Al-Maghrib	34	32	111	--	--
Specialized Fin. Institutions	3,446	3,717	2,273	3,275	4,313
Non-Financial Private Sector	5,345	9,897	15,414	16,017	17,836
TOTAL	25,572	37,128	44,728	49,773	57,056

Source: Ministry of Finance
Internal Debt Service

APPENDIX B

AUCTION STATISTICS

OUTSTANDING DOMESTIC PUBLIC DEBT

BY TYPE

(IN MILLION DIRHAMS)

AUGUST 31, 1990

	Maturity	Type/Description	Amount
1.	1 week	Auction - Treasury Bills	591
2.	3 week	Auction - Treasury Bills	1,115
3.	5 week	Auction - Treasury Bills	166
4.	13 week	Auction - Treasury Bills	310
5.	26 week	Auction - Treasury Bills	1,475
6.	52 week	Auction - Treasury Bills	2,936
7.	6 month	Individual 3/6 Certificates	2,432
	Short-Term Debt Potentially Traded in a Secondary Market		9,025
8.	1 month	BMCE Debt Holdings	6,000
9.	6 month	Bank "Plancher" Holdings	847
10.	1 year	Bank "Plancher" Holdings	13,337
11.	2 year	BCP Consolidation	500
12.	3 year	BCP Consolidation	1,084
13.	5 year	BCP Consolidation	6,265
14.	2 year	Emprunts Nationaux	1,260
15.	3 year	Emprunts Nationaux	1,294
16.	5 year	Emprunts Nationaux	3,832
17.	5 year	Non-Resident Bond Holdings	65
18.	5 year	World Bank PERL + S.O.E. Debt	3,098
19.	5 year	Emprunts Obligatoires	25
20.	10 year	Investment Reserve (Companies)	1,777
21.	10 year	Young Entrepreneurs	330
22.	15 year	Non-Bank and Insurance Holdings	9,428
23.	15 year	Bank Holdings	755
24.	15 year	Sahara Debt	156
	TOTAL		59,078

Source: Ministry of Finance
Internal Debt Service

TREASURY BILL AUCTION STATISTICS - 23 OCT. 1989 TO 11 SEPT. 1990

	23 Oct	7 Nov	16 Nov	5 Dec	19 Dec	5 Jan	17 Jan	23 Jan	7 Feb	15 Feb	23 Feb	5 Mar	19 Mar	29 Mar	4 Apr	16 Apr	23 Apr	15 May	4 Jun	12 Jun	19 Jun	29 Jun	18 Jul	1 Aug	9 Aug	16 Aug	22 Aug	29 Aug	5 Sep	11 Sep
Minimum Rate Offered (%)																														
1 week	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	8.00	8.00	—	—	8.00	8.00	8.00	8.00
3 week	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	8.25	8.50	—	8.50	8.50	—	—	8.50
5 week	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	8.50	8.75	9.00	—	—	9.00	8.75	9.00
3 month	9.10	9.10	9.10	9.20	9.20	9.25	9.25	9.25	9.25	9.25	9.25	9.25	9.25	—	—	9.25	9.25	9.25	9.25	—	—	—	—	9.25	9.50	—	10.00	—	—	—
6 month	9.50	9.50	9.50	9.50	9.50	—	9.75	9.50	9.75	9.75	9.75	9.75	9.50	—	—	9.75	9.60	9.75	9.75	—	—	—	—	9.75	10.00	10.00	—	—	—	—
1 year	9.62	9.75	9.75	9.75	9.90	—	10.00	10.25	10.25	10.35	10.35	10.35	10.25	10.35	10.50	10.35	10.30	10.45	—	—	—	—	—	—	10.75	10.75	—	—	—	—
Maximum Rate Accepted (%)																														
1 week	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	8.00	8.00	—	—	8.00	8.00	8.00	8.00
3 week	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	8.25	8.50	—	8.50	8.50	—	—	8.50
5 week	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	8.50	9.00	9.00	—	—	9.00	8.75	9.00
3 month	9.25	9.25	9.25	9.25	9.25	9.25	9.25	9.25	9.25	9.25	9.25	9.25	9.25	—	—	9.25	9.25	9.25	9.25	—	9.25	—	—	9.25	9.50	—	10.00	—	—	—
6 month	9.55	9.50	9.55	9.50	9.70	—	9.75	9.75	9.75	9.75	9.75	9.75	9.75	—	—	9.75	9.75	9.75	9.80	—	—	9.75	—	10.00	10.00	10.00	—	—	—	—
1 year	10.80	9.75	9.75	9.75	9.90	—	10.25	10.30	10.35	10.35	10.35	10.35	10.40	10.40	10.50	10.40	10.45	10.45	—	10.50	—	—	—	—	10.75	10.75	—	—	—	—
Weighted Avg. Rate (%)																														
1 week	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	8.00	8.00	—	—	8.00	8.00	8.00	8.00
3 week	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	8.25	8.50	—	8.50	8.50	—	—	8.50
5 week	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	8.50	8.82	9.00	—	—	9.00	8.75	9.00
3 month	9.19	9.13	9.23	9.23	9.23	9.25	9.25	9.25	9.25	9.25	9.25	9.25	9.25	—	—	9.25	9.25	9.25	9.25	—	9.25	—	—	9.25	9.50	—	10.00	—	—	—
6 month	9.51	—	9.54	9.50	9.62	—	9.75	9.71	9.75	9.75	9.75	9.75	9.65	—	—	9.75	9.75	9.75	9.75	—	—	9.75	—	—	10.00	10.00	—	—	—	—
1 year	—	—	9.75	9.75	9.92	—	10.18	10.29	10.33	10.35	10.35	10.35	10.34	10.39	10.50	10.38	10.43	10.45	—	10.50	—	—	—	—	10.75	10.75	—	—	—	—
Amount Sold (Million Dh)																														
1 week	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	40	180	—	—	100	300	200	250
3 week	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	10	20	—	50	85	—	—	90
5 week	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	50	68	20	—	—	50	68	70
3 month	430	60	520	180	120	30	110	180	20	120	182	500	50	—	—	70	160	110	30	—	20	—	—	30	20	—	30	—	—	—
6 month	680	—	370	70	390	—	10	640	200	240	30	500	95	—	—	50	320	250	60	—	—	100	—	80	20	80	—	—	—	—
1 year	—	—	10	20	290	—	70	350	180	30	20	300	625	130	30	60	420	40	—	20	—	—	—	—	20	30	—	—	—	—
	1,110	60	900	270	800	30	190	1,070	400	390	232	1,300	770	130	30	180	900	400	90	20	20	100	100	378	80	160	215	350	268	410

AVERAGE AMOUNT SOLD = 378 Million Dh

Source:
Ministry of Finance - Internal Debt Service

APPENDIX C:

TREASURY DEBT MATURITY MIX

TREASURY DEBT MATURITY MIX
(OPTIONAL APPENDIX)

The following is a discussion of the mix of maturities that would be desirable for Treasury issues.[1] It is intended to provide information to those who are not familiar with the Treasury's debt situation.

Policy Goals

Several of the Treasury's broad financial policy goals are directly relevant to its debt maturity mix. These policies include the following:

- Reduce the proportion of the Treasury deficit to 2% of GDP
- Broaden the range of holders of its debt, attracting more savers and investors by financing at market rates
- Increase competition within the banking system.

Treasury Debt Management Organization and Policies

The Direction du Trésor sets the terms of borrowings by the Treasury and the other sources of financing that it collects; proceeds to the issuance of loans necessary for financing the Treasury; and manages the resulting servicing of the debt. It is equally responsible for advising on security applications of the obligatory issues of the public and quasi-public institutions.

Data concerning issuance and repayment of short and long-term debt is collected and organized manually from numerous sources, particularly Bank Al-Maghrib. Summary information is organized on the basis of original maturity of each issue. For example, a fifteen year bond issued fourteen years and eleven months ago would still be classified as "long-term" debt. Repayment schedule summaries covering several years in the future are not readily available.

Data available for our study was thus affected by the following factors:

- The Internal Debt Service office does not yet have its data entered in computerized form.
- Except for one series, historical series for years before 1988 were not easily available.
- Actual repayment schedules (i.e., on a cash basis) beyond 1991 were not available.

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[1] In preparing this analysis, two significant aspects of the Government's debt, namely foreign debt and the debt of government agencies such as the Credit Immobilier et Hotelier, have not been taken into account as they appeared to lie outside the terms of reference.

The information system does produce accurate statistics on the amounts of principal and interest coming due on each payment date for the next three months. This data allows the Internal Debt Service to identify and plan the best dates for new issues. However, amounts of new issues are not planned far in advance, but are determined pragmatically a few days or weeks before the opportune dates.

To the extent our investigation permitted, we did not learn of any quantitative target for the maturity mix. The Treasury clearly tries to take advantage of every opportunity to issue new debt with a longer term than the maturing debt.

The Treasury has abandoned its earlier efforts to announce the long-term financing calendar in advance because, in their view, the main intended beneficiaries, the insurance companies, did not take particular advantage of the program. Differing views were expressed by others.

The characteristics of outstanding issues (see Appendix B for details) which impact on the mix of maturities include the following:

- All are free of VAT and withholding tax
- All are fixed rate, not floating
- Some short-term issues have market-determined rates, others have imposed rates.
- All medium and long-term issues have imposed rates.

Other points to note are as follows:

- Short-term debt. Interest rate anomalies frequently exist between Treasury bills sold at the auction and those sold to individuals. For example, 3 and 6 month maturity bills were sold at auction two months ago at rates 0.25% to 0.50% per annum higher than the 3/6 month certificate ("sur formule") issues reserved for individuals. At other times, the auction yielded lower rates than the sur formule issue.

- Long-term debt. Important anomalies exist in this sector. For example, the rate on a recent five-year non-amortizing issue quoted on the Bourse des Valeurs was set 2% per annum higher than the rate on a 15 year sinking fund issue, also quoted, that was launched two weeks later. The longer term issue would normally have the higher, not the lower, rate.

Conclusions

1. The basic available data on maturities of outstanding Treasury debt appear consistent and reliable. In particular, they seem to yield useful indications to the Treasury on suitable timing for launching new long-term issues.

2. However, until the Internal Debt Service has created an automated data base covering outstanding issues, thorough analysis of the maturity mix is impractical. Forecasting and simulations, in particular, are not feasible until that task has been completed.

3. As a result of past deficit financing, most short-term Treasury debt is not held voluntarily. The same is true for an important part of medium-term issues. The somewhat arbitrary rates on the largest long-term amounts may also be below levels that a free market would set.

4. If existing obligatory purchase requirements were relaxed and/or rates determined by a free market, the existing maturity structure of Treasury debt would quite likely change considerably.

   However, in the absence of larger free markets it is extremely difficult to forecast what the new maturity structure would be. This uncertainty would be even greater once encadrement credit ceilings were removed and banks were free to use their resources to fund higher yielding commercial loans.

5. In summary, the present structure of Treasury debt involves a high proportion of total short-term debt and massive amounts of obligatory and below-market price holdings. Especially in the context of increasing financial policy liberalization, this combination gives the Treasury little room to maneuver in varying the maturity mix of its debt. Within these constraints, some progress has been made to lengthen the maturities and reduce the portion financed through banks.

Recommendations

General

1. The Treasury should continue to seek to lengthen the maturities of its debt so that significantly less than half comes due for repayment within one year. We recommend a target of about 33% in short-term maturities, to be reached over several years.

   A lower proportion of short-term maturities seems inadvisable: banks and other short-term investors need an adequate supply of Treasury bills in the market to help meet liquidity requirements. Such a supply of short-term issues will be particularly important when a secondary debt market in Treasury issues is established.

2. The Treasury should also continue to reduce the proportion of obligatory and below market price issues, especially short-term issues.

The Treasury apparently intends further to reduce the Dh 6 billion of variable rate bills at the BMCE. Once further progress is made toward recommendation No. 1 above, plans for easing restrictions on the other obligatory holdings should also be made.

Specific

3. Short-term instruments

a. Announce a definite policy on the banks' obligatory plancher Treasury bill holdings. If early reduction appears impossible, it would still be beneficial to announce that there is to be no change for a given time.

Alternatively, required holdings could be frozen at the existing level. Announcement of a credible calendar for full liberalization would of course be the preferred solution. In any event, market confidence and certainty would no doubt benefit from a public announcement of the policy.

b. Recommendations on reducing the number of maturities sold at the Treasury bill auction are covered elsewhere in this report.

c. The existing maturity structure (3/6 months) for short-term bills sold to individuals (sur formule) seems appropriate, without change.

4. Medium and long-term instruments

a. Rate disparities among Treasury bonds of different maturities should be reduced. For example, rates on fifteen year issues quoted on the Bourse should normally be higher than those on five year issues also quoted on the Bourse. Reduction of such anomalies would work to improve liquidity, which in turn would help the long-term part of the market.

b. Long-term Treasury bond issues (i.e., with maturities beyond five years) should continue to have a structure that includes a sinking fund requiring equal annual amortization of principal during the life of the bond. Although this feature cuts the average life of a bond by almost half, it helps maintain investor confidence and liquidity in the market.

c. The Treasury should pursue its project to replace the awkward lottery procedure currently used to carry out the sinking fund amortization payments with a more efficient "series" technique.

d. It would seem advisable to limit final maturities of Treasury bonds to fifteen years for the time being in order to strengthen the existing market.

Longer maturity issues may become appropriate once the various obligatory and below market rate issues are eliminated or de-controlled (see no. 2 above) and after secondary markets in short-term Treasury issues are well developed.

e. Establishment and announcement of a calendar for long term issues intended for institutional investors would be a useful part of a broad effort to inform investors about the Treasury bond market, which in turn would help the Treasury's marketing program.

5. In summary, the Treasury's current policy to lengthen maturities and sell short and medium-term issues outside the banking system, should be continued. A target for short-term issues to represent 33% of total issues outstanding is appropriate. Despite near term problems it would pose, reduction of obligatory purchases would also favor success of this policy in the long run.

APPENDIX D:

FEDERAL RESERVE BANK OF NEW YORK: PRIMARY DEALERS DEFINED

fedpoints 2

Primary Dealers Defined

FEDERAL RESERVE BANK OF NEW YORK

Public Information Department
Revised January 1990

The market for United States government bills, notes and bonds is the most active money and capital market in the world. Thousands of investors are daily participants, buying and selling billions of dollars of "Treasuries."

The core of the market is comprised of over 40 large dealers who maintain an active market through their willingness to buy and sell (make bids and offers on) a full range of Treasury issues at all times. These dealers are significant—but not the only—underwriters of new Treasury debt and provide investors with the liquidity that is a major characteristic of the market for governments.

These firms, designated "primary" dealers, voluntarily report to the Federal Reserve Bank of New York on their volume of trading and their positions (holdings) in government and government agency issues. They also provide periodic reports on financing and their financial condition. Some of the primary dealers are banks or bank subsidiaries; some are departments of general securities broker-dealers, and others are firms specializing in government securities and other money market instruments.

Many of the statistics they report are published weekly in aggregate by the New York Fed and in the monthly Federal Reserve Bulletin (Tables 1.42 and 1.43). These figures often are used to judge the size of the government securities market because they are the only ones published regularly.

The Federal Reserve System, the nation's central bank, is a major participant in the government securities market. Primary dealers are named to help the Federal Reserve. In conducting open market operations, the New York Fed buys and sells U.S. government securities on behalf of the system. Open market operations is the major tool used by the central bank to influence the cost and availability of money and credit. (See Fedpoints 27 and 32.)

The Federal Reserve has no formal authority to regulate dealers. The information provided to the Federal Reserve is useful in monitoring market developments and in the central bank's efforts to encourage high standards of integrity and sound financial performance. But the reporting program and Federal Reserve market monitoring are not meant to substitute for prudent credit monitoring by market participants. Nor is the process designed to assist the public in determining credit worthiness.

In November 1988 the New York Fed revised the standards and procedures it uses to determine whether a securities firm should be added to the list of primary dealers. In general, primary dealers are expected to:

- *Make markets in the full range of Treasury issues for a reasonably diverse group of customers.
- *Participate meaningfully and consistently in Treasury auctions.
- *Be committed to continue as a market-maker in these securities over the long term.
- *Have management depth and experience, good internal controls and a reasonable profitability record.
- *Have sufficient capital to support their activities and prudently manage their risk exposure.

The standards establish a minimum trading activity guideline for primary dealers of one percent of the total customer volume of all current primary dealers. There is no specified minimum level of capital—which is evaluated in relation to risk—but the New York Fed believes a significant market-maker would have difficulty functioning prudently with less than $50 million of capital.

While all dealers trading with the Fed's desk for system open market purposes must be primary dealers, new primary dealers do not immediately begin a trading relationship. To establish a *trading relationship* with the Federal Reserve a dealer must improve upon and sustain the performance required for a designation as a primary dealer. The names of the primary dealers the Fed trades with at any given time are not disclosed.

Dealers wishing to become primary dealers file no formal applications. The New York Fed will accept informal reports from firms indicating a desire to become primary dealers. Financial data and volume statistics are evaluated and a visit from the dealer surveillance staff is arranged. At the start of each calendar quarter the Fed considers whether to begin accepting a full range of reports, including daily reports, from aspiring dealers it believes likely to qualify as a primary dealer within a reasonable time.

After evaluating these reports over time, the New York Fed may add the dealer to the list of primary dealers or the reporting may be discontinued if the dealer has not been added in a year.

At the end of 1989 there were 44 primary dealers which, as a group traded more than $100 billion a day, face value, in government securities. Fifteen of the 44 are majority owned by non-U.S. firms.

Copies of the current list of primary dealers are available from the New York Fed's Public Information Department. The New York Fed will not identify aspiring dealers.

The New York Fed has a formal organization of market and credit analysts, the dealer surveillance staff, under the direction of a vice president. Its role is to monitor practices and conditions in the government securities market. The staff reviews reports to assess the relationship between a dealer's risk and capital base. The staff also receives monthly financial statements and conducts periodic visits to the primary dealers.

APPENDIX E:

FEDERAL RESERVE BANK OF NEW YORK - PRIMARY DEALERS: CRITERIA AND PROCEDURES APPLIED TO FIRMS INTERESTED IN BECOMING PRIMARY DEALERS

PRIMARY DEALERS: CRITERIA AND PROCEDURES APPLIED TO FIRMS INTERESTED IN BECOMING AND REMAINING PRIMARY DEALERS

This statement outlines the criteria used in administering the list of reporting U.S. Government securities dealers ("primary dealers") and describes the process used by the Federal Reserve Bank of New York to handle requests from firms interested in becoming primary dealers.

General Criteria

All primary dealers are expected to make markets in the full range of U.S. Government securities for a reasonably diverse group of customers and to participate meaningfully in Treasury auctions. They are expected to facilitate the Federal Reserve's Open Market Operations and to provide the central bank with information to assist it in performing its duties. Dealers should evidence a strong commitment to continued participation as a market-maker over the long-term. Management depth and experience, a reasonable profitability record, and good internal controls are essential. Primary dealers must have sufficient capital to support comfortably their activities and must manage their risk exposures prudently, with due regard for the limitations of their capital and their ability to identify and control risks.

The minimum criteria discussed in this statement should be considered benchmarks rather than absolute levels at which a dealer is designated a primary dealer reporting to the Federal Reserve. The benchmarks are meant to provide dealers with guidance regarding the general level of development they must attain to qualify for and retain the designation. A dealer's qualifications are evaluated in total. It is expected that each dealer will achieve

and maintain overall levels of performance above the minimum standards; a dealer that barely achieves the minimum standards may not be designated or retained as a primary dealer.

Firms are designated primary dealers because they can be of service to the Federal Reserve. Other firms may be sound and capable, but it would be impractical for the Federal Reserve Bank of New York to maintain a reporting or dealing relationship with all such firms. The designation is not an endorsement, is not conferred under regulatory authority, and does not entail official supervision by the Federal Reserve. The Federal Reserve does monitor dealer activities to determine that the primary dealer performance standards are being met, and to obtain information about market developments. The process is not designed to assist the public in determining dealer creditworthiness.

Primary dealers are expected to be active and competitive participants in the Federal Reserve's Open Market Operations. They are also expected to freely and candidly supply the Federal Reserve with information about developments in the U.S. Government securities markets and in all other markets in which they participate. Trading performance and the quality of other support of Open Market Desk needs will be taken into account in decisions regarding primary dealer designation. While all dealers trading with the Open Market Desk must be primary dealers, newly designated primary dealers do not immmediately begin a trading relationship with the Reserve Bank. To establish such a trading relationship, a dealer is expected to demonstrate the ability to improve upon and sustain the levels of performance initially required for designation as a primary dealer. Those firms not demonstrating this capacity within a reasonable period of time may have the designation discontinued.

Primary dealers are expected to cooperate with the Federal Reserve in endeavors to increase the efficiency, effectiveness, and safety of the marketplace. They are also required to submit reports reflecting their activities to the Federal Reserve on a regular basis.

Primary dealers must be effective market-makers. The diversity and quality of a dealer's customer base, the breadth of its activity and the consistency of its performance carry significant weight in an evaluation of market-making. In addition, trading volume with customers provides a convenient numerical estimate of a dealer's performance as a market-maker. At a minimum, the dollar volume of a dealer's customer transactions in Treasury and Federal agency issues (excluding mortgage pass through instruments) should average one percent of the aggregate of primary dealer volume with customers if the dealer expects to present a convincing case that it is an effective market-maker. Transactions with other primary dealers or inter-dealer brokers are excluded from this measure. Also excluded from customer volume are (1) intra-firm transactions or trading with affiliates of the dealer unless the dealer can demonstrate that such transactions represent competitive market-making; and, (2) activity in repurchase agreements or similar transactions.

In addition to the standards for secondary market-making, a primary dealer is expected to be a consistent and meaningful participant in Treasury auctions of new securities. A dealer is expected to submit auction bids of a size roughly commensurate with the dealer's capacity. A dealer is expected to submit bids in every auction. At a minimum, the bids should be a percentage of the total being sold that is comparable to the dealer's share of total customer transaction volume reported to the Federal Reserve. A dealer is not required to be awarded a particular amount of securities, but the minimum

amount of bids a dealer is expected to submit should be in a realistic price range relative to current market conditions. Under ordinary conditions, a dealer would be expected to submit a significant amount of bids close to the prices accepted by the Treasury.

The experience of a firm and its key personnel are also considered. A primary dealer is expected to have strong management, experienced trading personnel, a seasoned sales staff, and well-trained back-office personnel. The dealer must possess operational capabilities to process and account for its transactions efficiently and accurately. Clearing of securities must be performed expeditiously and with due regard for the integrity and safety of the clearing process [see separate statement on dealer clearance behavior, dated April 1988]. Proper controls over all operations by management and auditing staffs are also essential.

The capitalization of a primary dealer must reflect a solid financial commitment and a strong capacity to participate in the market. Firms should have sufficient capital to provide an adequate cushion relative to risk exposures and overall leverage, and to more than meet the minimum capital levels required by the supervisory authorities. The main focus on capital is relative to risk, rather than level of capital. Most primary dealers have substantially more than $50 million of capital; major market-makers would have difficulty functioning prudently with less than $50 million in capital. Indeed, most primary dealers with moderate amounts of capital are affiliated with very substantial firms that can provide additional capital support if needed. In looking at a dealer's capital strength, the Federal Reserve considers the composition of capital, the variety and nature of the firm's activity, typical risk exposure, the quality of risk controls, and a dealer's affiliate and subsidiary relationships. A dealer's earnings history is also

considered. The earnings of a risk-taker understandably fluctuate; however, over a reasonable time period earnings should evidence a healthy business strategy. Poor earnings weaken a dealer's commitment to market-making and its ability to continue functioning as an effective primary dealer.

The ownership of a firm can have a bearing on its suitability as a primary dealer, particularly the reputation and conduct of the owners. The continuation of a primary dealer designation after a change in ownership is not automatic. New ownership arrangements will be evaluated based on the capacity to maintain or strengthen a dealer's performance in terms of financial, operational, managerial, and market-making criteria. In weighing whether to continue a primary dealer designation or request that a firm requalify, particular attention is placed on maintenance of continuity in the risk-management and market-making operations of the firm. When only the firm's primary dealer business, or a portion thereof, is being acquired by a new owner, the strong presumption is that the designation will not be continued without a period of requalification. The requalification process will be administered flexibly, with due regard for the qualifications of the new owner and the performance of the dealer operation during the transition.

Primary dealers may be foreign-owned though they should be incorporated in the United States with dedicated dollar capital. In keeping with a basic policy of national treatment, there are no limits on representation among primary dealers for firms with parent companies or shareholders based in foreign countries. The maintenance of an appropriate degree of balance and diversity within the primary dealer group will continue to be a factor in considering firms newly interested in becoming or acquiring primary dealers. In seeking to maintain such diversification weight may be

given to firms looking to develop business relationships on a de novo rather than acquisition basis. Consistent with the Omnibus Trade & Competitiveness Act of 1988, a foreign-owned firm may not be newly designated, or continue to be designated, a primary dealer after August 1989, in cases where the Federal Reserve concludes that the country in which the foreign parent is domiciled does not provide the same competitive opportunities to U.S. companies as it does to domestic firms in the underwriting and distribution of Government debt.

As noted earlier, primary dealers are designated because they can be of service to the Federal Reserve Bank of New York; however, it is not practical for the Bank to maintain a relationship with all firms who could potentially meet the minimum standards. Recognizing that a large expansion in the dealer list has been accommodated in recent years, it is believed that fifty or so primary dealers will more than meet the business needs of the Federal Reserve in conducting Open Market Operations. As the number of qualified dealers approaches this level, the Bank will be somewhat more selective in determining whether and when to add new dealers to the list and will also move more quickly to discontinue relationships with existing primary dealers. Recognizing that new dealers can add vitality to the market and that it is desirable to maintain an open system, the Bank will consider substituting newly qualified dealers which demonstrate particularly solid performance for existing primary dealers whose performance is not as strong as others in meeting the needs of the Bank. Such an event should not be interpreted as disapproval of the latter dealer's overall qualifications. Rather, such changes will only reflect the fact that it is impractical for the Bank to deal with every firm that might meet the minimum requirements.

Process for Aspiring Dealers

There is no formal application to be filed. Once a firm has a basic appreciation of the requirements of being a primary dealer and makes the decision to pursue designation it may make an informal indication of intent to the Federal Reserve Bank of New York. This step simply presents an opportunity to clarify criteria and procedures. It does not establish a reporting relationship.

At quarterly intervals, the Federal Reserve Bank of New York will decide whether to accept reports from additional dealers who have demonstrated significant potential to become primary dealers. Reports will be accepted only from dealers believed likely to qualify as a primary dealer within a reasonable time interval and for a trading relationship a short time thereafter. To be considered an aspiring dealer from whom reporting would be warranted, a dealer should have daily customer transaction volume for some time of at least half of that required for designation as a primary dealer. That amount of volume should evidence a broad, high-quality customer base, and a steady growth trend. The firm should also exhibit appropriate financial and managerial strength, internal controls, diversity of trading and customers, and a commitment to the market that is likely to continue. Each of these elements will be subjected to further and more intense scrutiny during the period before designation as a primary dealer. This Bank may discontinue receiving reports in cases where an aspiring dealer ceases to meet these criteria, such as if trading volume drops too low, a significant amount of capital is withdrawn, or key personnel are lost.

Before accepting reports, the Bank's Dealer Surveillance Staff will visit the dealer to review the firm's operational and financial capabilities.

In addition, the Bank will generally limit the period in which reports will be accepted from aspiring dealers. Within about one year an aspiring dealer should be able to achieve, and sustain for some months, a level of activity qualifying it as a primary dealer. If an aspiring dealer has not built sufficient volume within about a year or fails to meet other standards, reporting may be discontinued. The Bank would normally not consider accepting such reports again from that dealer for at least one year.

Reporting List

While the list of primary reporting dealers is available to the public--because this information is needed so that reporting dealers can distinguish trading activity with other primary reporting dealers from activity with "customers"--this Bank does not plan to comment on whether reports are being accepted from particular firms aspiring to be primary dealers. This is consistent with our view that acceptance of reports by the Federal Reserve for statistical purposes carries with it no official endorsement of the firm in question. More generally, it is also worth restating that appearance of a firm's name on the publicly available list of reporting primary dealers should not be taken as an official endorsement either; market participants are advised to make their own credit evaluations in selecting counterparties.

Federal Reserve Bank of New York
Dealer Surveillance Function
November 17, 1988

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LIST OF THE PRIMARY GOVERNMENT SECURITIES DEALERS REPORTING TO THE MARKET REPORTS DIVISION OF THE FEDERAL RESERVE BANK OF NEW YORK

Bank of America NT & SA
Barclays de Zoete Wedd Securities Inc.
Bear, Stearns & Co., Inc.
BT Securities Corporation
Carroll McEntee & McGinley Incorporated
Chase Securities, Inc.
Chemical Securities, Inc.
Citicorp Securities Markets, Inc.
Continental Bank, National Association
CRT Government Securities, Ltd.
Daiwa Securities America Inc.
Dean Witter Reynolds Inc.
Deutsche Bank Government Securities, Inc.
Dillon, Read & Co. Inc.
Discount Corporation of New York
Donaldson, Lufkin & Jenrette Securities Corporation
The First Boston Corporation
First Chicago Capital Markets, Inc.
Fuji Securities Inc.
Goldman, Sachs & Co.
Greenwich Capital Markets, Inc.
Harris Government Securities Inc.
Kidder, Peabody & Co., Incorporated
Aubrey G. Lanston & Co., Inc.
Lehman Government Securities, Inc.
Manufacturers Hanover Securities Corporation
Merrill Lynch Government Securities Inc.
J. P. Morgan Securities, Inc.
Morgan Stanley & Co. Incorporated
The Nikko Securities Co. International, Inc.
Nomura Securities International, Inc.
Paine Webber Incorporated
Prudential-Bache Securities, Inc.
Salomon Brothers Inc.
Sanwa-BGK Securities Co., L.P.
Smith Barney, Harris Upham & Co., Inc.
SBC Government Securities Inc.
UBS Securities Inc.
S.G. Warburg & Co., Inc.
Yamaichi International (America), Inc.

NOTE: This list has been compiled and made available for statistical purposes only and has no significance with respect to other relationships between dealers and the Federal Reserve Bank of New York. Qualifications for the reporting list is based on the achievement and maintenance of reasonable standards of activity.

Market Reports Division
Federal Reserve Bank of New York
January 17, 1991

APPENDIX F:

LIST OF PERSONS INTERVIEWED

LIST OF PEOPLE INTERVIEWED

Ministere des Finances -
Direction du Tresor et des Finances Exterieures

M. Mohamed Dairi
Directeur

M. Abdellatif Faouzi
Chef de la Division de la Monnaie et Credit

M. Allal Albakhti Youssef
Chef du Service du Marche des Capitaux

M. Ali Bedrane
Chef du Service de la Dette Intérieure

Mme. Zoulikha Nasri
Chef de la Division des Etudes et
de la Reglementation, Direction des Assurances

Bank Al Maghrib

M. Abdelouahed Belhaj
Directeur du Credit

M. Abdelaziz Drissi Messouak
Directeur Central

Caisse de Depot et de Gestion

M. Youssef Iraqui Houssaini
Directeur Financier

M. Mahmoud Laghmari
Sous-Directeur
Chef de la Division des Placements

Banque Centrale Populaire

M. Boubker Skalli
Directeur des Engagements Entreprises

M. Said Lefouili
Chef de Departement Etudes
Direction des Engagements des Entreprises

M. Mohamed Lemniai
Directeur des Etudes Economiques et
de la Documentation

M. Mustapha Rar
Chef du Departement Administratif Financier
et Comptable

Banque Marocaine du Commerce Exterieur

M. Abdellatif Jouahri
Chief Executive Officer

M. Abdelhakim Gasmi
Directeur Central
Direction du Developpement

Banque Commerciale du Maroc

M. Abdeslam Ouali
Directeur Delegue
Division des Services Bancaires

M. Tarik Sijilmassi
Directeur
Departement des Groupes

M. Jalal El Aroussi
Departement des Groupes

Wafabank

M. Hassan El Kouhene
Directeur General Adjoint

Banque Marocaine pour le Commerce et l'Industrie

M. Mohamed Trachen
Chef du Departement de la Comptabilite Generale

Mme. Youssef
Adjoint au Chef du Tresorie

M. Abdallah Iraqi
Chef de Service. Comptabilite

Societe Marocaine de Depot et Credit

M. Omar Akalay
Administrateur Directeur General

Mme. Soumiya Kabbas
Assistante

Societe Generale Marocaine de Banques

M. Michel Fay
Directeur

M. Abdeslam Maghnouj
Directeur, Direction Etranger et Tresorie

M. L. Benkirane
Directeur, Financements Speciaux et Etudes Industrielles

Societe de Banque et de Credit

M. Ali Iben Mansour
Administrateur Directeur General

Citibank

M. Kishore Gopaul
Vice President

M. Denis Richard
Vice President -
Directeur du Credit et du Marketing

Credit du Maroc

M. Mohamed Tazi Mezalek
Administrateur Directeur General

M. Jean-Pierre de Bellecombe
Administrateur Directeur General Adjoint

ABM Bank

M. Abdelali Tahri Joutey Hassani
Directeur

Office Nationale de la Poste et des Telecommunications

M. Ougmenssor Aomar
Administrateur Principal
Chef de la Division des Services Financiers

Groupe Office Cherifien des Phosphates

M. Abdelhadi Ninia
Directeur Financier

M. Bennani
Direction Financiere

SOPAR

M. Saad Kettani
Vice Chairman

Goodyear

M. Mohamed Benabderrazak
Directeur Financier

Industries Marocaines Modernes

M. Marcelin Goumand
Directeur Financier

Al Wataniya

M. Abdeljalil Chraibi
Directeur General

Federation Marocaine des Societes d'Assurances et de Reassurances

M. Hamid Besri
Directeur

Compagnie Nordafricaine & Intercontinentale d'Assurances

M. Ahmed Zinoun
Directeur General

Bourse Des Valeurs de Casablanca

M. Abderrazak Laraki
Directeur

Price Waterhouse

M. Abdelaziz Belkasmi
Associe-Partner

M. Aziz Bidah
Associe

Chambre de Commerce et d'Industrie de la
Wilaya du Grand Casablanca

M. Brahim El Amiri
Directeur General

U.S. Embassy

Mr. David S. Robins
Counselor for Economic Affairs

International Finance Corporation

M. Hany A. Asaad
Investment Officer - Africa I
(Washington, D.C.)

M. Younes Marrakchi
Investment Officer
(Casablanca)

University of Rabat

M. Mohamed El Qorchi
Professor of Finance

APPENDIX G:

PROJECT STAFFING AND MANAGEMENT