

*Guidelines*

*for Public Debt Management*

*2006*

# **Guidelines for Public Debt Management 2006**

## **Introduction**

The Italian public debt is composed of liabilities of the Central Government for 95%, with the remaining quota attributable to Local governments and by them autonomously managed. In turn, about 87% of Central government debt is represented by negotiable financial instruments – Government bills and bonds – and it is managed by the Public Debt Directorate within the Department of the Treasury of the Ministry of Economy and Finance.

The present document illustrates the guidelines for the management of the Government securities, which is carried out essentially through the issuance policy.

With regard to the investor base, over the past few years the trend observed in the distribution of bondholders by geographical area and by category shows that the market interest to invest in Italian Government bonds has grown remarkably: the demand from investors abroad has continually increased, with the relative quota of holdings growing from 22% of total Government securities outstanding in 1997 to 50% in 2004; the quota of Government securities held directly by Italian households has diminished since 1997 from 40% to the current 17%, signaling an ever greater recourse to investment by way of financial intermediaries.

## **Objectives of public debt management**

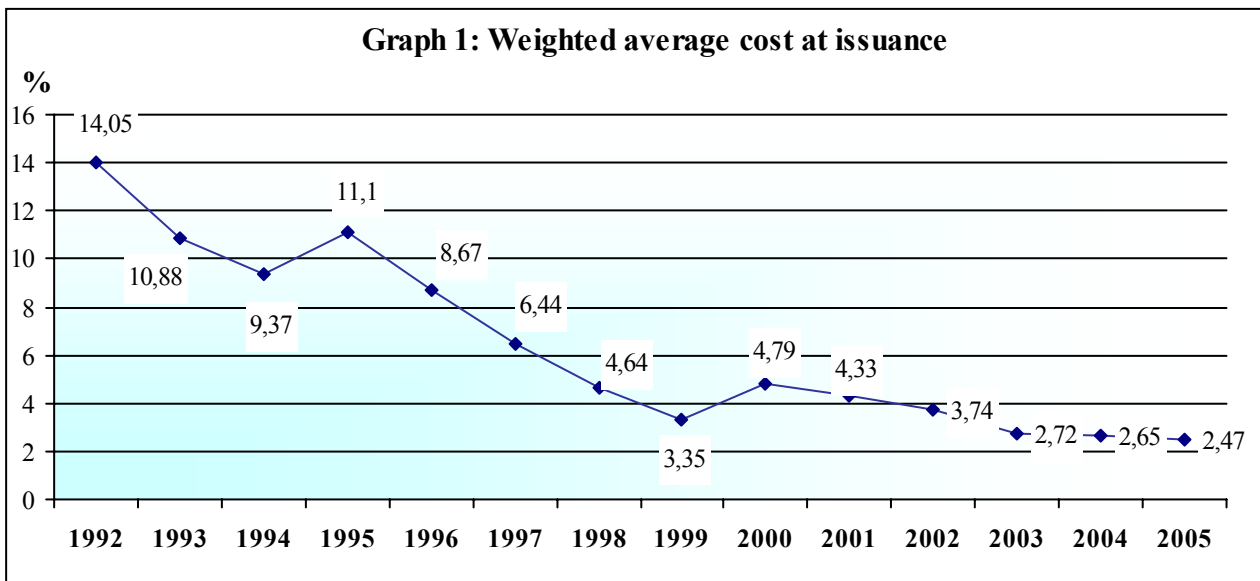
As known, the criteria underlying the issuance policy aim at addressing the financing needs of the Government at the most favorable economic conditions in the medium and long term, while limiting the exposure to different sources of risk, primarily the interest rate risk (nominal and real) and the refinancing risk.

## **Debt management policy in 2005**

The strategy carried out in 2005, in line with the policy undertaken in the past few years, focused on a careful management of the above mentioned risks and on the pursuit of a greater efficacy in the placement of Government bonds, with a view to guarantee an even more satisfactory distribution across geographical areas and categories of investors. The choice of the debt instruments to be offered each time to the market has been tailored also to this goal.

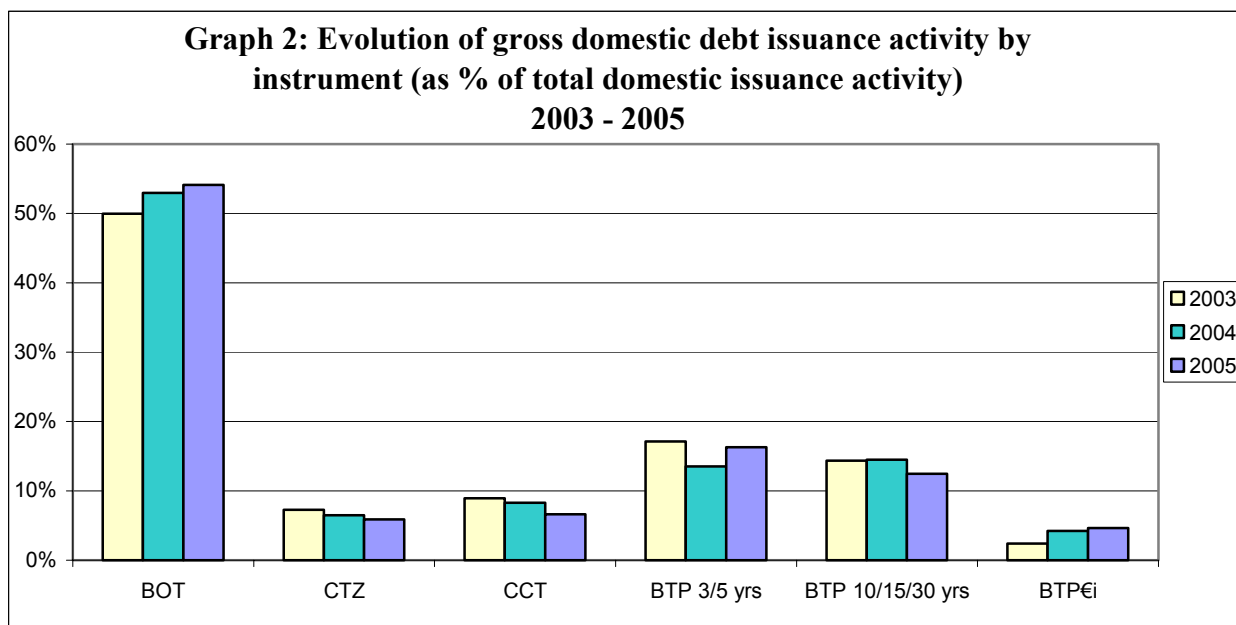
### *The issuance policy and its effects*

By exploiting the descending trend of interest rates, which continued up to September 2005, it was possible to obtain a progressive reduction of the total debt interest expenditure of the General Government sector, that went from 5.1% of GDP in 2004 to 4.9% in 2005. Government securities has contributed significantly to this reduction given that their marginal cost at issuance has continually decreased, reaching 2.47% in 2005, compared to 2.65% for the previous year (see Graph 1).



### *The issuance policy for nominal bonds*

The results obtained in reducing servicing costs is attributable to the issuance policy carried out over the past five years, which has combined the opportunities resulting from lower interest rates with a greater issuance of medium-long term instruments. In particular, Graph 2 shows how in the course of the past three years, the increase in Treasury bills (BOTs) issuance, aimed at taking advantage of the interest-rate trend and to bring about a more efficient cash management, was accompanied by a gradual reduction in other issuances, such as those linked to short-term rates (CCTs) or those of short maturity (CTZs), and by a substantial expansion of issuance of medium-long-term instruments (BTPs).



All the same, in 2005 the issuance policy saw a partial re-balancing: the strategy of increasing, however slightly, the quota of BOTs and reducing that of CCTs and CTZs continued, while the very long-term issuance (15 and 30 years BTPs) witnessed a reduction in light of an increase of that of the 5-year BTP. Indeed, the latter increased by 2.7%, while BOTs climbed by about 1.2 percentage points, compared to a reduction of 2.2 points for CCTs and CTZs and of about 2 points for BTPs with maturity of ten years or more. As already said, the reduction in long-term issuance, compared to the period 2003-2004, has principally occurred with respect to the 15-30 year segment. Compared to 2004, in fact, when two syndications were carried out, one for the 30-year first reopening and the second for the launch of the new 15-year *benchmark*, 2005 saw only the launch in October, and via syndication, of the new 30 year benchmark (BTP 2037). Long-term issuance was thus carried out exclusively through auction reopenings of the 15-year BTP.

#### *The issuance policy for inflation-linked bonds*

Thanks to the introduction in September 2004 of the auction system as a placement mechanism also for linkers, in 2005 the Treasury has regularly issued bonds linked to European inflation (BTP€is) offering on a monthly basis one or more of the 5, 10 and 30 year tenor available instruments, according to demand and market conditions.

The 18 billion euro supply carried out in this segment, in line with that of 2004, was primarily characterized by the syndicated launch of the new 5-year benchmark in January and by 11.3 billion euro reopenings of the same bond via auction over the course of the year. The liquidity of the on-the-run 10-year bond was guaranteed by auction reopenings, for a value of 4 billion, while the 30-

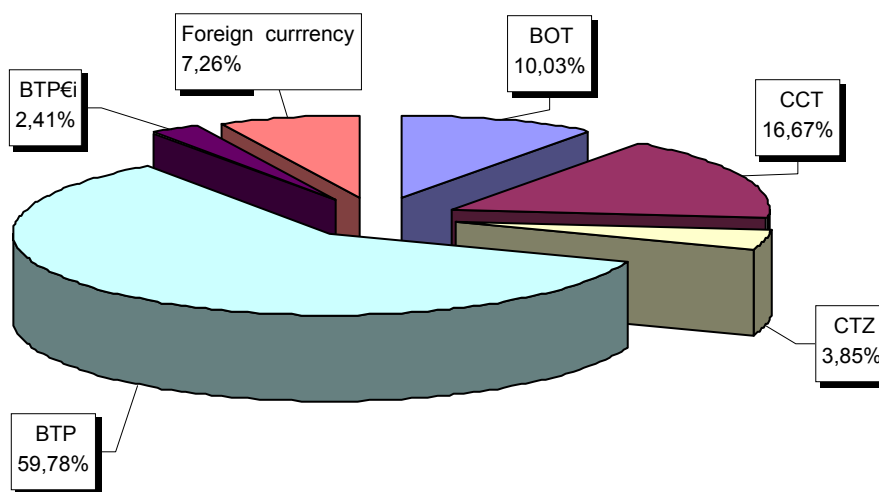
year bond was placed both via syndication and auctions, with reopenings of limited size based on the demand for this segment of the real curve.

In 2005 the BTP€is' stock reached almost 48 billion euro with an investor base now broadly distributed internationally, making the Italian Treasury a leader in the European market of such instruments.

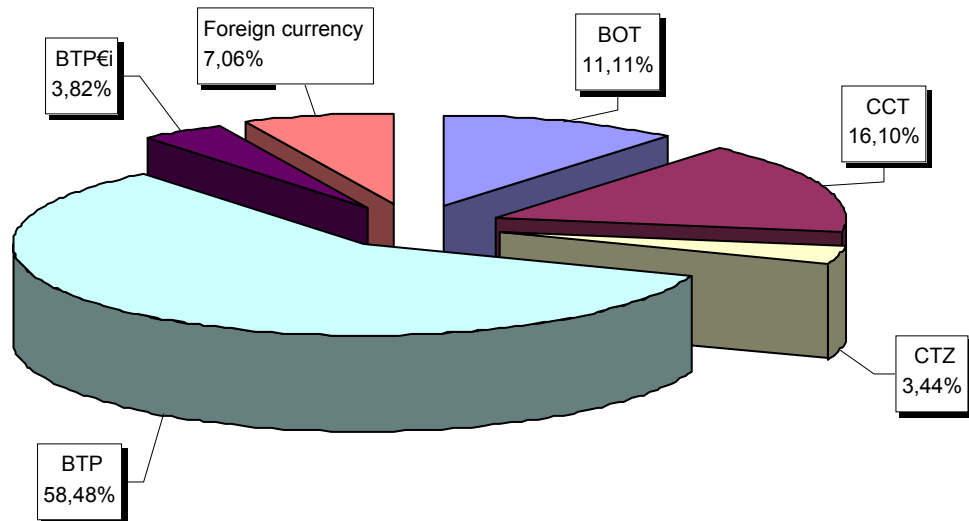
### *Effects on debt composition*

The 2005 issuance policy did not affect debt composition substantially. Observing Graphs 3 and 4, it is clear that the composition remained mostly unchanged, with the exception of the increasing role of inflation-linked bonds that rose from 2.41% in December 2004 to 3.82% in November 2005.

**Graph 3: Government debt breakdown by instrument  
as of 31 December 2004**



**Graph 4: Government debt breakdown by instrument**  
as of 30 November 2005



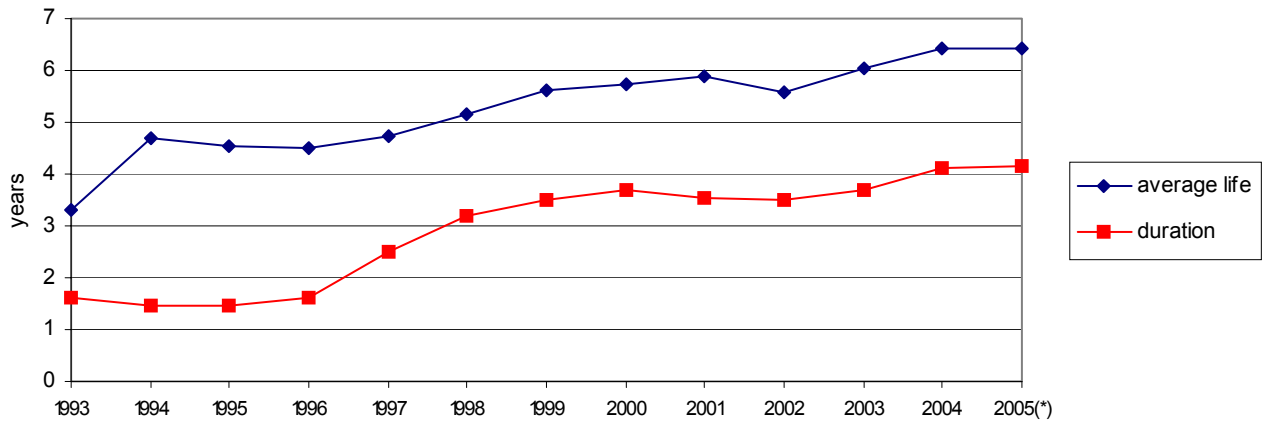
It is important, all the same, to stress that the goal of reducing the sensitivity of the borrowing cost to nominal interest rate variations has brought about a further lengthening of the debt duration (see graph 5) from 4.06 years at the end of 2004 to about 4.15 years as of November 30, 2005. In terms of the *Average Refixing Period*<sup>1</sup> there was a shift from 4.98 years of 2004 to 5.46 years at the end of November 2005. Therefore, the impact on interest expenditure due to an unexpected increase in interest rates<sup>2</sup> was reduced even further. Indeed, if a sudden one percentage-point increase of the entire yield curve occurred, the growth in interest expenditure as a percentage of GDP would rise of 0.2% in the first year, 0.38% in the second year, 0.50% in the third year, and 0.56% in the fourth year. The same exercise carried out one year ago showed slightly higher figures.

Debt average life, as of end-November (Graph 5), was kept unchanged at 6.42 years, which is considered a satisfactory level.

<sup>1</sup> The Average Refixing Period is another indicator of debt sensitivity to interest rates, that measures the average time in which debt coupons are refixed. For zero-coupon bonds and bonds with fixed coupons, it corresponds to the residual life of the bond. For floating rate notes, it corresponds to the time until the next coupon is refixed.

<sup>2</sup> Note that interest expenditure forecasts contained in the official documents are based on the forward rates for the same issuance strategy. These estimates, therefore, already include a growing interest-rate trend.

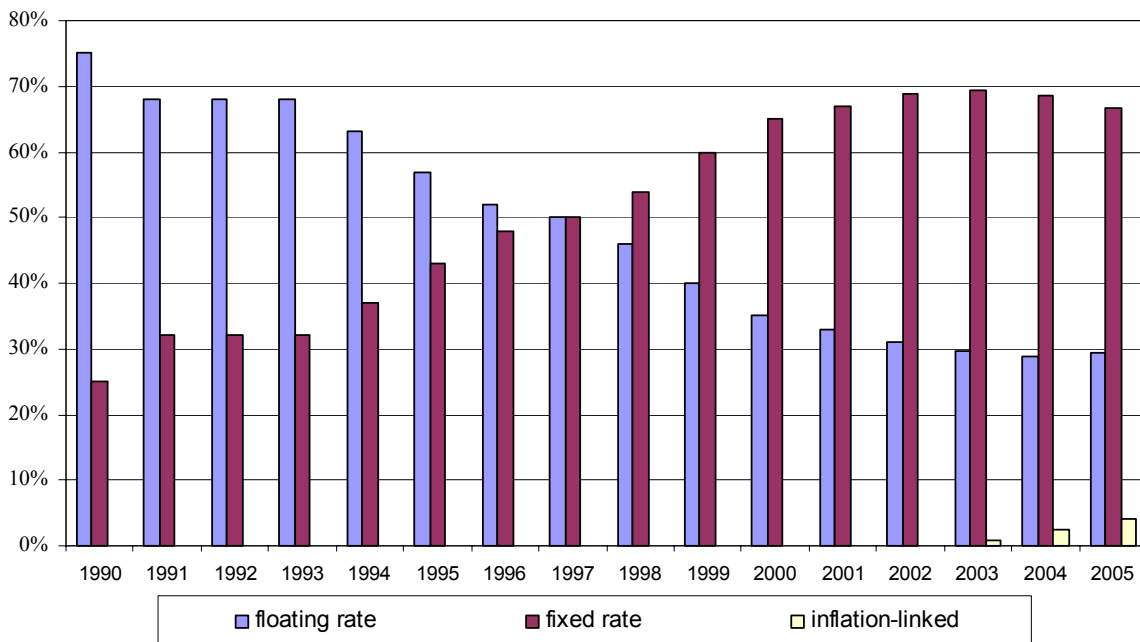
**Graph 5: Average life and duration of Central Government debt**



(\*) data as of 30 November 2005

In a medium term perspective, it can be noticed (Graph 6) that the quota of fixed-rate bonds has been steadily kept around 2/3 of total debt.

**Graph 6: Domestic Debt Composition**

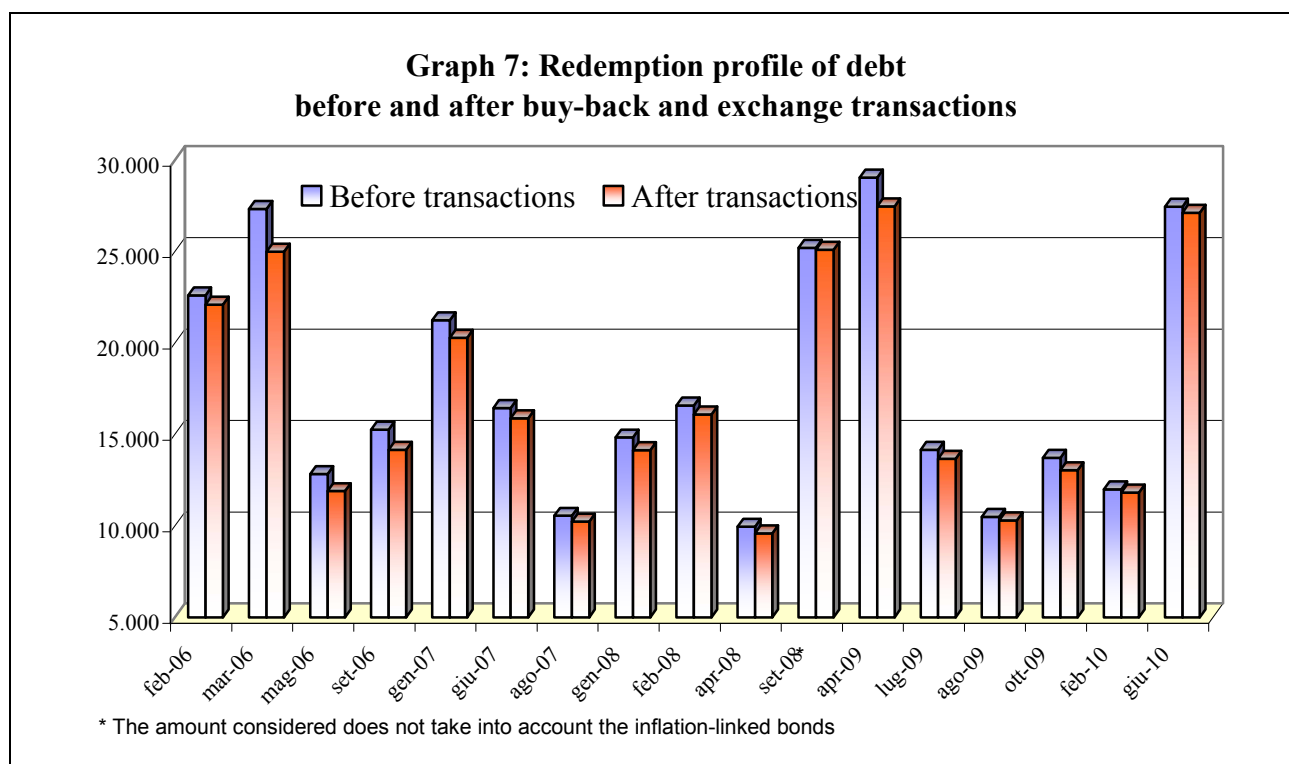


## The role of buy-back and exchange transactions reserved to Specialists in Government Bonds

The importance of buy-back and exchange transactions was confirmed in 2005 as tools for the reduction of refinancing risk, the optimal management of cash flows, and the support of secondary market liquidity of Government bonds.

Buy-back transactions, in line with these objectives, were realized by drawing on the cash availability of the Government Bond Sinking Fund and the Treasury Cash Account at the Bank of Italy and brought about a reduction in the amount of debt outstanding. Specifically, in 2005, the Treasury successfully conducted two auctions (*reverse auctions*) and various bilateral buy-back transactions, repurchasing in total over 10 billion euro of nominal debt and reducing in this way the quota of bonds maturing between 2006 and 2010. In addition, an exchange transaction of about 1.3 billion euro was carried out to withdraw from the market bonds maturing in 2006 in exchange of BTPs maturing in 2019.

In 2006 those transactions, according to the issuance policy implemented, will continue to serve for the reduction of refinancing risk and as a complementary instrument for cash management, by adopting in each case the operational devices deemed most appropriate.





### ***Methods of issuing Government securities within the domestic program***

Again in 2005, auctions were the principal issuance mechanism for domestic Government securities. Indeed, auctions, due to their characteristics, continue to be the most suitable mechanism for the pursuit of Treasury objectives in terms of transparency and regularity.

Conversely, syndications, in line with the experience of recent years, were used for the launch of both new Euro-area inflation linked bonds and new nominal *benchmarks* with a maturity greater than 10 years. Furthermore, it was also deemed appropriate to use syndicated issuance for the reopening of the 30-year inflation-linked, given the greater volatility of this particular market segment. Syndications have generally proven to be effective in terms of *pricing*, breadth of distribution (by investor type and geographical base) and secondary market performance .

In 2005 the structure of the auctions' calendar has not undergone substantial modifications with respect to 2004, year in which the medium-term segment was reorganized, resulting in a reduction to just one monthly auction for CTZs and 3-year BTPs. As already stated above, however, 2005 was the first year in which the Treasury systematically offered inflation-linked bonds via auction. BTP€is were, indeed, reopened monthly with maturities chosen according to market conditions.

### **The 2006 Issuance Program**

Over the course of 2006 the debt management policy will continue to be pursued according to the same principles that drove the strategy in the last years. Government securities' issuance will aim to strengthen the results achieved so far in terms of interest rate and refinancing risk exposure, taking into account market conditions. Again next year, in line with the successful approach followed by the Treasury for some years now, the issuance policy will strive to guarantee the liquidity of all the instruments and to strengthen the presence of the Italian public debt in international portfolios, without neglecting the needs of resident investors, both institutional and retail.

### ***Issuance program for domestic bonds***

Domestic debt securities (BOTs, CCTs, CTZs and BTPs) will be issued primarily via auction in order to guarantee transparency and regularity of the supply. The annual calendar of Government bond issuance for 2006 is currently available at the following web address: [www.debitopubblico.it](http://www.debitopubblico.it). The calendar includes the dates of announcement, auction, and settlement of the various types of securities. In the Quarterly Issuance Programs to be issued during the year, the new *benchmarks* will be announced together with the accrual dates of the new bonds.

**Auction schedule**  
(with reference to issuance date)

	Mid-month Auction	End-month Auction
Cash management bills – 3-mth BOT	<b>Issuance tailored to meet cash needs</b>	
6 mth BOT		X
12 mth BOT	X	
24 mth CTZ		X
3 year BTP		X
5 year BTP	X	
10 year BTP		X
15 and 30 year BTP	<b>These two bonds will be offered within the month according to market demand</b>	
7 year CCT		X
BTP€i		<b>Offer will be based on market demand</b>

*Nominal bonds*

**BOTs:** The 12-month BOT will continue to be offered with regularity in mid-month auctions. The supply will be chosen according to demand and financing needs. The 3-month BOT, as in 2005, will be offered discretely, according to an efficient cash management approach. With the same objective and with greater flexibility, the Treasury will issue BOTs with non-standard maturity (the so-called flexible BOTs) in sizes each time consistent with a proactive cash management framework to be carried out also in a context of improved forecasts of Treasury cash flows.

The 6-month BOT supply will be established according to flows of the same-type maturing bills and in order to ensure efficiency in the CCT market. In this way, the regularity of supply and the adequacy of volumes offered will be guaranteed both at ordinary auctions and at reopenings reserved to Specialists. The amount of the latter will be decided on a case-by-case basis according to results observed at auction and market conditions.

**CTZs:** During 2006 the Treasury will continue to issue the 24-month CTZ via end-month auctions. The issuance will aim at refinancing the maturing volumes, thus maintaining substantially unchanged the stock currently outstanding, which, after the reduction of the past few years, has reached a level considered adequate. This instrument will be guaranteed a level of liquidity in line with market expectations.

**CCTs:** Given the evolution of the CCT market in 2005 and the investor base composition for this instrument, increasingly represented by money market funds and institutional investors, the Treasury will continue to foster liquidity, issuing amounts in line with demand flows. The greater volume coming due in 2006 with respect to 2005 (about 27.7 billion compared to 20.3 billion euro), will enable a reduction in the outstanding stock by the end of the year 2006.

Furthermore, responding to investors' needs, the CCTs rounding rule underlying the coupon indexation mechanism has been revised as follows: new CCTs issued with settlement date after December 31<sup>st</sup>, 2005 will have the coupon determined by adding 15 basis points to the semiannual gross yield of the 6-month BOT issued in the very last auction before the accrual date of the coupon, rounded to the nearest one-hundredth. For CCTs already outstanding on December 31, 2005, the rounding rule will remain unchanged.

**Medium-term bonds:** As in the past years, the issuance policy of 3, 5 and 10-year BTPs will continue to be characterized by extremely regular monthly auctions.

**Long-term bonds:** As in recent years the placement of bonds with a duration of more than 10 years will be based on market conditions and the evolution of financial markets, with reference to the long part of the yield curve.

Flexibility will thus remain the main criterion to place these instruments at the mid-month medium long term auctions. Again in 2006 syndications will be implemented especially for the launch of new bonds, given the immediate liquidity and the broader presence in portfolios of domestic and international investors that this issuance technique is able to provide.

#### *Inflation-linked bonds*

The presence of the Treasury in the sector of bonds linked to euro-area inflation (ex-tobacco), as in the past two years, will represent a strategic pillar of the 2006 issuance policy. On a monthly basis, both through syndications – preferably used for the launch of new bonds – and through auctions, the Treasury will guarantee the liquidity of the entire real yield curve according to market conditions and in order to increase the weight of those bonds within the stock of debt.

When auctioned, as it occurred in 2005, the placement is scheduled in the second half of the month, one business day prior to the end-month medium-long-term auctions. The Treasury will announce the bonds to be issued and the maximum quantities to be offered four business days prior to the auction, that is, with the first announcement of the end-month auctions of medium-long-term bonds.

### ***Foreign currency issuance program***

The Republic of Italy has long established a significant presence in international capital markets. The program in foreign currency is aimed at containing the total cost of debt and the risk related to debt refinancing. With the overall issuance activity in international markets, the Treasury pursues the objective of reaching an ever-broader group of investors, fostering its relations with international investors, as to improve the recognition of the Republic of Italy as a sovereign issuer present in markets characterized by strong demand flows.

Over the course of 2006, the Republic will access foreign markets in the following ways:

#### **1. Global benchmark program in US dollars**

The Republic will continue to be an important issuer in the market of US dollar, guaranteeing liquidity for the bonds issued: therefore all the bonds issued within this program will have *benchmark* maturities and sizes. The Dealers of the program will continue to be: BNP Paribas, Citigroup, CSFB, Deutsche Bank, Goldman Sachs, JP Morgan Chase, Lehman Brothers, Merrill Lynch, Morgan Stanley and UBS.

#### **2. Issuance activity in other markets**

The Republic of Italy will evaluate the possibility of issuing bonds in other international markets on the basis of the investor demand and the opportunity cost. Issuance activity in currencies other than the US dollar will be typically carried out through the MTN program and occasionally through the *Global* format. These transactions are characterized by a more flexible approach and they include several currencies, including transactions in eurodollars in a non-*benchmark* format.

#### **3. Commercial Paper**

The use of Commercial Papers, carried out in both the Euro market and the USCP one, has always been a useful complement to the BOT program for cash management purposes, thanks to their extreme flexibility in terms of both amount and maturities.

In 2006, the Treasury will keep on taking advantage of the characteristics of flexibility and diversification offered by this instrument.