Debt Strategy 2006/07 Consultation Document

Overview

The Department of Finance, in conjunction with the Bank of Canada, is seeking views of government securities distributors, institutional investors, and other interested parties on adjustments to the Government of Canada bond program for fiscal year 2006/07 and beyond.

The government remains committed to achieving balanced budgets or better in 2005/06 and in each of the next four fiscal years, as announced in the February 2005 budget. In the 2005/06 *Debt Management Strategy*, the government announced that it would be assessing potential structural changes to the bond program in light of declining fixed-rate borrowing needs. The purpose of making changes to the bond program would be to maintain a well-functioning market for Government of Canada securities. In this regard, obtaining the views of market participants is important to the government.

This consultation paper identifies a broad spectrum of options, ranging from modest to more fundamental changes, for adjustment of the government's bond program in the short and medium terms. Interested parties are encouraged to comment on the potential adjustments presented in this document, and to propose any other changes that support a well-functioning market for Government of Canada securities over the medium term.

A summary of the comments received will be released on the Bank of Canada website concurrently with the release of the 2006/07 *Debt Management Strategy* in March 2006.

Context

As the sovereign and the largest borrower in the Canadian fixed-income market, the Government of Canada has a major interest in sustaining a liquid and efficient market for its securities. A liquid and efficient government securities market contributes to keeping borrowing costs low and also provides pricing and hedging tools for market participants, thereby contributing to the effective functioning of the broader Canadian fixed-income market. A challenge in recent years has been to maintain a liquid, well-functioning market for Government of Canada bonds in the face of declining borrowing needs and the 2003/04 strategic decision to gradually reduce the fixed-rate share of the debt from two-thirds to 60 per cent by 2007/08.

Gross annual bond issuance has declined over the past 10 years, from a peak of $54 billion in 1996/97 to an expected $33 billion in 2005/06. Based on current projections, annual gross bond issuance is expected to be in the range of $30 billion to $33 billion over the next five years. There are, however, factors that could affect the size of the bond program in future years, including unforeseen fiscal developments and changes in the government's borrowing practices—for example, the funding of existing non-market liabilities, or changes in the borrowing framework for major government-backed entities, which was the subject of a recent review evaluation by KPMG.

Since the peak of annual bond issuance in 1996/97, the government has taken a number of steps to facilitate an orderly adjustment to smaller bond programs. The government's approach has favoured progressive changes to the bond program to facilitate market adjustment. These changes include:

- Eliminating 3-year bond issuance in 1997/98 and concentrating issuance of large benchmark bonds in four key maturity sectors (2, 5, 10, and 30 years[1]);
- Gradually reducing 30-year bond issuance from about $6 billion in 1997/98 to about $3 billion in 2005/06 and moving to issuance on a semi-annual basis in 1998/99;
- Introducing a bond-buyback program in 1999 (30 per cent of gross issuance in 2004/05 was the result of recycling old bonds through the buyback program); and
- Beginning in 2002/03, reducing 2-year bond issuance when new 2-year benchmark bonds share a common maturity date with (i.e., are fungible with) older benchmark bonds. Annual total 2-year bond issuance was reduced from $14 billion in 2001/02 to $10 billion in 2005/06.

Even with the set of measures introduced in recent years, it has been increasingly difficult for the government to maintain current auction and benchmark sizes in all four bond maturities and to meet market liquidity needs. In particular, reduced issuance in the annual bond program has resulted in a relatively small quantity of long-dated government bonds being supplied to the market.

Issues for discussion

This consultation document presents a broad spectrum of potential changes to the current bond program that could be implemented progressively over time. As a point of departure, market participants are requested to provide their views on the government's general principles regarding liquidity and the regularity of issuance. Their views are then sought on specific potential measures, which are presented in two broad categories: a) potential near-term changes, which largely preserve the current structure of the bond program; and b) more fundamental changes, which would alter the design of the bond program over the medium term.

Finally, views are sought on operational measures to improve treasury management.

Debt Management Principles

In pursuit of its objectives of achieving stable, low-cost funding and maintaining a well-functioning market for Government of Canada securities, the government emphasizes liquidity and regularity in the design and implementation of the bond program. The government's approach is to build large benchmark bonds at key maturities through regular pre-announced auctions of adequate size (i.e., issuance at 2, 5, 10, and 30 years).

[1] Note that the government issues nominal and inflation-linked bonds in the 30-year maturity sector.

Declining borrowing needs may require that trade-offs be made in how the government puts these principles into practice in the medium term. In this regard, market participants' views are sought on the relative priority of liquidity and the regularity of issuance.

1. What is your view of liquidity in the Government of Canada bond market, as a whole and by maturity sector? How much of a change in the size of the annual gross bond program would have a material impact on market liquidity and efficiency?

2. How important are the frequency and size of bond auctions when building a benchmark?

Potential Measures

a. Potential measures over the near term

Potential modest adjustments (forgoing fungible 2-year bond auctions and changing the maturity cycle of 5-year bonds) are expected to be sufficient in the short term to maintain the current structure of the bond program—i.e., four key maturities, present benchmark target sizes, and the time periods for building benchmark bonds. These adjustments would build on past initiatives directed towards taking advantage of the fungibility between Government of Canada securities. Views are sought on the use of transition mechanisms, such as interest rate swaps, that could support the gross issuance of benchmark bonds.

i. Forgoing fungible 2-year issuance

Under current Canada Depository Securities rules, market participants have the ability to strip and reconstitute bonds sharing the same maturity date (i.e., fungible bonds) into a benchmark bond beyond the original issue size. In 2002, the government gradually began to reduce 2-year issuance in circumstances where new issues were fungible with existing old benchmark bonds. This allowed the government to reallocate forgone 2-year bond issuance to other maturity sectors. More recently, the government decided in the 2005/06 *Debt Management Strategy* to forgo the fungible 2-year auction in the fourth quarter of fiscal year 2005/06 to facilitate a reduction in gross bond issuance in the year.

3. How effective are existing fungible bonds in supporting the liquidity of building benchmarks? What is your view on the appropriate balance between fungible and non-fungible 2-year bonds?

4. What are your views on the possibility of forgoing one fungible 2-year bond auction each year as a permanent feature of the bond program in the future?

ii. Changing the maturity cycle of 5-year issuance

Another initiative that could sustain a well-functioning bond market in 2006/07 and beyond would be to change the 5-year benchmark maturity from 1 September to 1 June. The resulting fungibility of 5-year bonds with old 10-year bonds, and eventually with 2-year bonds, would allow the government to reduce issuance in the 5-year sector and maintain higher issuance in other sectors.

5. What would be the impact of changing the 5-year benchmark bond from a September maturity to a June maturity on other markets, such as the corporate, futures, and swap market, and on investors?

6. The fungibility of the 5-year benchmark with 10- and 2-year bonds would create large maturities. Is there a size at which a Government of Canada benchmark bond would become so large that it could negatively affect the government's funding cost or the functioning of the market?

iii. The bond buyback program

The buyback program continues to play an important role in supporting auction and benchmark sizes. The buyback program was introduced in 1999 to smooth the transition from the larger bond programs of the 1990s to the smaller programs sustainable in the future. In the 2005/06 *Debt Management Strategy*, the government announced that it would begin to reduce the size of the buyback program, since the need for a transition mechanism is diminishing as the bond stock becomes concentrated in fewer old benchmark bonds, which continue to provide liquidity for market participants.

7. Should the bond buyback program be maintained over the medium term? What would be the impact of reducing the $6 billion floor below which benchmark bonds are currently not repurchased? Could the basket of eligible bonds be broadened to include off-the-run (one-time, old) benchmark bonds?

iv. Use of interest rate swaps

The government used interest rate swaps (IRS) in domestic debt management from 1988 to 1995. The use of IRS was a cost-effective alternative to treasury-bill issuance for the government. Over the period 1988 to 1995, the government swapped $9.8 billion from fixed- to floating-rate debt. The domestic swap program was suspended in 1995 when the use of IRS became less cost-effective.

A cross-currency IRS program has been in place since February 1995 as a means of raising cost-effective funding of foreign exchange reserves for the government. The program consists of issuing nominal fixed-rate domestic bonds and then swapping them into foreign currency fixed- or floating-rate debt. The cross-currency program executes about Can$5 to $7 billion of swaps, on average, annually, which supports the maintenance of current domestic bond-auction sizes.

8. What is your assessment of the government using IRS as a tool to maintain bond issuance?

9. What would be the impact on the swap market if the government decided to implement a domestic IRS program, in addition to the cross-currency IRS program?

b. Potential measures over the medium term

As noted, maintaining the current structure of the bond program may not sustain a liquid and well-functioning Government of Canada bond market over the medium term if government borrowing requirements continue to move lower. Views are sought on the following potential measures, which could be implemented beyond the 2006/07 planning horizon.

v. Reducing the sizes of current benchmark targets

The current sizes of benchmark targets are: for 2-year bonds, $7 billion to $10 billion; for 5-year bonds, $9 billion to $12 billion; for 10-year bonds, $10 billion to $14 billion; and for 30-year bonds, $12 billion to $15 billion.

Given current benchmark cycles (6 months for a 2-year benchmark, 1 year for 5- and 10-year benchmarks, and 3 to 4 years for 30-year benchmarks), the sizes of target benchmarks would need to be reduced as a result of smaller auctions resulting from lower issuance. The reduction in benchmark sizes may, as a result, have implications for the liquidity and trading of Government of Canada benchmarks and for the broader Canadian fixed-income market.

10. What is your assessment of a reduction in the sizes of target benchmark bonds in all or some maturity sectors to maintain current benchmark-building cycles?

vi. Changing issuance pattern of some regular auctions

Bonds with 2-, 5-, and 10-year maturities and Real Return Bonds are regularly issued at quarterly auctions; nominal 30-year bonds are issued at semi-annual auctions.

With expectations of lower annual gross issuance, auctions could take place less frequently to permit larger auction sizes, thereby helping to maintain the well-functioning of the Government of Canada securities market.

11. What are your views on a potential reduction in the frequency of auctions to maintain larger auction sizes?

12. What are your views on issuing 30-year bonds through quarterly switches only, instead of auctions, once the building benchmark reaches a given outstanding amount?

vii. Eliminating a maturity sector

The government strikes a balance between low financing costs and cost stability over a medium-term horizon in selecting the mix of bond issuance among four key maturities (2, 5, 10, and 30 years). Each of the four key maturities provides value for the market. The government could eliminate one of the current bond maturities to facilitate a reduction in bond issuance.

13. If a maturity were to be eliminated, which one would you recommend?

c. Possible change to improve government treasury management operations

viii. Adjustment to the auction calendar

Regular auctions are announced in the quarterly bond schedule in the following order: 30-, 10-, 5-, and 2-year bonds. To improve the government's cash-management activities, 2-year bonds could be issued and settled on or before the important maturity dates of 1 June, 1 September, and 1 December to offset large cash outflows, rather than at present, when 2-year bond auctions settle after these maturity dates.

14. What are your views on the proposed change to the sequence of quarterly bond auctions? How important is the sequence of auctions?