Debt Strategy 2007/08 Consultations

Overview

The Department of Finance and the Bank of Canada are seeking views of government securities distributors, institutional investors, and other interested parties on conditions and developments in the Government of Canada securities market to support the development of the debt strategy for 2007/08. Market participants' views are also requested on certain operational aspects of the Government of Canada domestic debt programs.

The focus of the 2007/08 debt strategy consultations is to assess the state of the Government of Canada securities market in an environment of limited borrowing needs. In this context, views are sought on the Government of Canada securities market in terms of its liquidity and efficiency, the evolving pattern of trading activity, and the use of government securities for collateral management purposes.

A summary of the comments received will be released on the Bank of Canada website concurrently with the release of the *2007/08 Debt Management Strategy*.

Background

As the sovereign and the largest borrower in the Canadian fixed-income market, the Government of Canada has a strong interest in sustaining a well-functioning market for its securities, which contributes to achieving the fundamental debt-management objective of keeping borrowing costs low and stable for Canadian taxpayers. A well-functioning government securities market also contributes to the effective functioning of the broader Canadian fixed-income market by providing pricing and hedging tools for traders, investors, and other Canadian borrowers.

The principal challenge in recent years has been to maintain a liquid, well-functioning market for Government of Canada bonds given declining federal borrowing needs and the strategic decision to reduce the fixed-rate share of the debt from two-thirds to 60 per cent by 2007/08.

Over the past 10 years, gross annual bond issuance has declined steadily, from a peak of $54 billion in 1996/97 to about $31 billion in 2006/07. For the purposes of these consultations, it should be assumed that annual bond issuance over the next few years will stay around current levels. While some measures that could supplement bond issuance have been suggested (e.g., interest rate swaps and the consolidation of Crown borrowings), no decision to adopt these measures has been made or should be assumed.

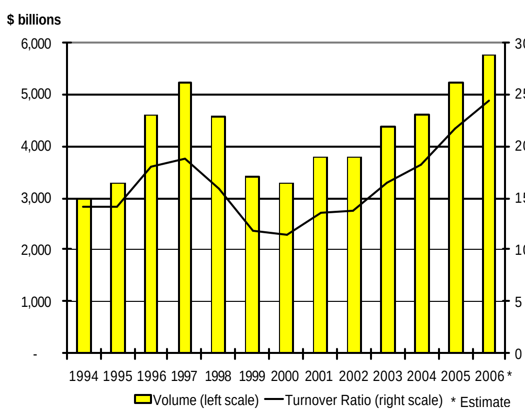
__Liquidity in the Government of Canada Bond Market__

These consultations are seeking to better understand the state of liquidity of the Government of Canada securities market, in order to assess possible program adjustments and recent initiatives to support market confidence.

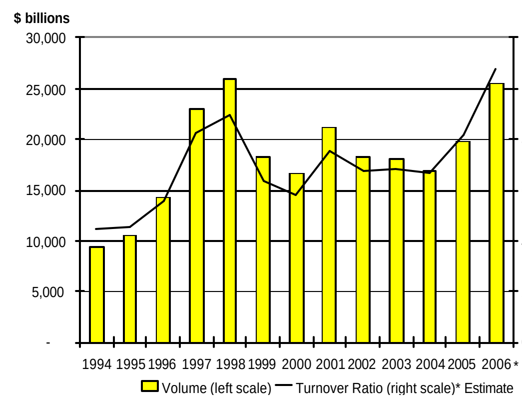
In recent years, market participants have indicated that liquidity in Government of Canada bonds is sufficient for bond maturities up to 10 years, but has declined for long-term maturities (please refer to the summary of the 2006/07 debt strategy consultations available at http://www.bankofcanada.ca/en/notices_fmd/2006/not060406.html).

The turnover ratio for Government of Canada bonds and bond repos, which is a widely used indicator of overall liquidity, actually hit record levels in 2006 (see Graphs 1 and 2). The data indicate that the turnover is highest in bonds with maturities between 3 and 10 years. For instance, a number of international investors have increased their purchases of Canadian fixed-income products, contributing to higher trading volumes in both the cash and derivatives markets, notably for 10-year Government of Canada bond futures (CGBs). However, some market participants have suggested that high turnover ratios, along with narrowing bid-ask spreads, may reflect a larger number of small transactions while liquidity for larger transactions has not improved.

Graph 1
Turnover and Trading Volume
Bonds (excluding Real Return Bonds)



Graph 2
Turnover and Trading Volume
Bond Repos (excluding Real Return Bonds)



More recently, the demand for Government of Canada securities for collateral purposes has been strong, leading to an increase in Government of Canada bond repo volumes that may have contributed to the increase in the cost of Government of Canada collateral in the repo market. The increased demand for Government of Canada securities has been attributed in part to the growing use of collateral due to more prudent risk-management practices, greater requirements for collateral to support transactions in settlement and clearing systems, and greater requirements for collateral related to the increased use of derivatives.

The liquidity of the Canadian marketplace is not only a function of program design, but also a function of public confidence in its integrity. Revisions were made in early 2006 to the Investment Dealers Association of Canada (IDA) Policy No. 5 (originally introduced in 1998), to further strengthen integrity in the trading of fixed-income securities.

In light of the tightness in the repo market, and for the first time since its securities lending program was implemented in 2002, the Bank of Canada conducted numerous securities lending operations in 2006 to relieve pressure in some sectors of the repo market. In June 2006, a net position report was requested by the Bank of Canada under the terms of IDA Policy No. 5. A review of the information gathered by the Bank concluded that there were insufficient grounds for requesting that the IDA conduct an investigation (available at http://www.bankofcanada.ca/en/notices_fmd/2006/not070906.html). Nevertheless, the episode highlighted the need for vigilance to ensure that market integrity is maintained.

Finally, it is noted that there has been a growing use of electronic trading systems, which have contributed to greater market transparency and efficiency. Over the past year, the standard of transparency of the government securities markets has been subject to review by the Canadian Securities Administrators in the context of the 31 December 2006 expiry date of the exemption of Government of Canada securities from the requirements of National Instruments 21-101, Marketplace Operation, Companion Policy 21-101CP, NI 23-101 Trading Rules and Companion Policy 23-101CP (the ATS Rules). In October, the Department of Finance and the Bank of Canada submitted comments on proposals made by the CSA earlier in the year, indicating general support for a higher level of transparency, along with concerns about the potential impact of specific rules on the liquidity of the market.

Issues for Discussion

In the context of the evolution of primary and secondary markets for Government of Canada securities, the Department of Finance and the Bank of Canada are seeking views on the Government of Canada securities market in terms of its liquidity and efficiency and on potential operational initiatives for the purposes of formulating the debt strategy for 2007/08 and future years.

Government of Canada Securities Market

1. Has liquidity changed? If so, how? Have average transaction sizes been changing in specific sectors or across the curve? Have bid-ask spreads changed for a given transaction size? Are there other factors than those cited in the previous section that have an impact on the liquidity of Government of Canada securities as a whole or for a sector of the yield curve in particular?

2. How have the roles of primary dealers or investors changed over the past two to five years? Are there notable trends in market practices, market structure, or specific

investment activities? How might participation in the market for Government of Canada securities evolve in future years?

3. How have developments in provincial, corporate, Maple, and other fixed-income sectors impacted the overall market for Government of Canada securities?

4. How has the growth in the use of CGBs and in other derivatives impacted the trading and the use of Government of Canada securities? What are the perceived drivers behind the growth in derivatives activity, and is participation broad-based? How will future developments in the derivatives markets impact the use of, or the trading of, Government of Canada bonds?

5. How might repo markets evolve in future years and what are the implications for Government of Canada securities? What is the potential for the development of market-based solutions that might enhance trading conditions for repo markets in Canada in a context of lower borrowing requirements of the government?

6. Are there any other domestic and international developments in collateral requirements, risk management, or regulatory frameworks that could have an impact on Government of Canada markets?

7. Have the revisions to IDA Policy No. 5 been adequately communicated within your organization and to other market participants? Are there other measures that could further support the integrity of the Government of Canada securities market?

8. Has transparency of the Government of Canada securities marketplace changed? Is there an appropriate balance between the level of transparency and the maintenance of a liquid market, or could transparency be enhanced?

Operational Issues

In planning the debt strategy for 2007/08 and future years, the Department of Finance and the Bank of Canada are seeking input on issues associated with the design of the debt program.

Bonds

As announced in the *2005/06 Debt Management Strategy*, the fungible 2-year bond auction was forgone in the fourth quarter of fiscal year 2005/06 to facilitate a reduction in annual gross bond issuance. In the *2006/07 Debt Management Strategy*, this measure was continued and extended to the 5-year sector, where the maturity date was changed from 1 September to 1 June in order to make the new 5-year bonds fungible with old 10-year bonds.

9. Factoring in the changes made to the issuance of 2-year and 5-year bonds described above, is liquidity in each of the Government of Canada's benchmark bonds

adequate? In previous consultations, market participants have stressed the importance of maintaining large liquid benchmark bonds in all four maturities. Have views changed?

10. In the event that the government would like to further increase its use of fungibility to support benchmark liquidity, which maturity sector would be most appropriate?

11. As announced in the *2006/07 Debt Management Strategy*, the government will not conduct 2- and 5-year auctions in the fourth quarter of fiscal year 2006/07. In the future, should the government avoid forgoing 2- and 5-year auctions in the same quarter? How significant is the sequence of operations across quarters in relation to the continuity of supply or the benchmark building process?

12. With the increased use of fungibility, most new bond issues will be fungible with at least one existing bond. In the event that market yields are close to the coupon rate of an existing fungible issue, could the Government reopen an old benchmark, instead of creating a new security with the same maturity but with a different coupon? How close should the market yield be to the coupon rate of an existing fungible bond to consider reopening that issue?

Treasury Bills and Cash-Management Bills

Over the years, the establishment of large and liquid Government of Canada benchmark bonds has resulted in the building of large government cash balances ahead of coupon and maturity payments. To address these seasonal peaks in cash balances, the government has developed several strategies:

- the cash-management bond buyback program, which allows the government to purchase bonds with less than 18 months to maturity, has helped reduce those large payments and therefore the buildup of cash balances;

- the use of cash-management bills (CMBs) has provided additional flexibility in raising cash balances on short notice before large payments, thereby reducing the cost and risk of holding large cash balances; and

- the ability to adjust the size of treasury bill auctions by larger increments from one auction to the other helps better match treasury inflows and outflows.

13. In the use of the strategies described above to aid in the management of cash balances, are there any issues the government should be aware of?

14. Following suggestions from market participants, and considering the potential cost savings, the government recently increased the issuance of CMBs that share the same maturity (hereafter referred to as fungible) as existing treasury bills. On each occasion, upon the release of the call for tenders for a fungible CMB, a significant increase in the yields of treasury bills with the same maturity has been observed. Did yields increase solely as a result of the additional supply of treasury bills for a

specific maturity, or were there other factors? What other factors should the government consider in its decision to issue fungible versus non-fungible CMBs?

15. A number of market participants have indicated their preference to have the release of the call for tenders for CMBs advanced from the current 10:00 Eastern Time, because it coincides with the release of several economic indicators. Would 09:45 Eastern Time be preferable to the current 10:00 Eastern Time release?

16. What factors explain the valuation of short-term bonds relative to treasury bills with similar maturities in the context of cash-management bond buyback operations?

17. One of the recommendations that came out of a recent review of the Receiver General Cash-Management program was that the government should consider introducing a 1-month treasury bill. Does there appear to be a market demand for regular auctions of 1-month treasury bills, and what might its potential impact be on the overall treasury bill market?