Changes to the Government of Canada Debt Distribution Framework

August 2005

Introduction

The purpose of the framework for distributing the government's debt securities is to raise stable, low-cost funding for the government and to support a well-functioning market for Government of Canada securities. Within this framework, the Department of Finance and the Bank of Canada (hereafter referred to as the "government") strive to attract broad, competitive participation and active bidding at auctions of marketable bonds and treasury bills. In recent years, in an environment of decreasing federal debt, the government has undertaken a wide range of measures to promote participation and competition in Government of Canada securities auctions.

In the fall of 2004, as an extension of efforts to maintain a well-functioning market, the government launched a review of the debt distribution framework. The scope of the review included analysis by the government and consultations with interested parties.

The review was considered timely, given the evolution of the government securities market since the last review of the framework in 1998: lower borrowing requirements of the federal government; greater concentration of auction participation and secondary market trading; interest by investors in direct participation at auctions; and innovation in financial markets, for example, development of alternative trading systems (ATSs).

General Findings of the Review

Analysis by the government and consultations with interested parties indicate that the current debt distribution framework is generally working well. Auctions have been consistently covered and well bid, and the debt distribution framework is helping to promote a generally well-functioning government securities market and, by extension, to support the well-functioning operation of the broader Canadian fixed-income market.

It was generally acknowledged by market participants that auction participation has become increasingly concentrated in recent years, with the government relying on fewer large dealers to cover the sale of securities at auctions. Trading in the secondary market for government securities, along with other sectors of the domestic fixed-income market, has also become increasingly concentrated. However, there was no contention or evidence that these levels of concentration have adversely affected competition. At the same time, there was general support for continued measures to promote competition and participation in Government of Canada securities auctions.

Changes to the Debt Distribution Framework

In view of these findings, the government has identified modest changes to the framework to ensure its continued effectiveness and to promote fair and competitive participation at auctions. The changes fall into two broad areas: adjustments in auction access for dealers and customers, and changes to minimum bidding obligations of dealers.

1. Auction Access

   a) *The government will modify the formulas used for the calculation of competitive bidding limits.*

      Specifically, the calculation of bidding limits will be adjusted to take into account the performance of dealers at buyback operations and auctions of non-fungible cash-management bills.[1] The formulas will also be modified to exclude the Bank of Canada purchases at auctions from the calculation, since the Bank holdings do not constitute part of the tradable market.

      These changes will better reflect dealers' participation in a broad range of government securities operations and more accurately reflect the supply of securities available to market participants. The changes will provide enhanced incentive to dealers to participate in a broad range of government operations, without negatively affecting the access of dealers who choose to maintain existing participation.

   b) *The government will increase customers' non-competitive bidding limits.*

      The non-competitive bidding limit for individual customers will be increased from $3 million to $5 million for treasury bill and bond auctions. In the case of Real Return Bonds, the non-competitive bidding limit will remain at $3 million for customers, given the smaller size of these auctions.

      The higher non-competitive bidding limit will promote access to auctions by a wide range of small investors

   c) *The government will increase bidding limits that Government Securities Distributors can submit on behalf of customers.*

      i) *Competitive Bids*

      Currently, a Government Securities Distributor (GSD)[2] is allowed to submit competitive bids from customers in an amount equal to the greater of 5 per cent of the auction amount or its own bidding limit. In the future, Primary Dealers (PDs) will be allowed to submit competitive bids from customers for up to 25 per cent of the auction amount. Other GSDs will be allowed to submit competitive bids from clients for up to 10 per cent of the auction amount. The maximum permissible sum for competitive bids submitted by a PD on its own behalf and on behalf of customers will remain at 40 per cent.

      ii) *Non-Competitive Bids*

      Dealers are currently limited to $3 million in non-competitive bids on behalf of all customers. In the future, dealers will be allowed to submit $10 million in non-competitive bids on behalf of their customers. This change applies only to auctions of nominal bonds and treasury bills.

      These changes are intended to help dealers to accept larger orders from customers and provide greater access for customers at auctions.

d) The government will affirm that qualifying ATSs can become GSDs.

The Terms of Participation set out the core requirements that entities must meet to participate directly at Government of Canada securities auctions. Subject to full compliance with operational, financial, and reporting standards, entities, including ATSs, that meet these requirements may become GSDs.

The share of ATSs in secondary market trading is growing and has the potential to provide an additional channel for the government to distribute its debt and broaden participation of investors.

This policy is intended to support market development and participation.

2. Changes to Minimum Bidding Obligations

a) The government will reduce PDs' bidding obligations.

Under the Terms of Participation for auctions, each PD must bid at every auction for a minimum of 50 per cent of its auction limit at a reasonable price for the government. The minimum bid amount of 50 per cent remains unchanged. The range of bids classified as being at reasonable prices will be increased from the cut-off yield[3] plus 5 basis points to the cut-off yield plus 10 basis points for all securities. This easing in requirements will reduce the burden borne by PDs, thereby supporting auction participation.

b) The government will require all dealers to participate periodically in auctions.

GSDs that are not PDs do not currently have minimum obligations to participate at auctions. In the future, these GSDs will be required to participate successfully in at least one Government of Canada securities auction every six months to retain the status of GSD, thereby increasing auction participation.

Timing of the Changes

Changes to the government's debt distribution framework will become effective in October 2005, following updating of the Terms of Participation and Standard Terms for Government of Canada auctions.

Changes to the Debt Distribution Framework

	Competitive Bidding Limits		Non-Competitive Bidding Limits		Acceptable Price Range for Submission of Bids at Auctions		Minimum Participation Requirements	
	Current Rules	New Rules	Current Rules	New Rules	Current Rules	New Rules	Current Rules	New Rules
Primary Dealers								
- For own account	Treasury bills: 25 per cent Bonds: From 10 to 25 per cent	No change	$3 million	No change	Cut-off yield + 5 basis points**	***Cut-off yield + 10 basis points***	50 per cent of their maximum bidding limit at every auction	No change
- For customers	Limited to the Primary Dealer's bidding limit	***Limited to 25 per cent of the tender***	$3 million	***$10 million $3 million for RRBs****	None	No change	None	No Change
- In aggregate	Limited to 40 per cent of the tender	No change	$6 million	***$13 million $6 million for RRBs***	None	No change	50 per cent of their maximum bidding limit at every auction	No change
Government Securities Distributors								
- For own account	Treasury bills: 10 per cent Bonds: From 1 to 9 per cent	No change	$3 million	No change	None	No change	None	***One successful bid (competitive or non-competitive) every six months on their own behalf or on behalf of customers***
- For customers	Limited to the greater of 5 per cent or the Government Securities Distributor's bidding limit	***Limited to 10 per cent of the tender***	$3 million	***$10 million $3 million for RRBs***	None	No change	None	None
Customers	25 per cent	No change	$3 million	***$5 million***	None	No change	None	No change

*RRBs: Real Return Bonds

** Secondary market yield + 5 basis points in the case of strong RRB auctions. On a trial basis since 1 June 2004.

[1] Fungible cash-management bills are already included in bidding limit calculations.
[2] Primary Dealers (PDs) are a subcategory of Government Securities Distributors (GSDs).
[3] The cut-off yield is the highest yield at which the securities are allocated at an auction.