

Debt Management Strategy Consultations - 2011-12

OVERVIEW

The Department of Finance and the Bank of Canada are seeking views of government securities distributors, institutional investors, and other interested parties on issues related to the design and operation of the domestic Government of Canada debt program for the fiscal year 2011-12 and beyond. The government considers regular consultations with market participants to be an integral part of the debt-management process. Feedback from this year's round of market consultations will be considered in the elaboration of the federal debt strategy and in the management of the debt maturity profile.

A summary of comments received from market participants will be made available on the Bank of Canada website concurrently with the release of the *Debt Management Strategy 2011-12*.

BACKGROUND

DEBT MANAGEMENT STRATEGY

The fundamental objective of debt management is to raise stable, low-cost funding to meet the financial needs of the Government of Canada. An associated objective is to maintain a well-functioning Government of Canada securities market, which helps to keep debt costs low and 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. In view of these objectives, the formulation of a debt strategy is a complex exercise.

Several years ago, a stochastic simulation model was developed at the Bank of Canada to support the debt strategy decision-making process (see Bolder (2008) for more details on the modeling approach used by Canada).¹ The model describes the interaction between debt service payments and government budget balances over a medium-term horizon for a large number of potential macro-economic outcomes. Optimizations can be performed to obtain a frontier of efficient financing strategies for different types of risk, including uncertainty about debt charges and budgetary outcomes.² Different constraints can also be added to the optimization module to ensure that minimum issuance is maintained in all maturity sectors or to limit the amount of debt rolling over in a given period of time. Accordingly, optimal debt structure portfolios and risk-cost trade-offs produced by the model can vary significantly depending on the constraints and risk perspectives imposed on the model.

While the quantitative results from the model are a key consideration in debt strategy decisions, they are not the only input into the debt strategy decision-making process. Other considerations include input from market participants and securities market developments.

This consultation document includes questions which seek to validate with market participants certain considerations used in the elaboration of the debt strategy for 2011-12 and beyond.

¹ Bolder, D.J. 2008. "The Canadian Debt-Strategy Model." *Bank of Canada Review* (Summer): 3-16.

² The measures of risk can be expressed in terms of conditional volatility or Cost-at-Risk (CaR), a concept similar to Value-at-Risk (VaR).

MANAGING LARGE FUTURE DEBT MATURITIES

Based on the current issuance pattern, a number of cash flow maturity spikes are expected in the near future. These large maturities are the result of a combination of increased issuance during the financial crisis and the issuance of bonds sharing the same maturity dates in the 2-, 5-, and 10-year sectors and to a lesser extent in the 2- and 3-year sectors. This concentration of maturities implies that the amount of coupon payments due on those dates is also large.

Initiatives that have been taken by the government to smooth the maturity profile include increased frequency of cash management bond buyback operations, switch operations in short-term to medium-term bond maturities, and the use of March / September maturity dates in the 2- and 3-year sectors. Further changes may be worthwhile to obtain a lower and more stable cash flow maturity profile of upcoming maturities and thus reduce operational and refinancing risks.

ISSUES FOR DISCUSSION

BOND PROGRAM

There has been a significant amount of Government of Canada bond issuance since 2008-09, resulting in an increased number and size of benchmark issues in some sectors (see Table 1). Going forward, adjustments to the balance between the number of benchmark issues and their respective sizes may be required.

Table 1: Annual bond issuance per maturity sector (\$ billions)³

	Current Benchmark Target Size	Decade Minimum			Decade Maximum	
		Gross Issuance	Net Issuance	Number of benchmarks per year	Gross Issuance	Number of benchmarks per year
2-year	7 to 10	10.3	8	2	32	4
3-year	7 to 10	0	0	0	20	2
5-year	9 to 12	6.5	5	1	24	2
10-year	10 to 14	10.5	8	1	17	1
30-year	12 to 15	3.2	1.9	n/a	6	n/a
RRB	5 to 7 ⁴	1.4	1.4	n/a	2.2	n/a

1. What are your views on minimum / maximum annual levels of bond issuance for each bond sector? What number and size of benchmarks would ensure sufficient depth and liquidity in each sector?

³ Does not include the current fiscal year (2010-11).

⁴ No specific targets for RRB benchmarks have ever been announced; this represents the ranges for past RRB benchmark sizes.

2. To achieve the benchmark target sizes described in Table 1, more than one re-opening of a new issue is often required. What are your views on the size and frequency of auctions across sectors?

In consideration of large future debt maturities, some benchmark maturity dates could be moved individually or as a block to reduce large future debt maturity dates.

3. To what extent is the maintenance of fungibility between 2- and 3-year bonds and between 2- and 5-year bonds important to the market?
4. Could issuance in the 2-, 3-, and 5-year sectors be consolidated in larger but fewer benchmarks, with a March / September cycle or another cycle?
5. Assuming the existing number of benchmarks in the 2-, 3- and 5-year sectors are retained, what are your views on an alternative cycle? For example, would a February, May, August, and November cycle be preferable to a January, April, July, and October cycle? Would the beginning of the month be preferable to the middle of the month?
6. To reduce the amount of bonds maturing on June 1, the date on which a 30-year nominal bond benchmark matures could be moved from June 1 to December 1, although on an alternating basis with Real Return Bonds. Do you envision any issues with such a change?

BOND BUYBACK PROGRAM

7. Do you have any comments on the bond buyback operations on a switch basis covering short-term to medium-term bond maturities, and / or the increased frequency of cash management bond buyback operations?

TREASURY BILL STOCK LEVEL

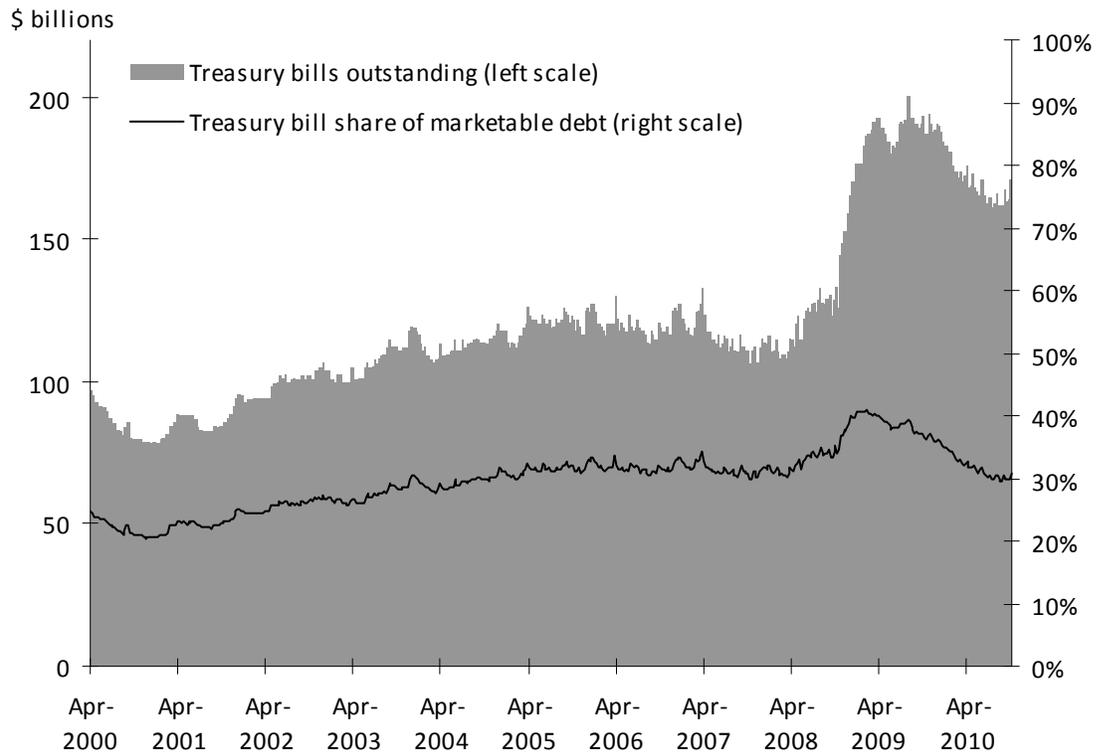
Since 2000, the treasury bill stock has varied from a low of \$89 billion in 2000-01 to a peak of \$200 billion in July 2009. As a share of marketable debt, the stock of treasury bills averaged 28% between April 2000 and March 2008, reached a high of 41% in December 2008, and has since declined to 30% (see Graph 1).

The size of bi-weekly treasury bill auctions has ranged between \$12 billion and \$15 billion since the start of the fiscal year.

The treasury bill stock is expected to fall to \$150 billion by the end of the current fiscal year.

8. What is your view on the capacity to increase or decrease the stock of treasury bills from current levels? What are your views on minimum or maximum treasury bill auction sizes necessary to maintain a well-functioning market?

Graph 1: Historic level of treasury bills outstanding in (\$) billions and as a share of market debt



CURRENT MARKET CONDITIONS

9. What are your views on the liquidity and functioning of Government of Canada securities across various maturity sectors and related fixed-income markets (e.g., repo, derivatives, strip, provincial, corporate)? How have these related fixed income markets impacted the functioning of Government of Canada securities market?