

## Debt Management Strategy Consultations - 2012-13

### 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 Government of Canada's domestic debt program for 2012-13 and beyond. The government considers regular consultations with market participants to be an integral part of the debt management process.

This year's exercise focuses on seeking feedback regarding the effectiveness of the government's debt distribution framework to ensure that the auction and intermediation processes continue to promote the government's debt strategy objectives of stable, low-cost funding, and a well-functioning market for its securities<sup>1</sup>. More specifically, views of market participants are sought regarding trends affecting the Government of Canada securities market, Department of Finance and Bank of Canada communications with market participants, and the changing profile of participants at auctions.

A summary of comments received from market participants will be made available on the Bank of Canada's website concurrently with the release of the *Debt Management Strategy for 2012-13*.

### CONTEXT

The effectiveness and success of the debt distribution framework is influenced by a number of factors. These include the design of the debt auction process, existing and projected funding requirements, the medium-term debt strategy, foreign investor interest in Canadian securities, participation at primary auctions, market transparency, alternative trading systems, and investor relations.

#### DEBT AUCTION PROCESS EVALUATION

An external evaluation of the Government of Canada's debt auction process for nominal bonds, Real Return Bonds, and treasury bills was performed from November 2008 through November 2009 under the Department of Finance's Treasury Evaluation Program. The final report<sup>2</sup> concluded that the current structure works well and supports the transparency, effectiveness and efficiency of debt auctions, and that the auction process has been successful in its immediate, intermediate, and ultimate goals of raising necessary funding at a low cost. In addition, the report indicated that the auction process has helped sustain a liquid and efficient secondary market for Government of Canada debt.

This year's consultations will help provide direction on certain recommendations put forward in the auction evaluation report. These recommendations included improving external communications with market participants; encouraging greater input by market participants in the design of the debt strategy; and promoting greater customer participation.

#### FUNDING REQUIREMENTS

Based on the latest fiscal projections<sup>3</sup>, gross issuance of domestic marketable bonds should remain near current levels for the next two to five years. The stock of treasury bills is expected to decrease significantly in 2013-14 to absorb the impact of maturing financial assets purchased under the Insured Mortgage Purchasing Program.

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<sup>1</sup> The debt distribution framework was previously reviewed as part of the debt strategy consultations for 2005-06

<sup>2</sup> <http://www.fin.gc.ca/treas/evaluations/edap-epatd-eng.asp>

<sup>3</sup> <http://www.fin.gc.ca/efp-pef/2011/index-eng.asp>

## NEW MEDIUM-TERM DEBT STRATEGY AND PRUDENTIAL LIQUIDITY PLAN

The new medium-term debt strategy presented in the *Debt Management Strategy for 2011-12*<sup>4</sup> is focused on stability and on the reduction of financial risk. Four new maturity dates have been introduced to reduce rollover risk and benchmark target sizes have been increased slightly in the 2-, 3-, and 5-year sectors to facilitate the transition to the adjusted maturity dates in those sectors<sup>5</sup>.

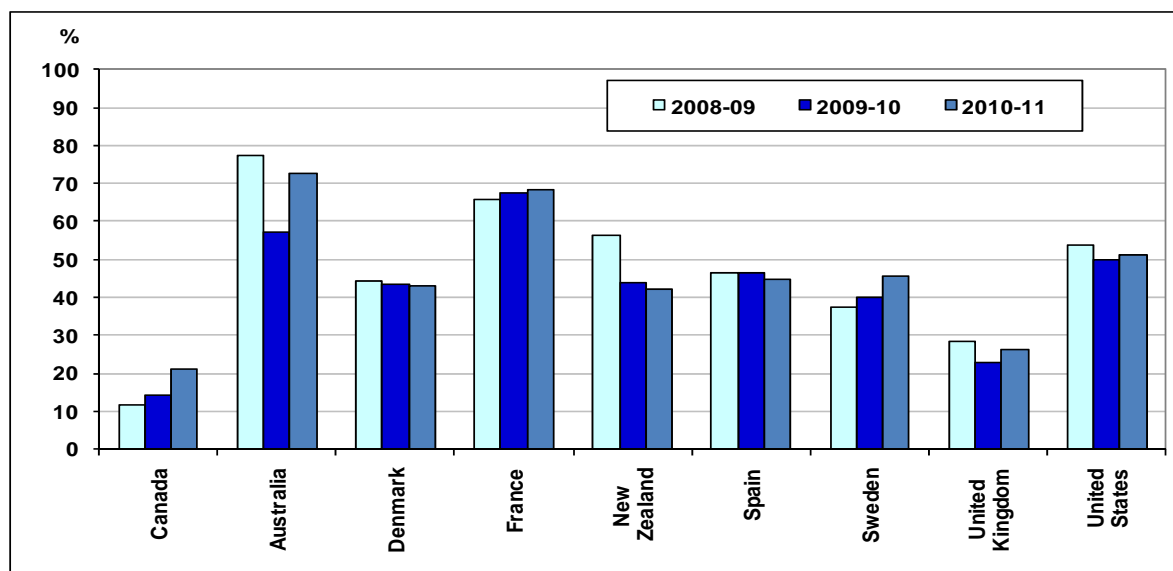
The government also announced a new prudential liquidity plan to increase its liquidity position over the medium-term. Once implemented, the government's overall liquidity levels will cover at least one month of net projected cash flows, including coupon payments and debt refinancing needs. Over the next three fiscal years, government deposits held with financial institutions and the Bank of Canada are expected to increase by about \$25 billion. Foreign exchange reserves are planned to increase by about US\$10 billion during the current fiscal year and subsequently rise sufficiently to maintain their level at or above 3 percent of nominal gross domestic product. In total, prudential liquidity will increase by about \$35 billion by the end of 2013-14.

### FOREIGN INVESTOR INTEREST

Non-resident holdings of Government of Canada securities have increased in recent years, owing partly to the growing investment in Canadian dollar assets by sovereign reserve managers. At 21 per cent, however, the level of non-resident holdings of Canadian government debt remains well below other sovereigns.

A diversified investor base, including non-resident investors, supports an active secondary market for Government of Canada securities, thereby helping to keep funding costs low and stable.

Figure 1: Non-Resident Holdings of Total Gross Marketable Government Debt



Source: OECD

<sup>4</sup> <http://www.budget.gc.ca/2011/plan/anx2-eng.html>

<sup>5</sup> For further information on the development of a medium-term debt strategy, see Larson, M. and E. Lessard, 2011. "Developing a Medium-Term Debt-Management Strategy for the Government of Canada." *Bank of Canada Review* (Summer): 43-50.

## PARTICIPATION AT PRIMARY AUCTIONS

The total number of Government Securities Distributors (GSDs) and Primary Dealers (PDs) has been relatively stable in recent years; there are currently 21 GSDs, of which 10 are PDs for treasury bills, and 12 are PDs for bonds.

The most notable change in the debt distribution framework over the last five years has been the increase in auction participation by customers. Customer allotments of Real Return Bonds at auction are now broadly equivalent to that of Primary Dealers (PDs).

Table 1: Primary Auction Share of Amount Allotted to Participants

### Nominal Bonds

Participant Type	2006-2007		2007-2008		2008-2009		2009-2010		2010-2011	
	\$ billion	%	\$ billion	%	\$ billion	%	\$ billion	%	\$ billion	%
PDs	26	95	28	95	66	94	85	87	75	84
Non-PD GSDs	0	1	0	1	0	0	0	0	0	0
Customers	1	4	1	4	4	6	13	13	14	15
Top 5 participants	18	65	20	67	46	66	55	56	46	52
Top 10 participants	25	91	26	89	63	91	81	83	72	81
Total Nominal Bonds Issued	27		30		70		98		88	

### Real Return Bonds

Participant Type	2006-2007		2007-2008		2008-2009		2009-2010		2010-2011	
	\$ billion	%	\$ billion	%	\$ billion	%	\$ billion	%	\$ billion	%
PDs	1	75	1	54	1	37	1	56	1	52
Non-PD GSDs	0	1	0	1	0	0	0	1	0	0
Customers	0	24	1	46	1	62	1	43	1	48
Top 5 participants	1	55	1	59	1	52	1	57	1	56
Top 10 participants	1	78	2	76	2	73	2	75	2	75
Total Real Return Bonds Issued	2		2		2		2		2	

### Treasury Bills

Participant Type	2006-2007		2007-2008		2008-2009		2009-2010		2010-2011	
	\$ billion	%	\$ billion	%	\$ billion	%	\$ billion	%	\$ billion	%
PDs	233	94	198	88	322	90	324	86	285	84
Non-PD GSDs	1	1	2	1	1	0	6	1	4	1
Customers	13	5	24	11	36	10	46	12	50	15
Top 5 participants	174	71	151	68	246	69	251	67	219	64
Top 10 participants	233	94	207	93	325	91	331	88	287	85
Total Treasury Bills Issued	247		224		359		376		339	

## TRANSPARENCY

Transparency pertains to the transparency of issuer information and the availability of reliable trading-related information. Markets that are more transparent can enhance the integrity and attractiveness of the Government of Canada securities market for a wide array of market participants.

The government has adopted a strategic and consistent approach to its communications about domestic debt issuance. In order to assure transparency and predictability of the bond program, a quarterly bond issuance schedule is published on the website of the Bank of Canada one to two weeks before the start of each quarter<sup>6</sup>. The terms, conditions, and rules governing Government of Canada security auctions are publically available on the same Bank of Canada webpage. Auction results are posted by the Bank of

<sup>6</sup> <http://www.bankofcanada.ca/markets/government-securities-auctions>

Canada shortly after each operation. The Department of Finance publishes the *Debt Management Strategy*, the *Debt Management Report*, and the *Report on the Management of Canada's Official International Reserves* to provide detailed accounts of the Government of Canada's borrowing and funds management activities<sup>7</sup>.

The pricing transparency of government securities has improved in recent years. There are now a number of marketplaces offering price information regarding government debt securities. The Canadian Securities Administrators (CSA) recently extended the exemption on pre-trade and post-trade transparency requirements for government debt securities to January 1, 2015<sup>8</sup> noting the continuing improvement in pricing transparency and also that no domestic or international jurisdiction has established mandatory transparency requirements for government debt.

#### *ALTERNATIVE TRADING SYSTEMS*

In recent years, the advancement of electronic trading systems (typically referred to as Alternative Trading Systems (ATSs)) have improved the pricing transparency of Government of Canada securities in the secondary market. CanDeal, CBid, and Bloomberg Tradebook are examples of ATS platforms operating in Canada. ATSs are eligible for GSD status (i.e., can participate directly in Government of Canada securities auctions) with specific conditions. To date, however, no ATS has completed the process to obtain the GSD designation.

Market participants have reported that the share of ATSs in secondary market trading is growing due to technical efficiencies that can be achieved with the technology, an increased focus on compliance and risk control by both dealers and institutional clients, and the promotion of electronic trading by regulators. ATS-related trade volumes of fixed income and money market securities have increased significantly over the last five years. For example, CanDeal trade volume was reported to be \$ 1.4 trillion in fiscal year 2011 as compared to \$289 billion in 2006<sup>9</sup>.

#### *INVESTOR RELATIONS*

A growing number of sovereigns are recognizing the value of an effective investor relations program that marries sound macroeconomic policies and fundamentals with a commitment to transparency and open communication with market participants. The Department of Finance and the Bank of Canada currently use their respective websites, official documents and reporting, and day-to-day interactions and consultations with market participants to promote transparency and communications.

The Department of Finance and Bank of Canada are aiming to improve on and add to these existing investor relations products and activities. Possible enhancements could include consolidating and updating funds management websites, enhancing reporting, data dissemination, and the availability of presentation materials, and an improved communications framework. Market participants' views on the accessibility, usefulness, and availability of these activities will help guide future improvements.

#### **DEBT DISTRIBUTION FRAMEWORK**

The debt distribution framework is the method by which the government issues its marketable debt securities to market participants. The debt distribution framework is designed to ensure that the

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<sup>7</sup> <http://www.fin.gc.ca/pub/index-eng.asp>

<sup>8</sup> [http://www.osc.gov.on.ca/documents/en/Securities-Category2/rule\\_20111028\\_21-501\\_deferral-info-transparency.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category2/rule_20111028_21-501_deferral-info-transparency.pdf)

<sup>9</sup> <http://www.candeal.ca>

government can sell its securities consistently at the best possible price. It is also designed to support the well-functioning of the government securities market by promoting participation of dealers and investors (see Pellerin (2006) for background information about the Government of Canada debt distribution framework)<sup>10</sup>. A well-functioning government securities market benefits the broader Canadian fixed-income market by providing effective pricing benchmarks and hedging tools for investors and issuers.

The debt distribution framework must balance a variety of interests: the government's own interest in achieving low funding costs on a consistent basis; securities dealers' interest in accessing government securities and maintaining an awareness of trading flows; and investors' interest in having access to government securities at reasonable prices.

Sovereign debt issuance procedures and policies differ across jurisdictions, reflecting adaptations to developments and trends in domestic government securities markets and globalized financial markets. Most industrialized countries use a PD distribution framework to market their securities. Compared with Canada, PD models in other developed countries generally tend to require fewer obligations for dealers at auctions but more obligations in secondary markets such as continuous market making and minimum trading volumes. The Government of Canada uses multiple-price auctions to issue treasury bills and nominal bonds, and single price auctions to issue Real Return Bonds. These two auction methods are the dominant types of auction format used by sovereigns to issue debt. Nevertheless, a few sovereigns use different auction formats, such as Spanish auctions and Dutch Direct auctions (see grey box below). In addition, some sovereigns have begun to use other distribution methods such as mini-tenders, syndications, private placements, and direct electronic access for retail investors as their borrowing requirements have increased in recent years.

**Single price or uniform price auction:** Winning bidders all pay the same price called the stop-out price, which is the minimum price that exhausts supply. This is the format used by the U.S. and U.K. treasuries. This auction format is also called a Dutch auction.

**Multiple price or discriminatory price auction:** Winning bidders pay their bid price for each unit until supply is exhausted. This is the auction format used by the Government of Canada for nominal bonds and is also used by the German and French treasuries.

**Spanish auction:** This is a hybrid of the previous two auction formats and has been used by the Spanish treasury since 1987. Winning bidders pay their bid price for each unit if it is lower than the weighted average price of winning bids; otherwise, winning bidders pay the weighted average price. Winning bidders cannot pay more than the weighted average price but some bidders pay less.

**Dutch Direct auction:** Bids are submitted as a spread against a reference bond with a comparable maturity to the bond on auction. A range of spreads, called the 'spread guidance', at which orders can be placed, is communicated to investors prior to the auction (usually the day before). Investors indicate the quantity of bonds they want to receive at each spread. The bonds are allocated at a uniform cut-off spread.

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<sup>10</sup> Pellerin, M. 2006. "The Evolution of the Government of Canada's Debt Distribution Framework." *Bank of Canada Review* (Spring): 37-44.

## **ISSUES FOR DISCUSSION**

### *PRIMARY AND SECONDARY MARKETS*

1. How do you view the role of GSD? What is your assessment of the balance between the benefits and the obligations that are associated with the PD status? How could the government further support the participation, visibility, and benefits of the PD/GSD designation?
2. To what reason(s) do you ascribe the recent sharp increase in customer participation? How do you see customer participation developing in the future? How could the government better support customer participation?
3. What impact has increased foreign investor interest in Canadian securities had on primary market auctions and secondary market trading at auctions?
4. What impact have Alternative Trading Systems had on the transparency of the secondary market for Government of Canada securities and the bidding behaviour of dealers and customers? Are there impediments to further increases in electronic trading of Government of Canada securities?

### *AUCTION FRAMEWORK*

5. Could the auction process be amended to provide a more cost-effective method for the government to raise funds while providing greater benefits to participants? Would a different auction format be more effective, perhaps for certain issuance sectors?

### *COMMUNICATIONS AND TRANSPARENCY*

6. What are your views on the improvement in the price and volume transparency of Government of Canada securities since the last review of the debt distribution framework in 2005-06?
7. The Department of Finance and the Bank of Canada utilize a mix of communication approaches to consult with market participants on debt strategy matters (i.e., telephone conference calls, multi-lateral discussions, and regular bi-lateral visits). What are your views on the frequency, type, and value of these various methods of interaction with federal debt managers? What investor relations activities do you find most useful/valuable? What activities do you think could be curtailed, improved or added?
8. Is there data or information on the Government of Canada's debt market that is either unavailable or should be made more readily accessible? Would the development of a website that groups all funds management information together be useful?

### *BOND PROGRAM AND TREASURY BILL PROGRAM*

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)?
10. Starting in 2011-12, the maturity dates of some bond benchmarks have been modified to help reduce single-day rollover risk. Has the transition to the new maturity dates in the 2-, 3-, and 5-year sectors gone smoothly? What is your view on the size of 2-year benchmarks when fungible with previously issued 3-year benchmarks (August and February)?
11. Are there any comments on the treasury bill program, bond program, or on the bond buyback program?