2013–14 Debt Management Strategy Consultations

Overview

The Department of Finance and the Bank of Canada are seeking the 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 2013–14 and beyond. Regular consultations with market participants are considered an integral and valued part of the debt management process, and a broad variety of market participants are welcome to provide input and feedback.

This year's consultations are focused on obtaining views to support a smooth transition to a smaller treasury bill program in 2013–14. Comments are also requested on the state of demand for longer-term securities and the impacts of regulatory changes.

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 for 2013–14.*

Context

Government of Canada debt continues to retain the highest-possible AAA credit ratings and a stable outlook. In fact, the Government of Canada is now one of only seven sovereigns with an uncontested AAA rating. Of these seven AAA sovereigns, Canada has the deepest debt market, with over $450 billion bonds and $180 billion treasury bills outstanding, helping make debt issued by the Government of Canada among the world's most sought-after investments.

Canada's relatively strong fiscal and economic position has continued to promote strong primary and secondary market demand for Government of Canada securities, with all treasury bill and bond auctions remaining well covered and well bid throughout the first half of 2012–13. Non-residents now hold just over 25 per cent of Government of Canada market debt securities, well above the 15 per cent average for the five years preceding the financial crisis.

Based on the latest fiscal projections,[1] gross issuance of domestic marketable bonds should track as planned for 2012–13. The stock of treasury bills is expected to range between $170 billion and $200 billion over the next few quarters until it begins to decline in the last half of 2013–14 to absorb the impact of maturing financial assets purchased under the Insured Mortgage Purchasing Program.[2]

Input received during these consultations will help federal debt managers design a debt strategy for 2013–14 that will continue to strike a prudent balance between costs and risks, and to maintain a liquid,

[1] http://www.fin.gc.ca/efp-pef/2012/index-eng.asp

[2] These mortgage-backed assets were purchased from financial institutions in 2008 and 2009 under the Insured Mortgage Purchase Program (IMPP), which formed part of the Government of Canada's response to the financial crisis.

well-functioning government securities market while remaining flexible in the face of financial and economic uncertainty.

ISSUES FOR DISCUSSION

BOND PROGRAM

As part of the medium-term debt strategy announced in *Debt Management Strategy for 2011–12,* the number of maturity dates used by the Government was increased to eight to reduce single-day rollover of debt (see Table 1). Benchmark target size ranges in the 2-, 3- and 5-year sectors were also increased to facilitate the transition to the adjusted maturity dates in those sectors.

Table 1: Size of Maturity Dates and Benchmark Size Ranges[3]

($ billions)								
	Feb.	Mar.	May	June	Aug.	Sept.	Nov.	Dec.
2-year	8–12		8–12		8–12		8–12	
3-year	8–12				8–12			
5-year		10–13				10–13		
10-year				10–14				
30-year								12–15
RRB								10–16
Total	16–24	10–13	8–12	10–14	16–24	10–13	8–12	10–16

<u>*Questions*</u>

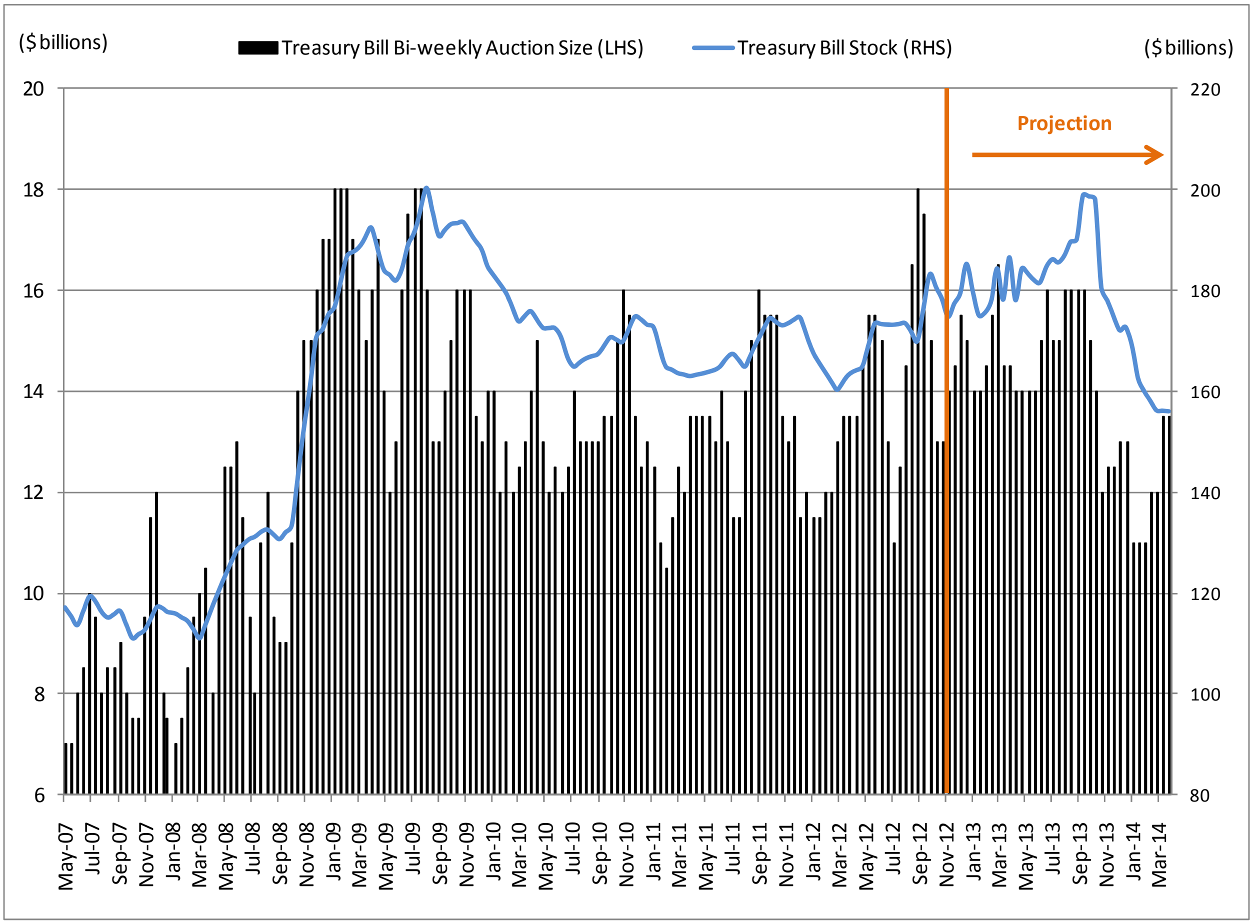
1. What are your views on the liquidity and functioning of the Government of Canada bond market across the various maturity sectors?
2. In 2012–13, it was possible to issue 2-year bonds by reopening previously issued 3-year benchmarks. Under such a scenario, what is the minimum issuance level of 2-year bonds when reopening an old 3-year benchmark?

[3] Benchmark size ranges for Real Return Bonds include an estimate for inflation adjustment. The 30-year nominal bond and Real Return Bond typically do not mature in the same year.

TREASURY BILL PROGRAM

Over the past three years, the stock of treasury bills has ranged between $160 billion and $190 billion and the size of biweekly treasury bill auctions has been typically above $12 billion (Chart 1). Demand for treasury bills remains strong, with coverage ratios for treasury bill auctions slightly higher and auction tails[4] slightly lower than the 5-year average (see Table 2).

Chart 1: Stock of Treasury Bills and Treasury Bill Biweekly Auction Sizes*



*Projections included in the graph are for illustrative purposes only since they contain data and assumptions that are subject to change. Note that they may not fully reflect the fall 2012 update of economic and fiscal projections.

[4] The auction tail represents the number of basis points between the highest yield accepted and the average yield of an auction. A small auction tail is preferable since it is generally indicative of improved transparency in the pricing of securities.

Table 2: Performance at Treasury Bill and Cash Management Bill Auctions

		3-Month	6-Month	12-Month	Cash Management Bills
Tail	2011–12	0.42	0.52	0.55	1.30
	5-year average	0.81	0.80	1.04	3.65
Coverage*	2011–12	2.21	2.47	2.53	2.44
	5-year average	2.11	2.33	2.28	2.31

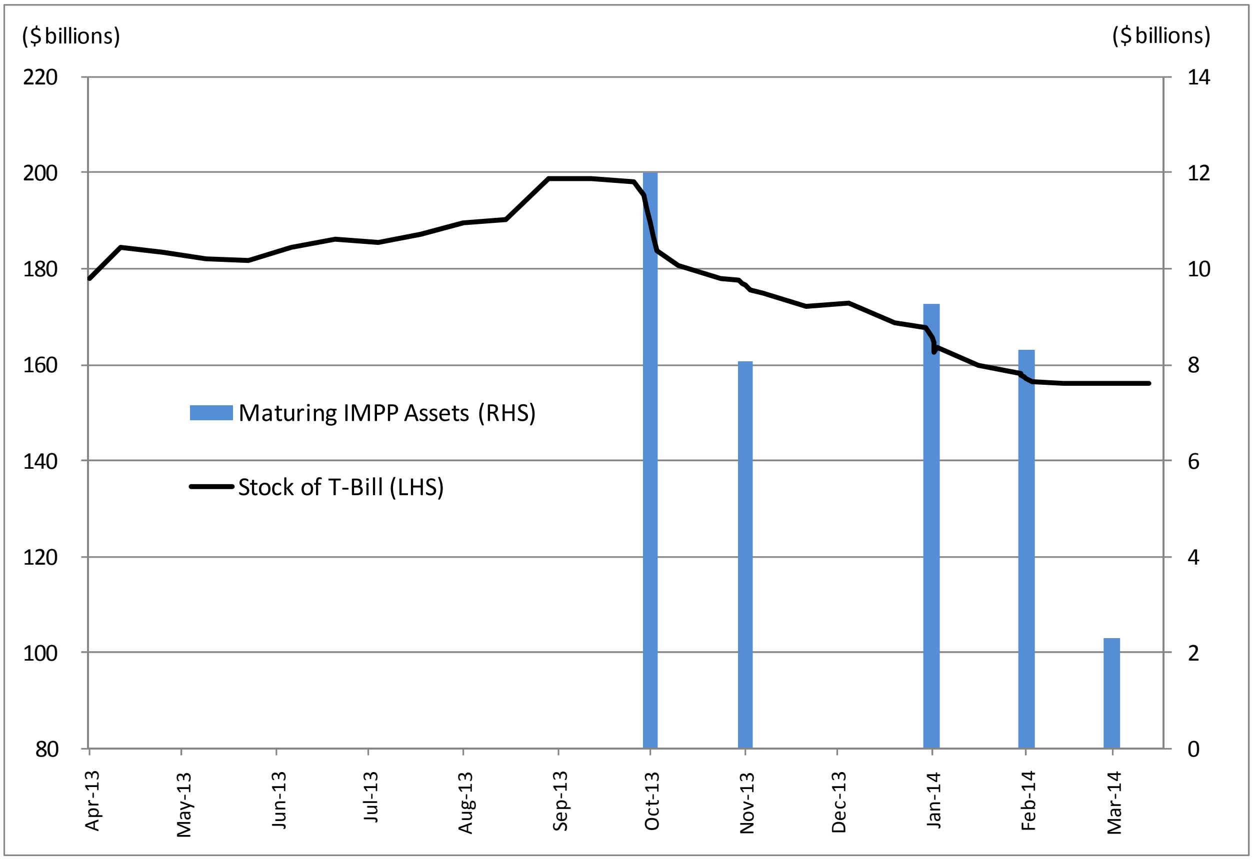
* Includes bids from the Bank of Canada

While the *Debt Management Strategy for 2012–13* projected a treasury bill stock of $159 billion at 2012–13 year-end, it is now expected to be $20 billion to $25 billion higher primarily because of a higher-than-forecast amount of bonds repurchased at Cash Management Bond Buyback (CMBB) operations (see Table 3).

In 2013–14, the stock of treasury bills is projected to remain largely stable through the first two quarters at around the $170 billion to $200 billion level, with biweekly auction sizes in the $14 billion to $16 billion range (see Charts 1 and 2).[5] In the last two quarters of 2013–14, the stock of treasury bills is expected to decline as large cash inflows related to mortgage securities purchased under the Insured Mortgage Purchase Program (IMPP) begin to occur. Based on current projections, the size of treasury bill auctions could temporarily fall to the $11 billion range in the second half of 2013–14 before returning to and stabilizing around the $13 billion range.

[5] One of the assumptions used for the projected stock of treasury bills for 2013–14 in Chart 1 is that the success rate of the CMBB program will remain at current levels (i.e., near 100 per cent usage). If the success of the CMBB operations declines next fiscal year, this would reinforce the expected drop in treasury bills as a result of IMPP maturities.

Chart 2: Projected Maturing Mortgage Assets and the Stock of Treasury Bills*



* Projections included in the graph are for illustrative purposes only since they contain data and assumptions that are subject to change. Note that they may not fully reflect the fall 2012 update of economic and fiscal projections.

Question

During last year's debt strategy consultations, some dealers expressed concern about the expected decrease in the stock of treasury bills in 2013–14, particularly if international demand remains strong and the need for high-quality, liquid collateral continues to increase with the implementation of new regulatory frameworks.

3. Some variation in the size of biweekly treasury bill auctions is to be expected in light of maturing IMPP assets. In previous years, both auction size and net issuance amounts have varied by as much as $6 billion. What are your views on the market's ability to adjust to larger changes?

Cash Management Bond Buyback Program

Since its inception in 2001, the CMBB program has proven to be an effective cash management tool for the Government. The CMBB program helps to manage cash requirements by reducing the high levels of cash balances needed for key maturity payment dates. The program also helps to smooth variations in treasury bill auction sizes over the year.

In light of the above considerations and taking into account feedback received during previous market consultations, CMBB operations have been held on a weekly basis since August 2010 in most weeks, with operations currently alternating between $500 million and $1 billion. Government of Canada bonds eligible for CMBB operations are those with a term of maturity of up to 18 months where the total amount of bonds maturing on a given date is greater than $8 billion.

The actual amount repurchased relative to the maximum amount the Government was prepared to buy back has increased in recent years, both in absolute terms and as a ratio, owing to a higher number of large outstanding eligible bonds and more active participation and interest in the program on the part of market participants (see Table 3).

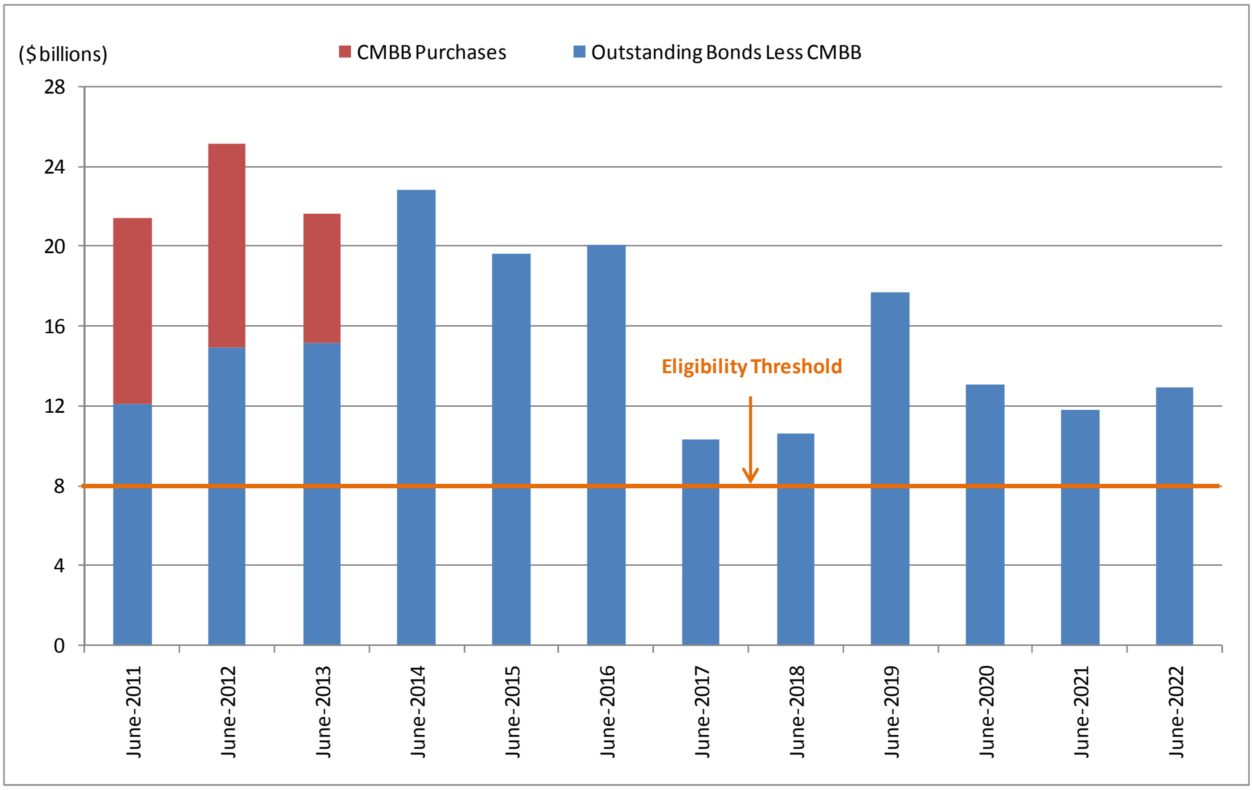
Table 3: Cash Management Bond Buyback Usage by Fiscal Year

($ billions)	Total Repurchased (A)	Maximum Buyback (B)	Ratio (A/B)
2006–07	8.2	18.4	45%
2007–08	10.9	22.0	50%
2008–09	8.6	18.2	47%
2009–10	10.3	16.0	65%
2010–11	21.9	32.5	68%
2011–12	30.5	35.0	87%
2012–13*	20.8	21.0	97%

* As of 31 October 2012

The CMBB program has significantly reduced the size of the actual amount of large maturing bonds, particularly with 1 June dates (Chart 3). In coming years, the new benchmark maturity pattern introduced in 2011–12, which includes eight dates, should serve to reduce the magnitude and frequency of large bond maturity spikes. Once the remaining larger June bonds mature, future June maturities should decline to below the $16 billion mark, while February and August bond maturities of 2-year and 3-year bonds will likely represent the largest single-day maturities (see Table 1).

Chart 3: June Bond Maturities as of 31 October 2012



Questions

4. Since April 2012, the CMBB eligibility threshold has been $8 billion. Previously, the amount outstanding on a given maturity date had to be in excess of $5 billion to be included in the basket and was removed from the basket when the amount outstanding dropped to $3 billion. How has the increase to the eligibility threshold affected the liquidity of the bonds that are included or excluded from the basket?

5. Do you have views on the frequency of operations, flexibility in size of operations or the basket of bonds included in CMBB operations?

LONG BONDS

Meeting the Government's objectives of stable, low-cost funding involves striking a balance between the costs and risks of a debt structure, which is achieved through the deliberate allocation of issuance among various debt instruments. In addition, the debt structure is conservatively managed to preserve access to diversified sources of funding and to support a broad investor base.

Since the release of *Debt Management Strategy for 2012–13*, interest rates have remained near historically low levels. Consequently, on 27 September, the Government announced a plan to reallocate more issuance toward long-term bonds. Additional 10- and 30-year bond auctions are planned for the remainder of the fiscal year, and the size of 10- and 30-year nominal bond auctions may be increased, subject to market conditions.

The temporary changes to longer-term issuance announced this year, combined with the issuance pattern projected under the medium-term debt strategy, will bring the share of bonds with original terms of 30 years or more to about 30 per cent of the stock of marketable debt over the next decade. If bonds with original terms of 10 years or longer are also included, that share is expected to be around 45 to 50 per cent.

Year-to-date, Canadian provinces, municipalities, utilities and other corporations have issued approximately $30 billion in long –term bonds, with around $5 billion in bonds with maturities beyond 35 years.[6] Ultra-long issuance in 2012 has predominantly been in the 40- and 50-year sectors with individual issues ranging in size from $25 million to $500 million, with some issuers reopening a bond multiple times to create a benchmark. In terms of sovereign ultra-long bond issuers, the United Kingdom regularly issues 40- and 50-year bonds, while Japan (40-year), France (50-year) and Mexico (100-year USD) have also been active in the sector.

Questions

6. Please characterize the demand for Canadian-dollar-denominated long bonds from domestic and international market participants.

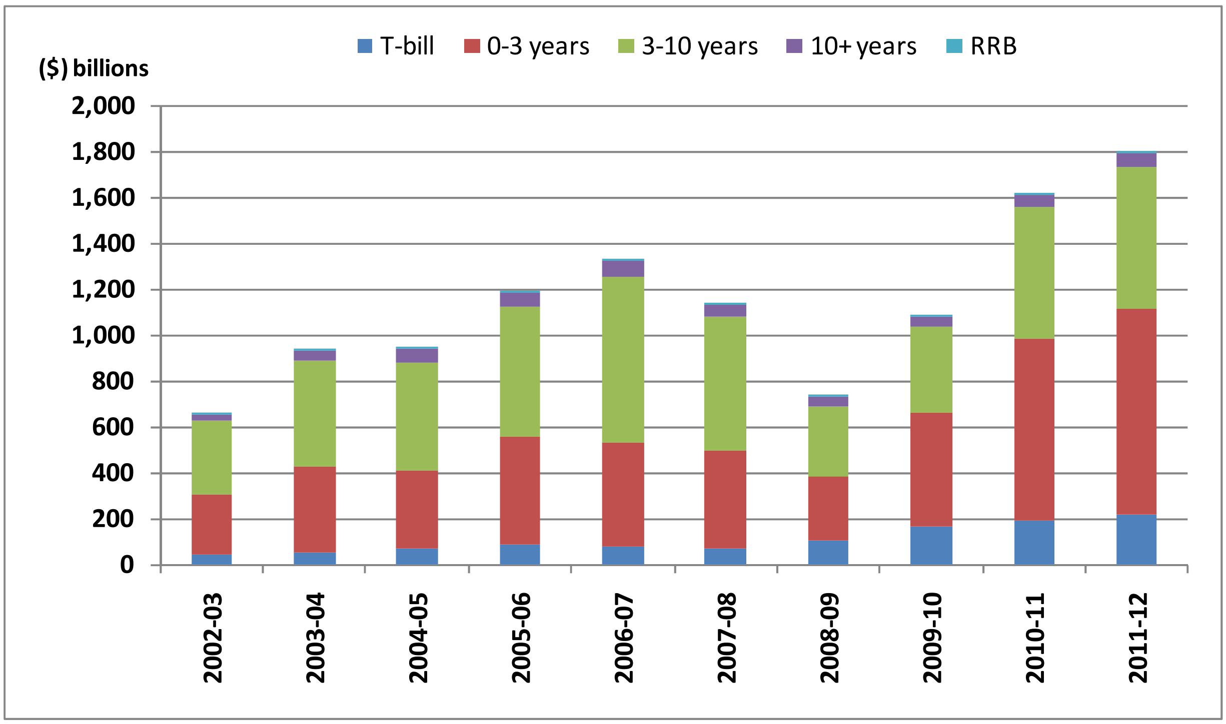
[6] Source: Bloomberg

Foreign Investor Interest

There has been a significant and continuing flow of funds from foreign investors into Government of Canada securities, with non-resident investor holdings of Government of Canada fixed-income securities having increased to a level of about $176 billion in June 2012, compared with $57 billion in 2008.

Correspondingly, the participation of non-resident investors in primary and secondary markets for Government of Canada securities continues to grow. Since 2008–09, secondary market trading volume by non-residents has risen by 65 per cent, owing primarily to increased trading volume of outstanding bonds with 0 to 3 years remaining to maturity (see Chart 4).[7]

Chart 4: Non-Resident Total Trading Volume of Government of Canada Securities



Question

7. What impact has the increased interest by foreign investors in Canadian securities had on primary market auctions, and secondary and repo market trading?

[7] The total stock of Government of Canada securities increased by $237 billion between 2007–08 and 2011–12.

REGULATORY CHANGE

During last year's debt strategy consultations, some dealers raised concerns regarding the implementation of new regulatory frameworks, such as Dodd-Frank and the Volcker Rule, and higher capital requirements under Basel III, since they could have a negative impact on the ability of dealers to use their balance sheets for market-making and risk-taking activities. Dealers reported that there was some migration away from a principal-based market in which dealers run large bond inventories, toward more of a hybrid, agency-based "order-driven" model.

Question

8. As market participants adapt to the changing regulatory environment, has there been any impact in market-making activities and inventory, collateral and balance-sheet management?

Annex

Outstanding Government of Canada Bonds				
TERM TO MATURITY (years)	BOND	ISSUANCE SECTOR	OUTSTANDING NET OF REPURCHASED (CAD Millions)	TOTAL REPURCHASED (CAD Millions)
0.1	1.5% Dec 2012	2Y	8,190	6,221
0.3	1.75% March 2013	3Y	11,130	7,861
0.6	3.5% June 2013	5Y	7,019	8,045
0.6	5.25% June 2013	10Y	8,126	3,874
0.8	2% Aug 2013	2Y	7,721	2,779
0.8	2.5% Sept 2013	3Y	7,632	1,568
1.0	1.5% Nov 2013	2Y	11,475	25
1.3	1% Feb 2014	2Y	11,114	0
1.3	2% March 2014	3Y	9,600	0
1.4	10.25% March 2014	25Y	710	2,440
1.6	3% June 2014	5Y	13,150	2,850
1.6	5% June 2014	10Y	9,670	1,198
1.8	2.25% Aug 2014	3Y	15,600	0
2.0	1% Nov 2014	2Y	9,900	0
2.1	2% Dec 2014	5Y	15,000	0
2.3	1% Feb 2015	3Y	9,000	0
2.6	2.5% June 2015	5Y	9,000	0
2.6	4.5% June 2015	10Y	10,143	157
2.6	11.25% June 2015	25Y	457	1,893
2.8	1.5% Aug 2015	3Y	8,700	0
3.1	3% Dec 2015	5Y	11,342	0
3.3	1.25% Feb 2016	3Y	2,700	0
3.6	2% June 2016	5Y	9,900	0
3.6	4% June 2016	10Y	10,157	143
3.9	2.75% Sept 2016	5Y	10,500	0
4.3	1.5% March 2017	5Y	10,500	0
4.6	4% June 2017	10Y	10,343	0
4.9	1.5% Sept 2017	5Y	10,200	0
5.6	4.25% June 2018	10Y	10,623	0
6.6	3.75% June 2019	10Y	17,650	0
7.6	3.5% June 2020	10Y	13,100	0
8.4	10.5% March 2021	30Y	567	1,233
8.6	3.25% June 2021	10Y	11,500	0
8.6	9.75% June 2021	30Y	286	4,364
9.1	4.25% Dec 2021	RRB	5,175	0
9.6	2.75% June 2022	10Y	12,700	0
9.6	9.25% June 2022	30Y	206	2,344
10.6	1.5% June 2023	10Y	5,500	0
10.6	8% June 2023	30Y	2,499	5,701
12.6	9% June 2025	30Y	2,669	6,231
14.1	4.25% Dec 2026	RRB	5,250	0
14.6	8% June 2027	30Y	4,555	5,045
16.6	5.75% June 2029	30Y	12,074	1,826
19.1	4% Dec 2031	RRB	5,800	0
20.6	5.75% June 2033	30Y	13,003	407
24.1	3% Dec 2036	RRB	5,850	0
24.6	5% June 2037	30Y	13,999	0
28.6	4% June 2041	30Y	15,800	0
29.1	2% Dec 2041	RRB	6,550	0
32.1	1.5% Dec 2044	RRB	5,500	0
33.1	3.5% Dec 2045	30Y	7,900	0

Benchmark **Building Benchmark**

**as of 31 October 2012*

**RRB numbers do not include inflation adjustment*