2014–15 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 2014–15 and beyond. Regular consultations with market participants are an integral and valued part of the debt management process. All market participants are encouraged to provide input and feedback.

The fundamental objective of debt management is to raise stable and low-cost funding to meet the needs of the Government of Canada. An associated objective is to maintain a well-functioning market in Government of Canada securities, which helps to keep debt costs low and stable, and is generally to the benefit of a wide array of domestic market participants.

This year's consultations are focused on obtaining views on the functioning of Government of Canada treasury bill and bond markets, as well as on the terms governing Government of Canada securities auctions. The consultations exercise also seeks to obtain greater insight into retail investor demand for and access to wholesale Government of Canada securities.

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 2014–15.*

Context

With a well-earned reputation for responsible fiscal, economic and financial sector management, Canada is one of only seven sovereigns bearing an uncontested AAA rating from all the major credit-rating agencies. On 28 June 2013, the International Monetary Fund's Currency Composition of Official Foreign Exchange Reserves began reporting on central bank holdings denominated in Canadian dollars, reflecting the growing importance of Canadian-dollar holdings in the world economy.

Non-residents now hold about 28 per cent of Government of Canada marketable debt securities, approximately double the average for the five years preceding the financial crisis. Increased demand for Government of Canada securities by non-residents helps to diversify the investor base. At the same time, some market participants suggest that the growing share of securities held by foreign institutional investors, in particular, central banks and sovereign wealth funds, may be affecting the liquidity of certain sectors of the Government of Canada securities market, since some of these investors may not actively lend their securities in the repo market. Anecdotal evidence gathered by the Bank of Canada suggests that large increases in foreign official Canadian-dollar holdings have coincided with the more frequent "specials" in the Canadian debt markets.[1] More research is necessary, however, to determine to what extent this relationship is causal and not explained by other factors.

Demand for Government of Canada securities is being affected by several other important factors. Regulatory initiatives are increasing the need for high-quality collateral, which in Canada is reflected in greater demand for treasury bills and short-term bonds. In addition, the federal government and a number of provincial governments, as well as some corporations have put in place new prudential liquidity and contingency measures that have large, stable allocations to Government of Canada securities, especially treasury bills and short-term bonds. Structural changes, such as Canada's new central counterparty for the fixed-income market and, in particular, the introduction of central clearing for blind repo trades for interdealer brokers, may also be influencing dynamics in the repo market.[2]

With the government projecting to return to a balanced budget by 2015–16 and beyond, the net new supply of Government of Canada securities will continue to decline over the medium term. For 2013–14, the net issuance of domestic marketable bonds is planned to be approximately $87 billion, down from $94 billion in 2012–13. The stock of treasury bills is projected to decline from $181 billion at the start of 2013–14 to about $135 billion by the end of 2014–15.

Within this context, input received during these consultations will help federal debt managers to ensure that the debt strategy and the debt-distribution framework strike a prudent balance between costs and risks, while remaining appropriate and responsive to changing circumstances.

Bond Program

1. To what degree is the increased frequency of bonds trading "on special" viewed as structural? How do you see this trend evolving, and how does this trend affect the well-functioning of Government of Canada bond markets? Aside from the increasing non-resident investment in Government of Canada securities, are there any other factors that have led to the increased frequency of bonds trading "on special" in the repo market?

2. In the *Debt Management Strategy for 2013–14*, the government announced the continuation of the temporary increase in the issuance of 10- and 30-year bonds and signalled that it would be assessing the potential benefits of issuing bonds with a maturity of 40 years or longer.

   How would you characterize the demand for long-term bonds since yields began rising in May 2013 and how do you see it evolving?

3. What additional views do you have on the liquidity and functioning of the Government of Canada bond market across the various maturity sectors?

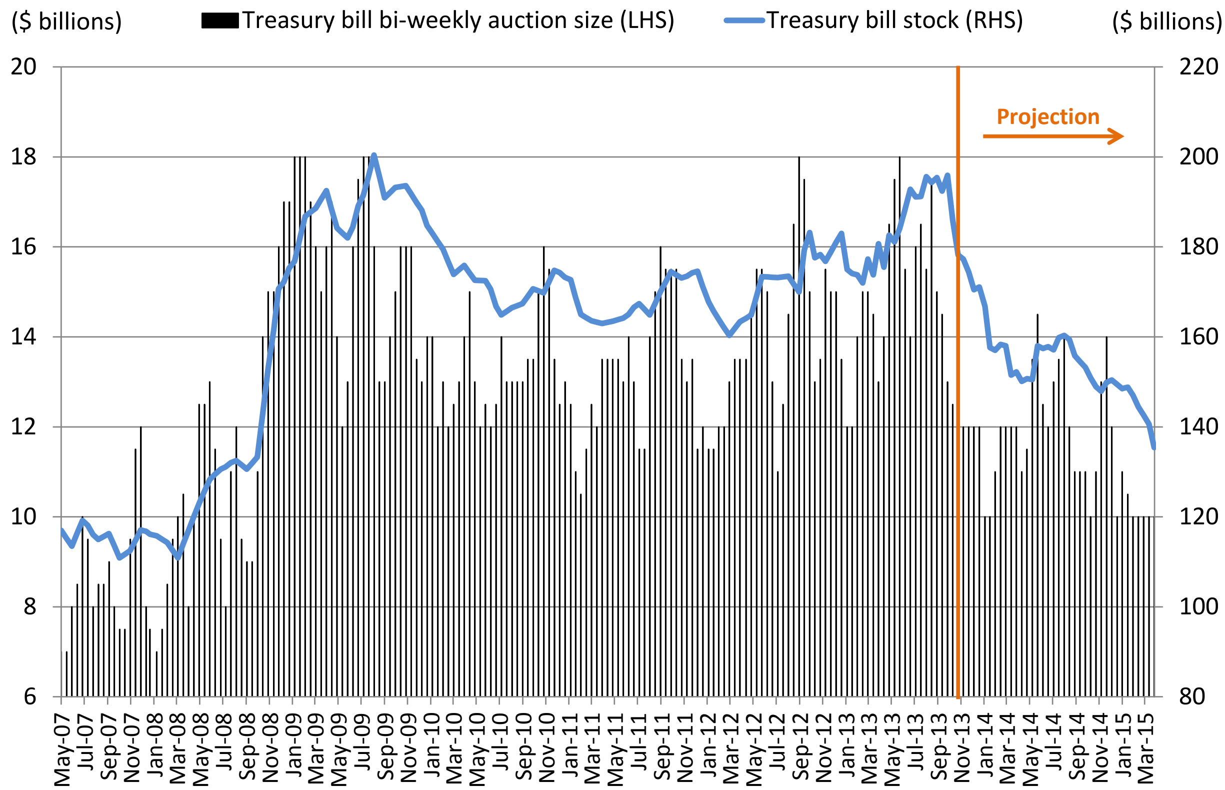
[1] A security that is "on special" is an asset that is subject to elevated demand in the repo market. This causes securities borrowers in the repo market to compete for the asset by offering to lend cash below prevailing interest rates.

[2] In a blind repo trade, the buyer and seller remain anonymous.

Treasury Bill Program

The stock of treasury bills will decline materially through to the end of 2014–15 to accommodate large cash inflows related to asset maturities under the Insured Mortgage Purchase Program. As a result, the size of biweekly treasury bill auctions will drop to a range of about $10 billion to $12 billion (**Chart 1**).

Chart 1: Stock of treasury bills and size of treasury bill biweekly auctions *



*Projections included in the chart are for the purposes of illustration only, since they contain data and assumptions that are subject to change. Note that the projections do not reflect the fall 2013 update of economic and fiscal projections.

4. During periods of high volatility in cash balances, as are expected until the end of 2014–15, the ability to adjust the size of treasury bill auctions from one operation to the next can be an effective cash-management tool for the government.

   How would you characterize the market's ability to absorb variations in the size of treasury bill auctions? Is the amount of acceptable variation dependent on the absolute amount auctioned, the amount coming to maturity or the amount of stock outstanding? Would the amount of acceptable variation differ across the three treasury bill maturity terms (i.e., 3-, 6-, and 12-month terms)?

5. Cash-management bills (CMBs) are used to raise cash balances on short notice before large payments are due, thereby reducing the cost and risk of holding large cash balances. Cash-management bills are being issued more heavily, given the increasing volatility in cash balances. The

average size and term to maturity of CMBs in 2012–13 was $2.4 billion and 20 days, respectively, while for 2013–14, they are currently $2.5 billion and 29 days.

What are your views on the increased use of CMBs?

Terms Governing Government of Canada Securities Auctions

The debt-distribution framework, which includes the rules for Government of Canada securities auctions, is designed to ensure that the government can consistently sell its securities at the best possible price. It is also designed to support the well-functioning of the government securities market by promoting the participation of dealers and investors.

The terms governing Government of Canada securities auctions (the "Terms") must balance a variety of interests: the government's own interest in achieving low funding costs on a consistent basis; the interest of securities dealers in accessing government securities and maintaining an awareness of trading flows; and investors' interest in having access to government securities at fair and transparent prices.[3]

Developments in global capital markets are prompting a review of the Terms to ensure that they remain relevant and appropriate. These developments include diminishing margins on secondary trading for dealers, changes in the regulatory landscape that may affect the capacity of financial institutions to warehouse bond positions, greater price transparency and liquidity arising from electronic trading platforms, and the increasing sophistication of institutional investors.

Input and feedback on the following elements of the Terms are being sought: eligibility criteria; minimum bidding requirements; maximum bidding limits; the price range for the submission of bids at auctions; non-competitive bidding; and reporting requirements.

Eligibility criteria

Eligibility criteria for government securities distributor (GSD) status include a demonstrated capacity to trade in the domestic fixed-income market, the ability to submit bids and settle at auctions, membership in the Investment Industry Regulatory Organization of Canada (IIROC), having core domestic fixed-income market trading and sales operations for Government of Canada securities residing in Canada and an agreement to submit weekly statistical reports on domestic fixed-income trading activities to IIROC and the Bank of Canada.

To be designated a primary dealer (PD), an entity must, in addition to meeting all GSD eligibility requirements, provide evidence of sufficient resources, have the desire to participate actively in market-making for Government of Canada securities and maintain a bidding limit of at least 10 per cent.

[3] The terms of participation in auctions for government securities distributors and customers, and the standard terms for auctions of treasury bills, nominal bonds and Real Return Bonds can be found on the Bank of Canada's website at www.bankofcanada.ca/markets/government-securities-auctions/.

There are currently 11 PDs for treasury bills, 12 PDs for bonds and 7 non-PD GSDs (**Box 1**).

Box 1: Primary dealers and non-primary dealer government securities distributors

Primary dealers for treasury bills

Bank of Montreal
Canadian Imperial Bank of Commerce
Desjardins Securities Inc.
Deutsche Bank Securities Limited
HSBC Bank Canada
Laurentian Bank Securities Inc.
Merrill Lynch Canada Inc.
National Bank Financial Inc.
RBC Dominion Securities Inc.
Scotia Capital Inc.
The Toronto-Dominion Bank

Primary dealers for bonds

BMO Nesbitt Burns Inc.
Casgrain & Company Limited
CIBC World Markets Inc.
Desjardins Securities Inc.
Deutsche Bank Securities Limited
HSBC Securities (Canada) Inc.
Merrill Lynch Canada Inc.
Laurentian Bank Securities Inc.
National Bank Financial Inc.
RBC Dominion Securities Inc.
Scotia Capital Inc.
The Toronto-Dominion Bank

Non-primary dealer government securities distributors

Beacon Securities Limited
Canaccord Genuity Corp.
CTI Capital Securities Inc.
Morgan Stanley Canada Limited
Ocean Securities Inc
Odlum Brown Limited
PI Financial Corp

Customers are required to obtain a unique bidder identification number (BIN) before they can bid competitively and must submit their bids through a GSD. Under the current framework, the customer category is not intended for entities that purchase securities at auctions for distribution (i.e., acting as a dealer). There are approximately 100 customers with BINs, of which 34 are regular participants in auctions.

6. What are your views on the appropriateness of eligibility requirements for GSDs, PDs and customers for participation in securities auctions? How might changes to the residency requirements for PDs affect the structure of the domestic fixed-income market?

Minimum bidding requirements

A GSD must submit at least one winning competitive or non-competitive bid on its own behalf or on behalf of customers every six months. Since the minimum bid size is $100,000, a GSD needs to win only $200,000 per year at auction to maintain its status. A PD must submit bids for at least 50 per cent of its auction limit or formula calculation at no more than 10 basis points above the highest yield accepted (cut-off rate).[4] Customer BINs may be deactivated if they have been inactive for longer than one year.

PDs are the largest and most active group of participants in the primary market for Government of Canada securities (**Table 1**). There is a blurring of the lines, however, between participant categories, with some customers being far more actively engaged in auctions than some GSDs, and, in certain cases, than small PDs. In fact, the customer allotment of Real Return Bonds (RRBs) surpasses that of PDs.

Table 1: Share of allocations at auctions by participant and sector, 2012–13 (%)

Sector	Large PDs	Medium PDs	Small PDs	Non-PD GSDs	Customers	Bank of Canada
Treasury bills						
3-month	51	18	4	1	16	9
6-month	41	11	7	2	26	13
12-month	44	11	3	5	25	13
Total	47	15	4	2	20	11
Nominal bonds						
2-year	32	22	8	2	17	20
3-year	35	21	9	1	13	20
5-year	33	22	12	2	11	20
10-year	35	25	11	2	6	20
30-year	44	13	10	2	11	20
Total	34	22	10	2	13	20
Real Return Bonds	19	9	8	0	64	0

7. Minimum bidding requirements for PDs are fairly light, making the category accessible to small participants. The primary market share of the smallest PD, for example, is less than 2 per cent. Smaller PDs have been observed to submit frequent and regular "throwaway bids" at auctions simply to meet their minimum bidding requirements.

   What are your views on changing the minimum bidding requirements for PDs to minimum *winning* requirements? What would constitute a fair minimum winning requirement for a PD? Would these minimum winning requirements be applied to each auction or sector, and/or could they cover a certain time period (e.g., minimum winning bids of X per cent over the previous quarter)?

8. Participation at auctions by most non-PD GSDs is generally very low. Should consideration be given to reserving this category for those entities aspiring to become PDs? What is a reasonable time limit

[4] Bids are deemed reasonable for RRB auctions if the bid yield is no more than 10 basis points above the higher of the cut-off yield of the auction or the yield in the secondary market prior to the auction.

to allow an entity to build its business to the point where it could apply for full PD status? Should certain eligibility requirements (e.g., residency) be relaxed for this trial period?

9. What challenges do Government of Canada securities dealers face in trying to achieve the level of participation necessary to acquire or maintain GSD or PD status?

Maximum bidding limits

Maximum bidding limits for PDs are tiered from 10 to 25 per cent of the auctioned amount for bids on their own account plus an additional limit of 25 per cent of the tender for bids on behalf of customers. The sum of the bids submitted by a PD on its own behalf and on behalf of its customers cannot exceed 40 per cent of the tender less the dealer's excess net long position (**Appendix 1** and **Appendix 2**). As the Terms are currently designed, customers are able to bid for more securities than non-PD GSDs.

10. How appropriate are the maximum bidding limits for PDs, non-PD GSDs and customers?

11. In what manner should maximum bidding limits differ across sectors (e.g., RRB auctions)?

Price range for submission of bids at auctions

The acceptable price range for the submission of bids at auctions has been adjusted periodically. For example, the acceptable price range was increased from the cut-off rate plus 5 basis points to plus 10 basis points in 2005 and was temporarily increased to plus 15 basis points for treasury bills and plus 20 basis points for bonds from October 2008 to April 2010.

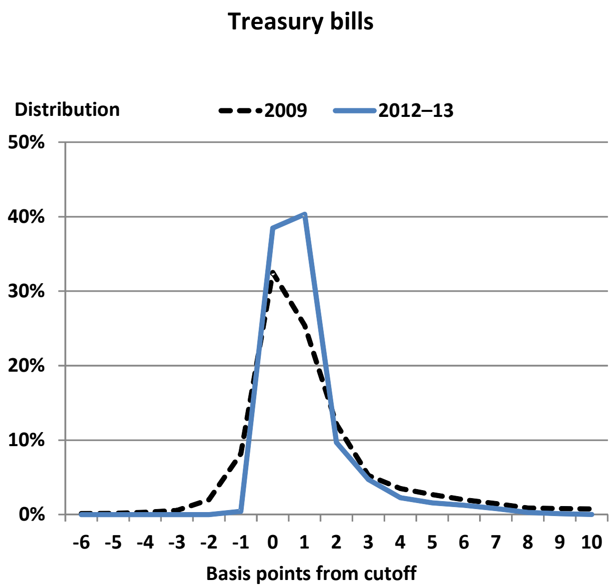
In 2012–13, over 90 per cent of the bids at auctions for treasury bills and nominal bonds were below the cut-off rate plus 4 basis points, while 90 per cent of the bids for RRBs were below the cut-off rate plus 10 basis points (**Chart 2**).

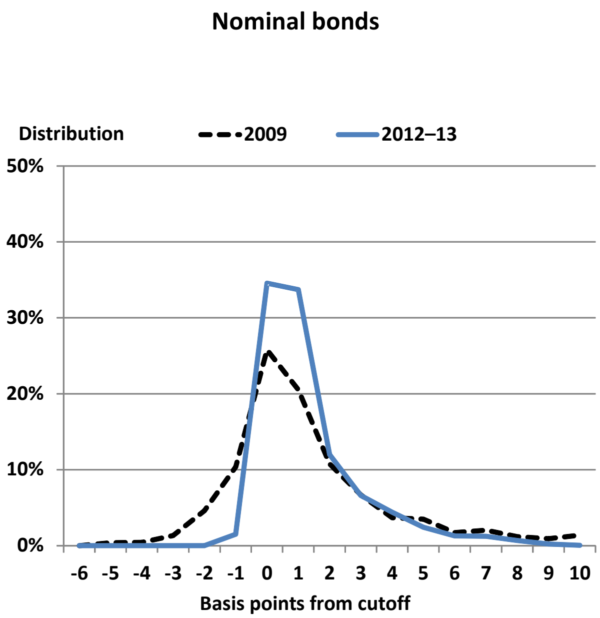
While bids submitted during the financial crisis had a wider distribution (as indicated by the dashed black lines in **Chart 2**), the price range for submission of bids at auctions in 2009 does not appear to have been necessary, since participants were clearly able to bid successfully in auctions at well under the cut-off rate plus 10 basis points. Low liquidity and the niche market demand for RRBs may result in some market participants having challenges in submitting bids for these securities at auctions. Moreover, RRB auctions are held in a single-price format, which further explains the larger bid dispersion for these operations.

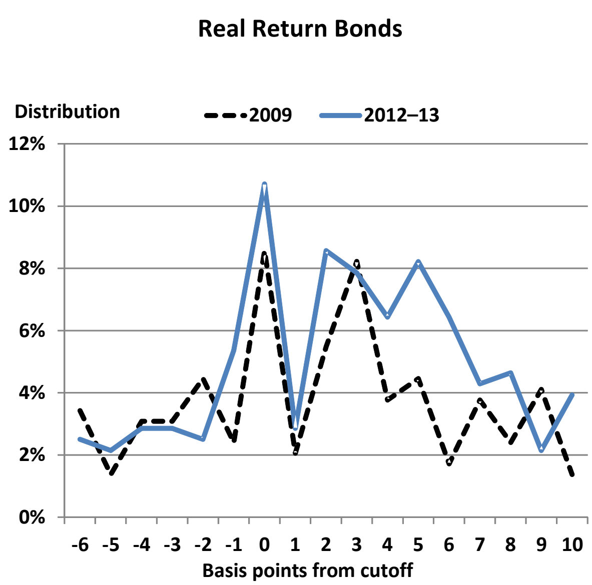
12. What are your views on the acceptable price range for the submission of bids at auctions for treasury bills, nominal bonds and RRBs?

13. If the Terms were amended to require that PDs win a certain minimum primary market share, how would that affect the acceptable price range?

Chart 2: Bid-yield dispersion around the cut-off rate (2009 versus 2012–13)







Non-competitive bidding

The current Terms include an optional non-competitive allocation for PDs, non-PD GSDs and customers that permit these entities to purchase securities at the average yield of the accepted bids of an auction. For PDs and non-PD GSDs, the non-competitive bidding limit is capped at $3 million for their own account and at $10 million for customers ($3 million for RRBs). Each customer's non-competitive bid is capped at $5 million ($3 million for RRBs).

Auction statistics reveal that many PDs and non-PD GSDs take full advantage of the non-competitive bidding allocation despite having the ability (and market intelligence) to purchase the securities at lower cost through competitive bidding, and the relatively small size of the allocation. Theoretically, non-competitive bidding should be most useful for small customers that have limited pricing information, since it is a risk-mitigation tool.

14. What value does your institution place on having access to a non-competitive allocation?

Reporting requirements

Auction net position reporting requirements were introduced in 1998 as one of several initiatives to support the integrity of the Government of Canada's debt-distribution framework. Since that time, the net position reporting requirements have been reviewed periodically, but no material changes have been made.

Under the current net position reporting requirements, GSDs must report their aggregate net position in the auctioned security when submitting their own bids or bids on behalf of customers (customers must submit their net positions either directly or through a GSD that is submitting a bid on their behalf). A GSD or customer must resubmit its auction net position if the position changes by more than $25 million before the auction deadline. The net position for a security includes when-issued positions, security-specific futures contracts and other categories that are outlined in the Terms.

15. What are your views on the existing auction net position reporting framework and how could it be improved?

Retail Investor Access to Government of Canada Securities

Fixed-income products in Canada are typically traded over the counter (OTC), whereas equities are traded on public exchanges. Many financial institutions, institutional investors and wealth managers participate in electronic marketplaces to facilitate the trading of fixed-income securities. However, for retail investors, acquiring a position in fixed-income securities often involves buying money market and bond mutual funds or exchange-traded funds (ETFs). Wealth managers offer another avenue for retail investors to acquire fixed-income securities by leveraging institutional buying of fixed-income securities.

Retail investors that prefer not to pay the asset-management fees associated with mutual funds, ETFs and wealth managers can buy and sell fixed-income securities through an online or discount brokerage account. However, the relative opaqueness of the OTC market has led to criticism of broker compensation, transaction fees and the cost of trading from one's own broker account.

Changes implemented by the Canadian Securities Administrators to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Re*gistrant *Obligations*[5] seek to enhance registrants' relationships with their clients (retail investors) through an expansion of cost and registrant compensation disclosure, as well as the introduction of performance reporting.

16. Of those retail investors with an online or discount brokerage account, what proportion use their account to buy fixed-income securities in general and Government of Canada securities specifically?

17. What are your views on the impact of the additional fee, commission and cost transparency required under National Instrument 31-103 for dealer and broker activities? Will these changes help to promote greater price transparency for retail investors?

18. What measures could the Government of Canada take to facilitate easier retail investor access to its debt securities?

[5] Available at http://www.osc.gov.on.ca/documents/en/Securities-Category3/rule_20090717_31-103_national-instrument.pdf.

Appendix 1

Maximum bidding limits for treasury bill auctions

BIDDING LIMITS FOR TREASURY BILL AUCTIONS			
	Competitive Bidding		Non-Competitive Bidding (per tranche, for all treasury bills and cash-management bills)
	Regular treasury bills and fungible cash-management bills (per tranche)	Non-fungible cash-management bills (per tranche)	
Primary Dealer - for own account	25 per cent	100 per cent	$3 million
- for customers	25 per cent	100 per cent	$10 million
- in aggregate	The sum of the bids submitted by a primary dealer on its own behalf and on behalf of its customers cannot exceed 40 per cent of the auctioned amount less the dealer's excess net long position (up to the dealer's bidding limit).		
Other Government Securities Distributor - for own account*	0 or 10 per cent	0 or 100 per cent	$0 or $3 million
- for customers	10 per cent	100 per cent	$10 million

* Government securities distributors that do not act as principal in the purchase and sale of Government of Canada securities directly with customers and other financial intermediaries have a competitive bidding limit of 0 per cent and a non-competitive bidding limit of $0 for their own account.

Appendix 2

Maximum bidding limits for bond auctions

BIDDING LIMITS FOR BOND AUCTIONS	Competitive Bidding	Non-Competitive Bidding
Primary Dealer - for own account	From 10 to 25 per cent	$3 million
- for customers	25 per cent	The sum of customer bids cannot exceed $3 million for Real Return Bonds and $10 million for other marketable Government of Canada bonds.
- in aggregate	The sum of the bids submitted by a primary dealer on its own behalf and on behalf of its customers cannot exceed 40 per cent of the tender less the dealer's excess net long position (up to the dealer's bidding limit).	
Other Government Securities Distributor* - for own account	From 0 to 9 per cent	$0 or $3 million
- for customers	10 per cent	The sum of customer bids cannot exceed $3 million for Real Return Bonds and $10 million for other marketable Government of Canada bonds.

* Government securities distributors that do not act as principal in the purchase and sale of Government of Canada securities directly with customers and other financial intermediaries have a competitive bidding limit of 0 per cent and a non-competitive bidding limit of $0 for their own account.

Appendix 3

BOND PORTFOLIO

Term to Maturity (years)	Bond	Issuance Sector	Outstanding Net of Repurchased (CAD Millions)	Repurchased (CAD Millions)
0.1	1.5% Nov 2013	2Y	7,954	3,546
0.3	1% Feb 2014	2Y	9,417	1,697
0.4	2% March 2014	3Y	7,992	1,608
0.5	10.25% March 2014	25Y	710	2,440
0.6	0.75% May 2014	2Y	7,974	2,893
0.7	3% June 2014	5Y	8,792	7,208
0.7	5% June 2014	10Y	7,702	3,166
0.8	2.25% Aug 2014	2Y	11,641	3,959
1.1	1% Nov 2014	2Y	9,900	0
1.2	2% Dec 2014	5Y	14,775	225
1.3	1% Feb 2015	2Y	15,600	0
1.6	1% May 2015	2Y	9,900	0
1.7	2.5% June 2015	5Y	9,000	0
1.7	4.5% June 2015	10Y	10,143	157
1.7	11.25% June 2015	25Y	457	1,893
1.8	1.5% Aug 2015	2Y	15,300	0
2.1	1% Nov 2015	2Y	9,900	0
2.2	3% Dec 2015	5Y	11,342	0
2.3	1.25% Feb 2016	3Y	8,100	0
2.7	2% June 2016	5Y	9,900	0
2.7	4% June 2016	10Y	10,157	143
2.8	1% Aug 2016	3Y	8,100	0
2.9	2.75% Sept 2016	5Y	10,500	0
3.4	1.5% March 2017	5Y	10,500	0
3.7	4% June 2017	10Y	10,343	0
3.9	1.5% Sept 2017	5Y	10,200	0
4.4	1.25% March 2018	5Y	10,200	0
4.7	4.25% June 2018	10Y	10,623	0
4.9	1.25% Sept 2018	5Y	10,200	0
5.7	3.75% June 2019	10Y	17,650	0
6.7	3.5% June 2020	10Y	13,100	0
7.5	10.5% March 2021	30Y	567	1,233
7.7	3.25% June 2021	10Y	11,500	0
7.7	9.75% June 2021	30Y	286	4,364
8.2	4.25% Dec 2021	RRB	5,175	0
8.7	2.75% June 2022	10Y	12,700	0
8.7	9.25% June 2022	30Y	206	2,344
9.7	1.5% June 2023	10Y	14,200	0
9.7	8% June 2023	30Y	2,359	5,841
10.7	2.5% June 2024	10Y	5,600	0
11.7	9% June 2025	30Y	2,303	6,597
13.2	4.25% Dec 2026	RRB	5,250	0
13.7	8% June 2027	30Y	4,430	5,170
15.7	5.75% June 2029	30Y	11,452	2,448
18.2	4% Dec 2031	RRB	5,800	0
19.7	5.75% June 2033	30Y	13,003	407
23.2	3% Dec 2036	RRB	5,850	0
23.7	5% June 2037	30Y	13,924	75
27.7	4% June 2041	30Y	15,800	0
28.2	2% Dec 2041	RRB	6,550	0
31.2	1.5% Dec 2044	RRB	7,700	0
32.2	3.5% Dec 2045	30Y	13,200	0

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RRB numbers do not include inflation adjustment

Source: Bloomberg as of 27 September 2013