Government of Canada Real Return Bond Consultations

Overview

The Department of Finance (DoF) and the Bank of Canada (BoC) are seeking the views of Government Securities Distributors (GSD), institutional investors and other interested parties on the functioning of the Government of Canada's (GoC) Real Return Bond (RRB) program. The views gathered from these consultations will guide the DoF and BoC in assessing the performance of the RRB program and in identifying whether any potential adjustments should be contemplated to ensure that the program continues to support the objectives of debt management.

Context

The DoF and BoC perform regular evaluations of key debt management areas. As part of this practice, the DoF and BoC are conducting a review of the RRB program in light of the evolution of the macroeconomic environment, debt management practices, and market demand for inflation-linked securities.

At the outset of the RRB program in 1991, the GoC outlined a number of objectives for the program:

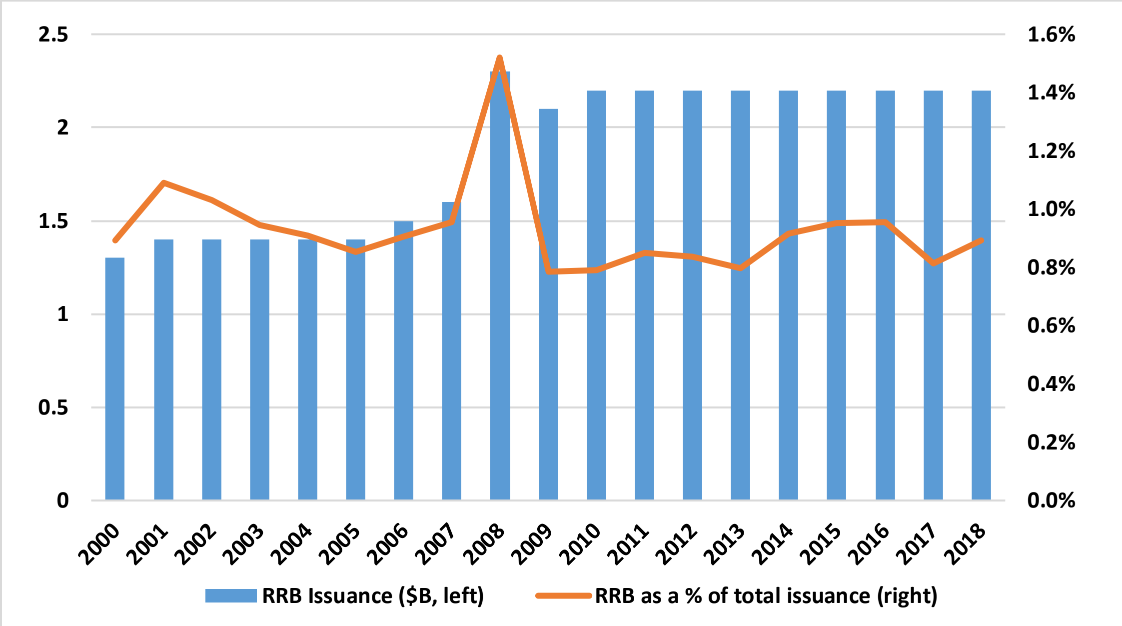
1. Cost-effectiveness compared with other sources of funds
2. Diversification of the marketable bond program for the Government
3. Broader selection of instruments provided to investors and diversification of the investor base
4. Secondary market development
5. Anti-inflationary stance signal to the market
6. Indicator of real return and long-term inflation expectations

The results of these consultations will aid in assessing the performance of the program in meeting the above-outlined objectives and the appropriateness of these objectives moving forward. Market participants are encouraged to provide their input by providing their responses to the questionnaire below.

Historical Issuance and Stock of RRBs

The issuance of RRBs had been constant at $2.2 billion annually since 2010 and has been relatively steady as a proportion of total annual issuance (Chart 1). While the Debt Management Strategy for 2019-20 contains a slight re-allocation from RRBs to 30-year nominal bonds in response to market feedback, the last significant adjustment to issuance came in the 2007-08 fiscal year, when issuance was increased from $1.6 billion to $2.3 billion.

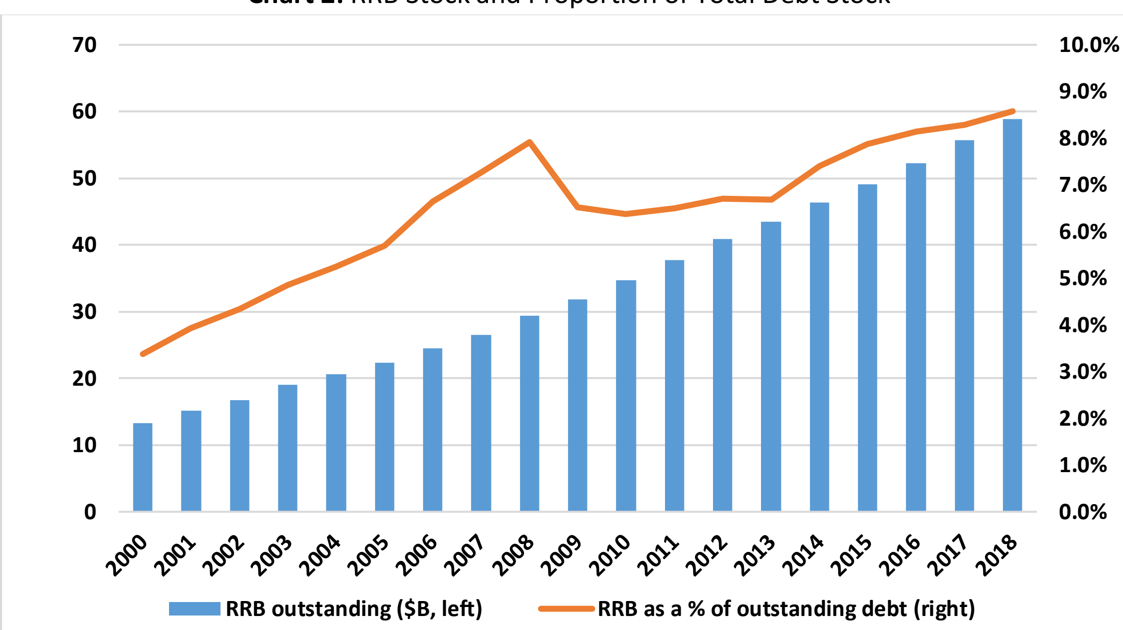
Chart 1: Annual RRB Issuance and Proportion of Total Issuance



Source: Debt Management Report
Note: Total issuance includes annual bond issuance and year-end treasury bill stock

Given the long-term nature of the sector, this steady issuance has implied a growing stock of RRBs, both in absolute terms and as a proportion of the total debt stock (Chart 2). The earliest issued RRBs will begin to mature in the coming years, with the first maturity upcoming in December 2021.

Chart 2: RRB Stock and Proportion of Total Debt Stock

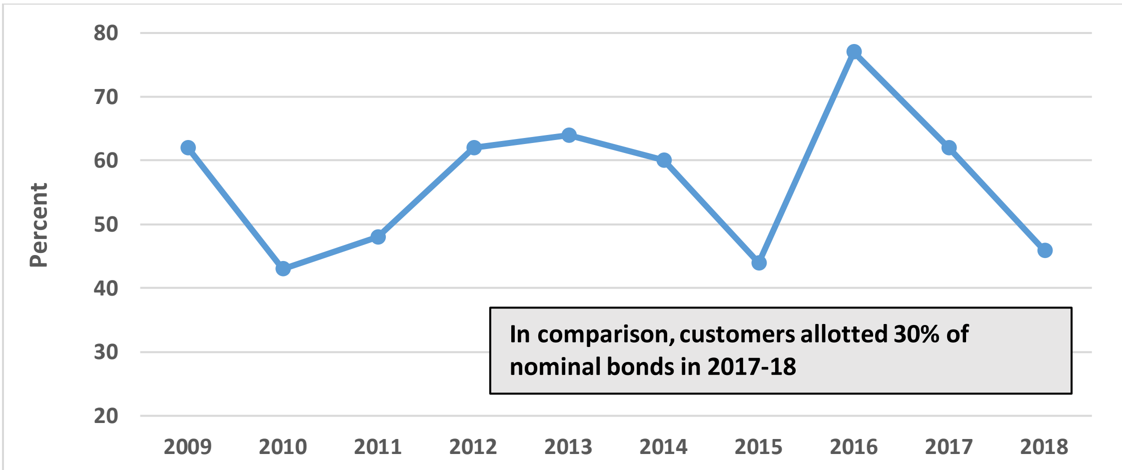


Source: Debt Management Report
Note: Outstanding debt includes outstanding bonds and treasury bills

Uses of RRBs for Investors

Demand for GoC RRBs has continued to be supported primarily by buy-side clients such as asset managers, pension funds and insurance companies. Customers have been allotted the majority of RRB issuance at auctions since 2009 (Chart 3). This set of questions focuses on role of RRBs in investors' portfolios.

Chart 3: Share of RRB Auctions Allotted to Customers



Source: Debt Management Report

1. What is your organization's primary reason for holding RRBs? Do you hold RRBs for the purpose of liability-matching requirements, improving your portfolio's risk/return profile, trading or other purposes? Please also specify your secondary reasons for using RRBs, if any.

2. Do you hedge your RRB exposure and, if so, how?

3. Are there other assets that you hold for similar purposes as RRBs? If yes, what are these assets and what is their relative importance in your portfolio versus that of RRBs?

4. Do you consider RRBs as a separate asset class?

5. Is there sufficient GoC RRB issuance to meet your institution's needs?

6. What are your anticipated future portfolio needs for inflation-indexed securities in comparison to the past ten years?

7. Would you prefer other tenors of RRBs (5y, 10y, 20y) to 30-year RRBs? If so, would you prefer them to nominal issuance in the same sector?

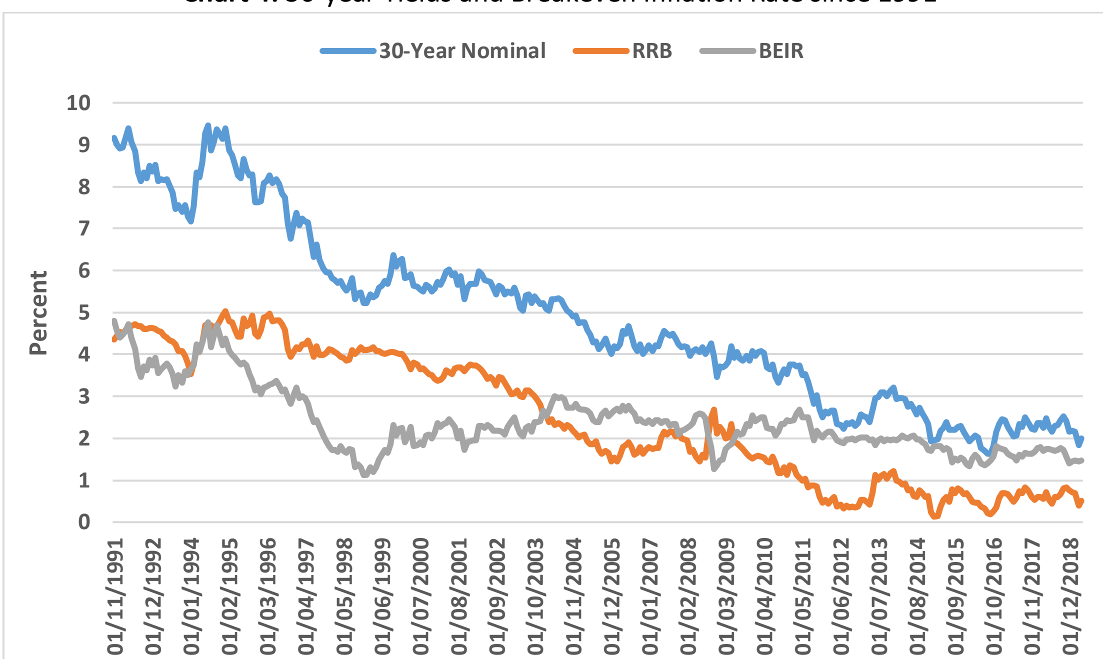
RRB Market Trends: Demand and Pricing

One of the fundamental objectives of Government of Canada debt management is to ensure access to stable, low-cost funding. RRB pricing can be evaluated relative to nominal issuance in the same sector based on the break-even inflation rate (BEIR) at the time of issuance, which is the difference between the RRB yield and the yield on a nominal bond with the same remaining term to maturity.

Breakeven inflation rates have varied over time and have recently been below two per cent since 2014 (Chart 4), which may reflect several different factors, including lower inflation expectations, a lower value of insurance against inflation risk, or a larger liquidity premium versus the 30-year nominal.

This section focuses on overall trends in RRB demand and pricing, and the factors underlying these trends.

Chart 4: 30-year Yields and Breakeven Inflation Rate since 1991



Source: Bank of Canada

8. How would you characterize current overall demand for Real Return Bonds?
    a) What trends have you noticed over the past few years?
    b) How do you expect demand to evolve in the future?

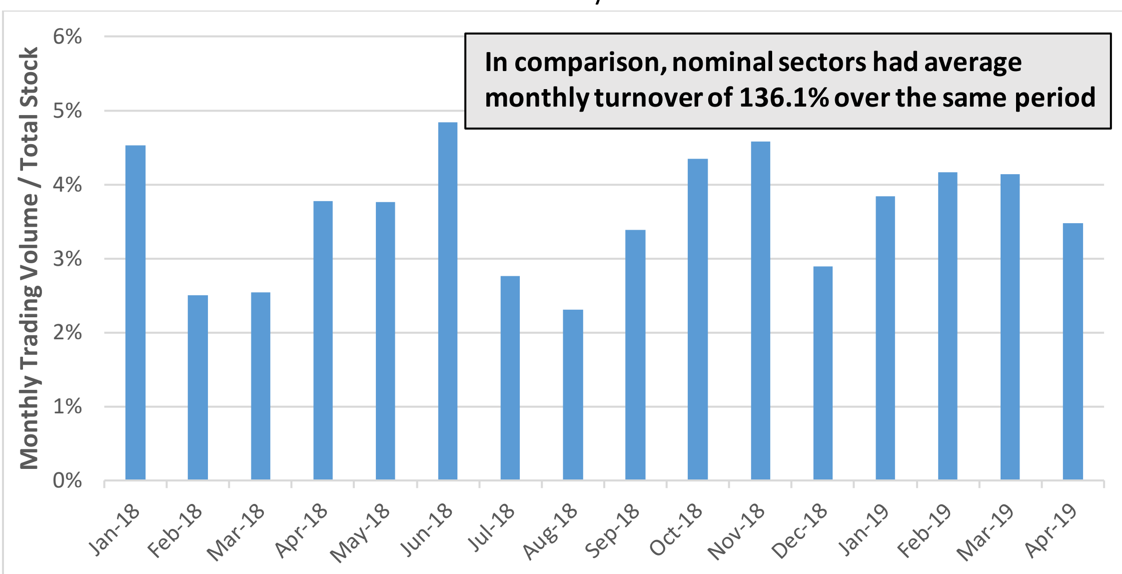
9. How would you compare the pricing of RRBs to that of 30-year nominal bonds? Do you feel that the difference in nominal and RRB yields accurately reflects market inflation expectations?

10. Are breakeven inflation rates an accurate signal of market inflation expectations? What other factors are most important in driving recent RRB pricing (e.g. inflation expectations, inflation risk, liquidity premium)?

Secondary Market Activity and Related Markets

Activity on the RRB secondary market has been limited since their inception. In particular, RRB trading represents a relatively small share of overall trading in GoC securities (Chart 5), despite representing about 8.7% of the outstanding GoC marketable debt.

Chart 5: RRB Secondary Market Turnover



Source: Bank of Canada calculations

11. How would you characterize secondary market conditions for RRBs and how has market liquidity evolved over time?

12. Do you have any views on why a derivative market for RRBs has not developed in Canada?