Government of Canada Debt Distribution Framework Consultations

1. Overview

The Department of Finance 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) debt distribution framework (DDF) in light of the evolving regulatory and market landscape. The views gathered from these consultations will guide the Government in assessing the resilience of the framework and identifying whether any potential adjustments should be contemplated to ensure that the framework continues to support the objectives of debt management.

The fundamental objectives of debt management are: (1) to raise stable and low-cost funding to meet the financial needs of the GoC, and (2) to maintain a well-functioning GoC securities market. A robust, effective DDF is critical to the achievement of these debt management objectives. Consistent with these objectives and guided by common practices among other sovereign debt managers, a DDF must facilitate access to funding markets during normal and stressed market conditions by supporting four fundamental principles:

1. Facilitating continuous access to funding markets;
2. Supporting a well-functioning government securities market;
3. Fostering a competitive primary market for government securities; and
4. Mitigating execution, settlement and operational risks.

Although the GoC's current DDF has been supportive of these fundamental principles, it has been over a decade since a comprehensive review[1] of the framework was conducted, and new trends have emerged in government securities markets that suggest a review of the framework is warranted.

2. Context

The GoC funds itself by issuing Canadian dollar-denominated debt securities, relying on primary dealers (PDs) and other GSDs to intermediate in primary and secondary markets with investors. Similar debt issuance frameworks, often referred to as the primary dealer (PD) model, are commonly used by sovereign issuers in developed market economies. The current framework was implemented in 1998, with several adjustments being made since then to ensure the integrity of auctions. The DDF was last reviewed in 2005. The 2005 review resulted in a number of changes to the DDF: an increase in customers' non-competitive bidding limits and in the bidding limits that Government Securities Distributors can submit on behalf of customers; an increase in the range of bids classified as being at a reasonable price; and the imposition of minimum auction participation for all GSDs, among others.

3. Balance of Interests in the Current Debt Distribution Framework

The current DDF was designed to balance the stable and low cost funding objective of the GoC with the stability of the framework, which depends on the attractiveness of the DDF for firms and the commitment of participants to GoC securities auctions. Through the adoption of a tiered system, the current framework balances the interests of the Government with those of market participants, where only GSDs have direct

[1] https://www.bankofcanada.ca/2005/08/review-government-canada-debt-distribution/

access to the auctions and customers may participate indirectly by submitting their bids through a GSD. PDs are a subset of GSDs that are required to maintain a minimum level of activity in primary and secondary markets, must participate for a minimum amount within a certain price threshold at every auction, and are expected to participate actively in making two-sided markets for GoC securities. PDs also have a residency requirement that stipulates that the firm's core domestic fixed-income market trading and sales operation for GoC securities must reside in Canada.[2]

For meeting these obligations, PDs benefit by having greater access to GoC securities auctions for their own account and on behalf of their customers, and are eligible to participate in the morning auctions of Receiver General cash balances. PDs also benefit from being eligible to take part in BoC operations: overnight repos and reverse repos, term repos, securities lending, and overnight standing repo facility. Non-PD GSDs, on the other hand, have fewer obligations and benefits. They do not have minimum bidding or market-making obligations to satisfy other than having to submit at least one winning competitive or non-competitive bid on their own or a customer's behalf every six months. In terms of benefits, non-PD GSDs may bid up to the lesser of their calculated bidding limit or 9 per cent of the auctioned amount on their own behalf and 10 per cent on behalf of their customers.

4. Market Trends

In recent years, the current DDF has been effective at facilitating the Government's access to funding markets. Bond and treasury bill auctions have been fully covered and remain competitive despite a decline in the number of PDs and an increase in concentration in the treasury bill market since the last review. Nonetheless, four trends have emerged in the government securities market that suggest a review of the framework is warranted: (1) changes in dealers' business model; (2) retrenchment of foreign dealers from non-core markets; (3) electronification of fixed income markets; and (4) changes in investor behaviour.

4.1 Changes in Dealers' Business Model

The implementation of Basel III and other regulatory reforms, as well as the review of business and risk management practices at many firms since the global financial crisis, have incentivized some dealers to rationalize their business models to de-emphasize risk-warehousing in favour of risk distribution. Anecdotal evidence from market consultations suggests that this rationalization process has manifested itself in dealers acting more as pass-through agents by transferring client orders directly to the market, with little impact on their balance sheets. Although a recent BoC Staff Analytical Note[3] suggests agency trading is still relatively limited in GoC securities, this tendency is becoming more prevalent in off-the-run bonds that trade less frequently than benchmark bonds. Market-makers are also increasingly viewed as allocating their balance sheet to the most profitable clients and trading activities. Changes in dealer business models have also contributed to a bifurcation in liquidity where on-the-run or benchmark bonds have a great deal of liquidity while off-the-run bonds remain less liquid. Further changes in dealer business

[2] Reference to full T&Cs: http://www.bankofcanada.ca/wp-content/uploads/2016/08/standard-terms-securities180816.pdf

[3] Hyun D., Johal J. and Garriott C. (2017): "Do Canadian Broker-Dealers Act as Agents or Principals in Bond Trading?" Bank of Canada Staff Analytical Note 2017-11 http://www.bankofcanada.ca/wp-content/uploads/2017/09/san2017-11.pdf

models could affect their participation in both primary and secondary markets with negative effects on general market liquidity and the GoC's issuance cost.

4.2 Retrenchment of Foreign Dealers from Non-Core Markets

The increased focus of global banks and dealers on core markets, primarily their domestic markets and other significant international markets, could also affect the DDF. The more stringent regulatory landscape has led some global banks to consolidate their balance sheets by pulling away from actively market-making in non-core markets. Most sovereign debt managers have a market-making provision as one of the main obligations that an institution must satisfy in order to enjoy the privilege of being a PD. Market-making is a balance sheet intensive activity that has made being a primary dealer in foreign jurisdictions one of the main targets for capital consolidation. Indeed, over the last few years, numerous banks have ceased being a primary dealer in jurisdictions where they thought they could not achieve a required level of profitability or which they no longer consider to be strategically important markets.

Canada is not exempt from this trend, with two foreign banks retreating from GoC market-making activities in Canada in recent years. Morgan Stanley ceased being a GSD for GoC securities in May 2014, while Deutsche Bank AG gave up its PD status in July 2014. These two withdrawals brought the number of PDs participating at GoC securities auctions to 11 PDs in bond auctions and 10 PDs in treasury bill auctions.

Under the current framework and level of minimum bidding obligations (and abstracting from BoC purchases), it takes at least 8 PDs to ensure full auction coverage. This assumes that primary dealers' bids and those from its customers total a minimum of 50 per cent of its auction limit (i.e. 8 x 0.5 x 25% = 100%). Any further retrenchment of PDs from GoC securities auctions would bring the number of PDs closer to 8, potentially requiring new ways to mitigate the risk of unsuccessful auctions or to accept higher levels of auction risk.

4.3 Electronification of the Canadian Fixed Income Markets

Electronic trading has become a growing part of the GoC securities market and is a trend that is expected to continue due to the speed and efficiency it delivers while also reducing operational risks. It can also potentially put pressure on PDs as it can lead to increased competition. The GoC electronic market can be broken down into two parts, the inter-dealer market and the dealer-to-customer market.

The inter-dealer market facilitates inventory management and risk-sharing among dealers, and is served by three platforms: Shorcan Brokers Ltd., Freedom Bond Brokers and Tullett Prebon Canada Ltd. The dealer-to-customer market on the other hand is predominantly served by Candeal.

The current structure of the GoC electronic market limits the ability to directly pool liquidity between dealers and investors, since customers do not have access to inter-dealer trading platforms and there is no platform to facilitate customer-to-customer trading. This structure reflects the fact that securities dealers have traditionally played a key role in intermediating and providing liquidity in GoC securities.

4.4 Changes in Investor Behaviour

The new market and regulatory landscape has started to affect the behaviour of investors in the GoC securities market. Market intelligence collected from several sources including the annual debt management strategy consultations and the Canadian Fixed-Income Forum (CFIF) surveys show that investors have adapted their investment strategies to account for reduced liquidity in off-the-run bonds. Increasingly, relative values funds are positioning their holdings into on-the-run benchmark bonds, exploring strategies that focus more on trade execution and require less immediacy services. The October 2016 CFIF survey[4] showed that the majority of market participants increased their holdings of building benchmark and benchmark bonds in lieu of off-the-run bonds because of the more stringent regulatory environment. More than 50 per cent of respondents to the October 2016 CFIF survey indicated that they are leaning towards strategies that require less trading and are exploring strategies that minimize the price impact of their trading, such as splitting transactions into smaller amounts. The survey also revealed increasing use of derivatives, notably futures contracts and exchange traded funds, to obtain a position and hedge interest rate risk.

By reducing pressure on the demand for immediacy services, changes in investor behaviour could partially offset the negative effect of decreased market-making capacity resulting from the recent regulatory changes and decreased risk appetite of financial institutions. While these developments may support or even help improve market liquidity during normal market conditions, market participants are concerned about the potentially increased fragility of liquidity during market stress when demand for liquidity generally increases. The reduced market-making capacity could also limit dealers' ability to act as shock absorbers in times of financial distress.

Questions:

1. What are your views on the four trends in the GoC securities market? Are there other trends not highlighted that you believe might impact the effectiveness of the DDF?

2. Please comment on the progression and impacts of any current and potential trends on the DDF.

3. How important is your participation in GoC bond markets to your overall fixed income business?

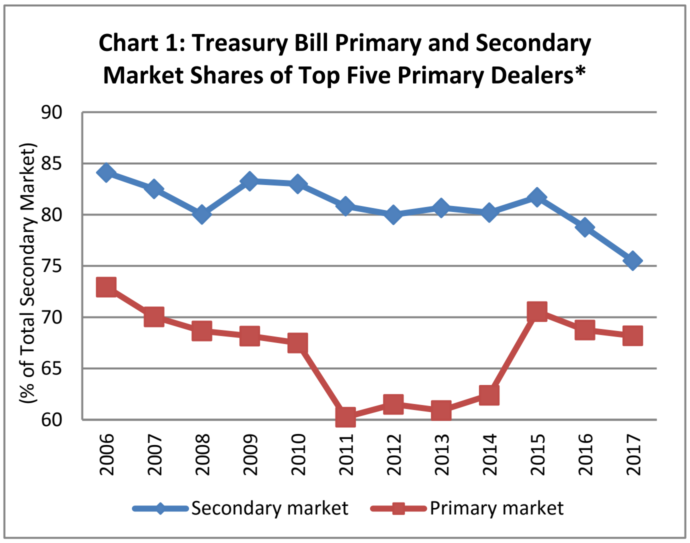
4. How well do the current electronic trading platforms support the well-functioning of the GoC bond market?

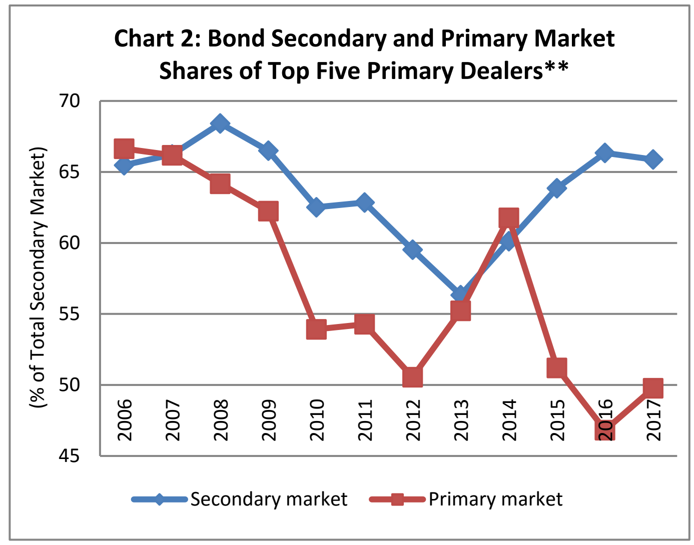
5. Competitiveness of the Treasury Bill Market Versus the Bond Market

Since the global financial crisis, the stock of GoC bonds outstanding has increased from about $264 billion in December 2008 to $570 billion in December 2017. Meanwhile, the stock of treasury bills has declined from an historic high of $200 billion in July 2009 to $120 billion by December 2017. Over roughly the same period, the treasury bill market has remained highly concentrated with the top five PDs controlling on average 66 per cent and 80 per cent of the primary and secondary markets, respectively (see Chart 1). Trading in the bond market, on the other hand, has become relatively more distributed among PDs. The

[4] http://www.bankofcanada.ca/wp-content/uploads/2016/10/cfif-survey-overview-031016.pdf

primary market share in bonds for the top five PDs decreased from 65 to 50 per cent, while their secondary market share averaged about 60 per cent (see Chart 2). Although the higher concentration of the treasury bill market relative to the bond market has not materially affected the well-functioning of the market, a further concentration of activity into a small number of intermediaries could potentially limit the ability of the market to absorb unexpected large changes in issuance.





Source: Bank of Canada

*Primary market share measured by PD winning share at GoC securities auctions.
**Secondary market share measured by PD trading volume in GoC securities.

Questions:

5. Within this context, how would you characterize the level of competitiveness of the Government of Canada treasury bill and bond market?
6. What are the drivers behind the higher concentration of the treasury bill market compared to the bond market?
7. How would you characterize the effectiveness of the current bidding obligations imposed on primary dealers in fostering participation and competition in the treasury bill market? How would you characterize their effectiveness in the bond market?

6. Assessing the Effectiveness of the Current Debt Distribution Framework

The GoC's PD model has been supportive of its debt management objectives of raising stable and low cost funding, and supporting a well-functioning GoC securities market. Given the medium-sized nature of the Canadian financial market and the important financial intermediation role played by securities dealers, the PD model currently appears to remain the most appropriate debt distribution model for GoC securities.

PDs offer a range of services to the Government, including submitting auction bids on their clients' behalf, marketing securities to their clients, redistributing securities to end investors, and mitigating operational risk by limiting the number of direct participant interactions with the Government. Importantly, PDs also warehouse securities on their balance sheets when there is insufficient immediate investor demand for securities at auctions since they are obliged to participate in every auction irrespective of market conditions.

Since the adoption of the PD model, auctions have been the primary method to sell wholesale domestic GoC debt securities, with the only exception being the syndications used in 2014 to issue the first Government of Canada ultra-long bond. Nominal bonds and treasury bills are allotted based on multiple-price auctions, whereas real return bonds and ultra-long bonds are allocated based on single-price auctions. Auctions have contributed to the effectiveness of the PD model, and it is expected that they will continue to be effective for the foreseeable future.

Four DDF features are discussed below as potential areas where adjustments could be made in order to rebalance the benefits and obligations of the current DDF. Advice on other potential adjustments is also welcome.

6.1 Assessing the Primary Dealers Minimum Bidding Requirement

The current DDF supports the GoC's desire to maintain continuous access to the funding market by requiring that a PD should bid a minimum of 50 per cent of its calculated bidding limit amount at each auction. Given the current number of GoC PDs, the 50 per cent minimum bidding obligation provides the Government with the guarantee that any bond or treasury bill auction will be more than fully covered. Nonetheless, the evolving regulatory landscape has increased the cost of balance sheet intensive activities, and some firms have been rationalizing their business models by reducing capital allocations to capital intensive business lines that do not produce the required return. Although the functioning of the GoC market has not been materially impacted by dealer balance sheet rationalization, there are growing signs that dealers globally, including in Canada, are changing the way they conduct their market-making activities. Anecdotal evidence suggests that dealers are more frequently conducting off-the-run trades on an agency basis and they are allocating more balance sheet to benchmark bonds, which are relatively more liquid than off-the-run bonds.

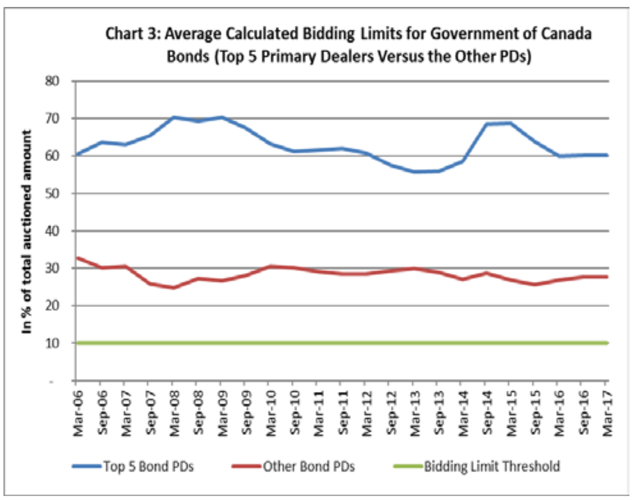
Questions:

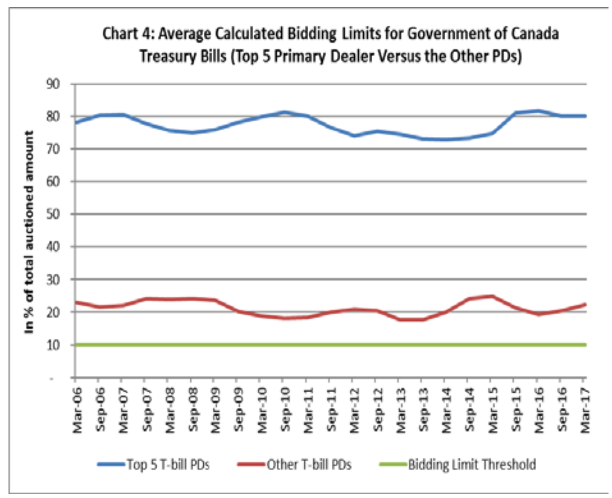
8. From your perspective, have balance sheet costs and internal limits impacted bidding behaviour at GoC securities auctions? If so, how?

9. How would higher or lower minimum bidding requirements for Primary Dealers affect bidding behaviour and GoC auctions results more broadly?

6.2 Requirements to Gain and Maintain PD Status

Benefits associated with PD status require that a set of obligations be met, such as mandatory reporting, a commitment to the domestic market, and maintaining a certain level of primary and secondary market activity in GoC securities. The Government monitors how each PD meets its intermediation obligations by calculating the bidding limit of each PD on a semi-annual basis[5]. The bidding limit is based on the primary and secondary market shares of the PD, as well as optional participation in some auctions such as non-fungible cash management bills. A PD must maintain a calculated bidding limit of 10 per cent to preserve its PD status. A PD whose calculated bidding limit drops below the 10 per cent threshold will be given a 6-month grace period to improve its performance before it loses its primary dealer status. Though this threshold can motivate existing PDs to remain active in the primary market and support liquidity in the secondary market for GoC securities, it also makes it more difficult for new entities to meet the eligibility criteria to become a PD. A slightly lower calculated bidding limit threshold would provide more flexibility to existing PDs, particularly those with smaller market shares, while facilitating firms to become PDs. As depicted in Charts 3 and 4 below, the calculated bidding limit of the top 5 PDs remains well above the 10 per cent threshold while those of the remaining PDs tend to be closer to the threshold.





Source: Bank of Canada

Questions:

10. How do you view the current balance of benefits and obligations that are associated with PD status?

11. What is your view on the current level of activity required (the 'calculated bidding limit threshold') to achieve and maintain PD status? How would reducing or increasing this threshold affect your behaviour at auctions and the resilience of the DDF more broadly?

6.3 Secondary Market Obligations

Like most major sovereign debt managers, the GoC relies on PDs to make markets in its securities, which helps to foster a well-functioning market for its securities and support its ability to raise stable, low cost funding over the long term. However, unlike most other jurisdictions whose secondary market obligations are clearly specified, the GoC's current secondary market obligations are not quantified. Although the GoC

[5] Calculated bidding limit is given by the following formula: 3x(primary market share) + 2x(secondary market share)+ 0.5x(share in optional operations).

secondary market is relatively liquid and PDs strongly support market liquidity, the lack of clarity around secondary market obligations could negatively affect the well-functioning of the market during a period of market stress. Requiring PDs to maintain a minimum secondary market share has the potential to reinforce the liquidity of the GoC securities market and avoid the gradual erosion of that liquidity over time. Since all PDs are already actively supporting liquidity in the GoC securities market and reporting on their trades, this threshold should not represent a material change to PD's current activity levels and practices. It would, however, bring Canada in line with the other major sovereign debt managers that have implemented specific secondary market obligations.

Questions:

12. What are your views on the potential impact of imposing a minimum secondary market share on PDs?

13. What are your views on the appropriate level and calculation frequency of a potential secondary market share floor?

14. Please comment on other measures that Government could take to strengthen the existing secondary market-making obligation.

6.4 Non-Primary Dealers Bidding Limit for Customer

As mentioned above, under the current Canadian PD model, the Government relies exclusively on GSDs to distribute its debt. Alongside PDs that are required to participate at each auction, a non-PD GSD category was created to foster broader auction participation and competition by allowing smaller dealers to access GoC auctions. The non-PD GSD category can also be viewed as a stepping stone for dealers interested in becoming a PD. Nonetheless, unlike PDs that have more primary and secondary market obligations, non-PD GSDs are only required to submit at least one winning competitive or non-competitive bid on its own behalf or on behalf of customers every six months in order to obtain some primary dealing benefits.

Questions:

15. Within this context, what are your views on aligning the non-PD GSD bidding limit for customers to their own level of participation at GoC securities auctions?

16. How would you characterize the balance of benefits and obligations of non-PD GSDs at GoC securities auctions?

6.5 Other Potential DDF Adjustments

To the extent that there are other key trends and factors influencing the DDF that have not been highlighted, there may be alternate framework adjustments that are worthy of consideration.

Question:

17. To the extent that there are other key trends and/or factors influencing the GoC's DDF, what changes would you propose making to ensure that the DDF continues to support the four fundamental principles of debt distribution and the Government's debt management objectives?