Summary of Comments – 2007/08 Debt Strategy Consultations

In December 2006, officials from the Department of Finance and the Bank of Canada sought views from government securities distributors, institutional investors, and other interested parties on the state of the Government of Canada securities market in an environment of limited borrowing needs. Views were requested on the market's liquidity and efficiency, the evolving pattern of trading activity, the use of government securities for collateral-management purposes, and on certain operational aspects of domestic debt programs. The consultations served as input to the development of the 2007/08 debt strategy and were in keeping with the government's ongoing commitment to consult with market participants. This document provides a summary of the views received during these consultations.

In Brief

Market participants indicated that Government of Canada securities markets are functioning well and are adapting to the environment of limited borrowing needs, despite the challenges that this situation poses for the government as issuer and for the marketplace. A clear majority of participants indicated that a large structural adjustment to the bond program, such as the elimination of a benchmark maturity, is not needed at this time. They suggested that the government continue to use fungibility (i.e., the ability to combine different bonds that share the same maturity date) to maintain large liquid benchmarks in the existing four nominal bond maturities.

Participants mentioned that market liquidity and trading activity have been enhanced by increased activity in interest rate futures for 10-year bonds (CGBs), growing involvement from hedge funds and international accounts, and increased price transparency and competitiveness resulting from the growing popularity of electronic trading.

Market participants indicated that the growing demand for Government of Canada securities because of increasing collateral requirements, combined with the strong growth in derivatives trading (particularly by hedge funds), has resulted in more dynamic trading in the cash and repo markets. Strong investment demand for longer-term nominal and

Real Return bonds was a recurring comment expressed by institutional investors.

Participants also provided useful input on issues associated with the design of the bond program and the management of government cash balances. In general, most participants felt that the strategies and initiatives pursued by the government in recent years have been working well.

Liquidity, Trading, and Investment Activity

Market participants viewed the overall level of liquidity as similar to or improved when compared with recent years, taking into account the environment of limited government borrowing needs. Most dealers indicated that liquidity in the benchmark maturities for treasury bills and bonds is currently adequate, with the 30-year sector characterized as being relatively less liquid. All dealers believed that liquidity in the 10-year sector has been enhanced owing to an increase in CGB trading. The majority of participants reported that average transaction sizes in the secondary market have increased, and bid-ask spreads have narrowed. Most dealers mentioned that liquidity for clients has never been better, largely because of developments in electronic trading, and some dealers expressed concerns about the potential for further erosion of profit margins.

Market participants indicated that hedge funds have provided additional liquidity to the market. Dealers commented that they had to manage higher levels of risk to accommodate demand for larger transaction sizes from sophisticated international investors and a consolidating domestic account base. Some dealers mentioned that increased trading in CGBs and interest rate swaps in Canada in recent years has facilitated the market's adjustment to an environment of limited borrowing needs by the Government of Canada.

The development of Maple Bonds, defined as Canadian-dollar denominated bonds issued by foreign borrowers in the domestic Canadian market, was viewed positively by all participants, since it broadens the list of potential investments available and provides increased activity for the bond and swap markets. Institutional clients with long duration mandates expressed the need for more issuance at the long end, including Real Return Bonds. They noted that the increase in the provincial issuance of long-term bonds in recent years was not in itself sufficient to meet the strong level of demand.

Repo Markets and Collateral

Market participants noted that there has been a significant increase in the demand for general collateral over the past few years, and that this trend, coupled with the decreasing issuance of government debt, has contributed to more frequent and pronounced periods of tightness in the repo market for particular Government of Canada bonds. As a result of conditions in the repo market during the first half of 2006, as well as the increasing interaction between the cash, swaps, and futures markets, some dealers indicated that they have had to adjust their pricing and trading practices. Market participants provided various suggestions as to how the market, the government, and the Bank could further support the functioning of the repo market in light of the changing environment.

Market Integrity and Transparency

Market participants recognized that liquidity and a well-functioning Canadian marketplace depend on program design and also on public confidence in the market's integrity. The general consensus was that revisions to IDA Policy No. 5 have strengthened the integrity of the Canadian fixed-income securities market. Although it was observed that most dealers were well informed regarding the revisions to IDA Policy No. 5, it was thought that the awareness of other market participants, including institutional accounts, could be enhanced.

The majority of participants indicated that the growth in electronic trading in recent years has increased the level of transparency and pricing competitiveness in the market. Dealers remarked that there is a trade-off between increasing transparency and the maintenance of a liquid and well-functioning fixed-income market.

Operational Issues

Bonds

Dealers mentioned that although fungibility has been helpful in maintaining benchmark liquidity in light of reduced issuance, the availability of existing benchmark bonds for stripping and reconstitution purposes varies depending on the particular bond.

Many dealers expressed some concern with the size and liquidity of the 2–year June benchmark, as a result of the foregone auctions in the fourth quarter of 2005-06 and 2006-07. In addition, a number of participants also indicated that the relatively smaller size of the upcoming June 2-year benchmarks could lead to tightness in the repo market.

Some participants noted that it was currently possible to increase the use of fungibility in the 5-year sector and, eventually, in the 10-year sector, when future benchmark bonds become fungible with existing large benchmark issues. However, there was a consensus among market participants that the use of fungibility in the 2-year sector had already been maximized.

Most participants indicated a slight preference for alternating between quarters when the government foregoes auctions in the 2-year and 5-year sectors to smooth the overall level of issuance, but also indicated that this was not critical. No participant opposed delaying the start of issuance of a new 5-year benchmark by one quarter to accommodate this change.

Market participants strongly favoured re-opening an existing bond instead of creating a new fungible security when the coupon rate on the existing bond is close to market rates.

Treasury Bills and Cash-Management Bills

Market participants commented that the strategies used by the government to aid in the management of cash balances, such as the cash-management bond buyback program, the use of cash-management bills, and increased variance in the size of treasury bill auctions from one auction to the next, were generally working well. The main concern noted by some was that a minimum level of issuance at regular treasury bill auctions was required to maintain a well-functioning market and auction process. Many commented that the increased treasury bill issuance had been very well absorbed by the market, even at times of large auctions.

Market participants indicated that any potential increase in the issuance of cash-management bills would probably go towards meeting growing collateral requirements, and that secondary market trading would remain limited.

Participants were mildly supportive of changing the release time of the call for tender of cash-management bills from 10:00 a.m. Eastern

Time to 9:45 a.m. Eastern Time, so that it no longer coincides with the release of several economic indicators.

With respect to the cash-management bond buyback program, market participants cited various factors to explain the recent difference in valuation between short-term bonds and treasury bills with similar maturities, including the increased demand for collateral, reduced bonds outstanding, investor preferences, and the segmentation of money market and bond instruments in fixed-income portfolios.

Views on potential market demand for a 1-month treasury bill were mixed, with most stating that if a regular 1-month bill was introduced, it should not compromise the issuance of existing regular treasury bill maturities. Those supporting a 1-month treasury bill were of the view that it would help normalize the money market yield curve, thereby facilitating trading and enhancing market liquidity. Those expressing concern indicated that the demand for the 1-month sector has declined and, with competing products in the sector, thought that the existing cost advantage for the government would be reduced.