Debt Distribution Framework Review Consultations

Overview

The Department of Finance and the Bank of Canada (the Bank) are seeking the views of Government Securities Distributors (GSDs), institutional investors, and other interested parties on the functioning of the Government of Canada's (GoC) Debt Distribution Framework (DDF) in the current market landscape. The views gathered from these consultations will guide the GoC in identifying whether any potential adjustments should be made 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 was found to be supportive of these fundamental principles during the last framework review in 2018, we seek to conduct reviews every five years.

Context

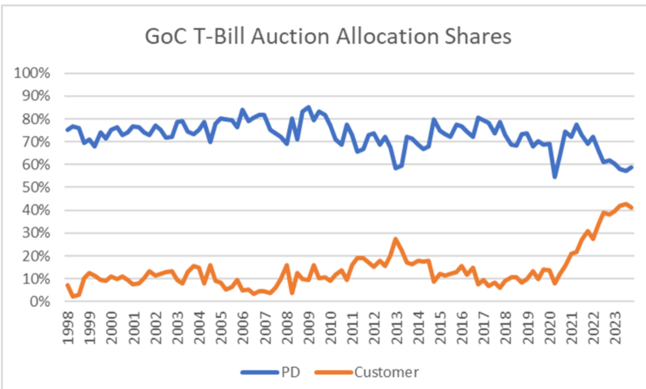
The GoC funds itself by issuing Canadian-dollar denominated debt securities, relying on primary dealers (PDs) and other GSDs (non-PD GSDs) to participate in primary market auctions and intermediate in secondary markets with investors. In addition, customers of GoC securities can participate in auctions by placing bids through a GSD intermediary. Similar debt issuance frameworks are commonly used by sovereign issuers in developed market economies. The current framework was implemented in 1998 and adjustments were made in 2005. The DDF was last reviewed in 2018, however, no adjustments were made at that time to the framework.

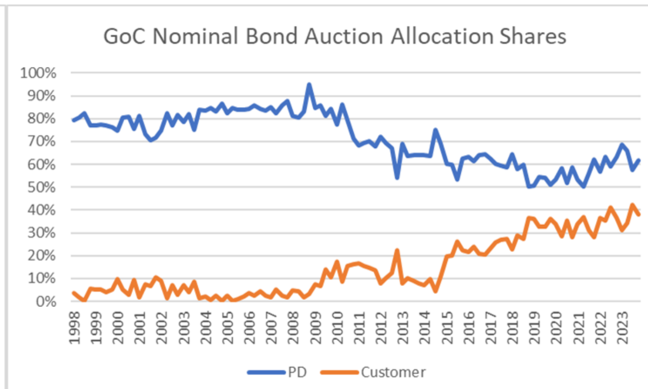
The 2024 DDF review is ongoing. Preliminary stages completed earlier this year included the analysis of the primary and secondary market data for GoC securities, as well as conversations with peer sovereign issuers, GSDs, and a sample of large investors in GoC securities.

Key findings of the 2024 DDF review

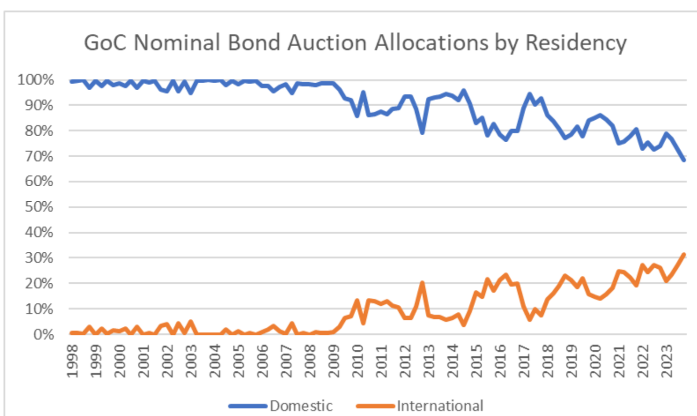
Canada's auctions for GoC securities continue to be an effective means for raising funds, evidenced both in consistently strong metrics such as auction coverage and auction tail, as well as in the commentary received from market participants.

One trend highlighted in the 2018 DDF review, and still evident today, is the shift in primary allocations of GoC securities away from GSDs and towards customers. As regulatory reforms following the 2008 financial crisis influence financial institutions' incentives, our dealers continue to exhibit a gradual move away from a principal model to a more agent model where they focus more on customer needs and have a lesser tendency to warehouse securities.





Another continuing trend is the increase in allocations of GoC bond auctions to international accounts (foreign allocations of GoC treasury bills at auction, however, remain negligible). Active bidders at bond auctions continue to be mixed among several investor types, with hedge fund customers being the most numerous investor class present in the primary market.



Concentration at auctions remains within historical levels, with different accounts regularly able to achieve a "top five" allocation at bond and treasury bill auctions. Treasury bills continue to exhibit a higher concentration than bonds.

Total secondary market dealer-to-customer trading in GoC securities has continued to increase steadily in recent years. However, as a percentage of total GoC securities outstanding, secondary market trading has declined rather than kept pace with the increasing size of Canada's debt stock. At a firm level, trading activity has been relatively stable and balanced across PDs and is minimal for non-PD GSDs.

In our exchanges with peer sovereign issuers, we found that Canada's PD base stands out in that it has fewer PDs and the majority of these are domestic firms (in contrast to the predominately foreign PD bases for most issuers). The scarcity of foreign dealers in Canada was increased when HSBC Canada was removed as a PD in March 2024, and reflects the retrenchment of foreign dealers from their non-core markets as firms consolidate their balance sheets.

There are other notable differences between Canada's DDF and that of peer sovereign issuers. For example, many do not have minimum bidding obligations for their dealers or make use of bidding limits; some employ post-auction facilities and re-open off-the-run securities; and many make routine use of single-price auctions and/or syndications for their conventional bond programs.

Given the above findings and market trends, the potential changes to the DDF described below are focused on incremental, mutually beneficial improvements and simplifications to Canada's framework. Proposals are also being considered to enhance the resilience of Canada's dealer base by potentially attracting new entrants and reinforcing it.

Questions:

1. What market trends have you observed in the Canadian fixed income markets, and the GoC securities market specifically, over the past five years that are not discussed above yet might impact Canada's DDF?
2. How would you describe the overall effectiveness of Canada's DDF over recent years?

The remainder of this document covers potential adjustments to Canada's DDF.

Non-PD Government Securities Distributors

Canada employs two tiers of dealers: PDs and non-PD GSDs. This GSD model has been unchanged since 1998.

PDs have greater access to auctions. In return, they must meet minimum bidding requirements (MBRs) at every auction and be active market-makers for GoC securities. The PD status also grants them eligibility to participate in the Bank's operations and morning auctions of Receiver General cash balances. Further, the PD label is valuable in attracting ancillary customer business and is a prerequisite for leading syndications within the Canadian market (e.g., for Canada's provinces). Non-PD GSDs, by comparison, have lower access to Canada's auctions yet only need to submit one winning bid every six-months and they do not have market-making responsibilities.

While the balance of benefits and obligations for our PDs continues to serve Canada well, we observed that the inherent challenges of the dealer business model lead to higher thresholds with respect to attracting new participants. When considering whether and how to address this, there are few options available within the scope of DDF adjustments. However, there may be opportunity to make refinements to the non-PD GSD dealer class which could attract new participants and thereby enhance the resilience of our overall dealer base .

At present, bidding activity from non-PD GSDs at GoC securities auctions is limited. Modest increases to these dealers' bidding requirements could generate increased bidding activity from them and better balance their obligations with the benefit of auction access and the dealer label (while still endeavoring to keep this non-PD GSD category attractive). Debt managers could also seek to raise awareness of the existence of the non-PD GSD option among foreign financial institutions, given preliminary discussions revealed it to be mostly unknown outside Canada.

To lower barriers to entry for prospective foreign dealers and, as a result, increase the size and diversity of Canada's dealer base, the eligibility requirements for non-PD GSDs could be reviewed (these requirements would be retained for PDs, however). These include the following:

- GSDs must have their core fixed-income trading and sales operations for GoC securities physically located in Canada. This provides evidence of a dealer's commitment to Canada and the GoC securities market. However, the continued electronification of fixed-income markets and the growth of e-trading have reduced the link between physical location and commitment for securities trading. In this context, the policy benefit once provided by a residency requirement for non-PD GSDs may no longer exist and may provide a non-necessary barrier to entry.
- GSDs must be members of the Canadian Investment Regulatory Organization (CIRO). Removing this requirement for non-PD GSDs may reduce a barrier to entry. This would align with the removal of the residency requirement, allowing dealers in other jurisdictions to apply and to become non-PD GSDs in GoC securities. To manage risk and ensure continued data completeness, foreign-based non-PD GSDs would need to be regulated to a satisfactory standard (for example, by a regulator member of IOSCO) and, like other GSDs, submit all

relevant trading data to CIRO.

Questions:

3. What are your views on increasing Canada's non PD-GSD's winning bid obligations to at least once per month?
    - What other types of obligations or requirements should be considered?
4. What material risks do you see in removing the Canadian residency requirement and/or the CIRO membership requirement for non-PD GSDs? How could new risks from such changes be managed?
5. What are your views on seeking to encourage more dealers, especially major international firms, into applying to be non-PD GSDs? What impacts do you believe this may have on other aspects of Canada's DDF and the markets for GoC securities?
6. Do you have any other views or comments on Canada's two-tiered GSD system?

Auction rules for Government Securities Distributors

Currently, Canada employs a bidding limit and MBR regime that assigns all PDs a uniform T-Bill bidding limit, variable bidding limits for bonds, and variable MBRs for both bonds and T-Bills. Each PD's bidding limit for bond auctions and MBRs for bond and T-Bill auctions are derived from their unique "Calculated Value" (CV), which are regularly computed for each dealer based on their presence at GoC auctions, their trading activity in GoC securities on the secondary market, and their activity in optional operations such as cash management bond buyback operations. A minimum CV score is also required to maintain PD status. The rationale for this system lies in rewarding dealers' strong showings in GoC securities markets with a greater ability to bid at the auctions, which in turn is accompanied by a heightened responsibility to bid competitively at these auctions.

Many PDs have consistently maintained CV scores well above the 25% ceiling which confers the maximum bidding limit and greatest MBR. However, most dealers noted that they have a limited understanding of the CV system. Further, it was assessed that dealers' strong primary and secondary activity isn't motivated by the CV scores themselves, but rather dealers' natural incentives to be active in GoC securities markets to attract investor business.

Removing CVs and adopting a more uniform arrangement for all bidding limits and MRBs may be an opportunity to streamline and simplify Canada's DDF. Other benefits include aligning our framework more with international practice where all dealers are subject to the same auction rules, reducing operational burdens for debt managers, and ultimately making our PD criteria less mechanistic and more based on discretion, two-way discussion, and holistic performance. Canada would retain its two tiers of GSD dealers with their different auction rules, however.

Questions:

7. How do you see a simpler uniform system for GoC securities auction rules, where all PDs would be assigned the same bidding limit and minimum bidding requirement, impacting your bidding (and that of others) at auction?[1]
    - What should Canada take into consideration in setting uniform limits and requirements?
8. What impacts do you foresee from assigning the same minimum bidding requirement to each PD, for example by determining PDs' MBRs on a *pro rata* basis?[2] Note that such a change would be expected to raise some PDs' MBRs.

Bidding limits

From conversations with market participants, most dealers and customers expressed that the current 25% competitive bidding limit remains appropriate for their needs.

Canada allows for non-competitive bidding at its auctions as well, whereby bidders are guaranteed allocations at the auction's average price. For investors and distributors who may not have the expertise in GoC securities auctions and markets to make successful competitive bids, this allows them to acquire small amounts of the securities. The non-competitive bidding limits were last revised in 2005 and are currently $5 Mn for customers and $3 Mn for GSDs.

Questions:

9. How would you describe the appropriateness of the maximum competitive bidding limit level of 25% for PDs and customers, and the 40% aggregate bidding limit for a PD's bids as well as its customers' bids?
    - What different bidding limit levels could be considered?
    - What would be the impacts from a removal of bidding limits altogether (as is the case in some jurisdictions)?
10. Similarly, how would you describe the appropriateness of the non-competitive bidding

[1] Likewise, non-PD GSDs would be assigned a uniform bidding limit.

[2] That is, dividing 100% auction coverage by the number of PDs to create each PD's minimum bidding requirement. For example, with ten PDs for bonds, the MBR for these PDs would be 10% each at bond auctions.

limits, given the rise of Canada's debt stock and issuances since these limits were last adjusted in 2005?

  - If the non-competitive bidding limits were to be revised, what levels would you recommend?
  - How should Canada balance the desire to keep its non-competitive bidding limits at relevant levels with the need to guard against too much of an auction being allocated at the average price?
  - Should these bidding limits be defined as percentages of an auction's size, or kept as dollar amounts?

11. Do you have any other views regarding the bidding limits used for GoC securities auctions?

Individuals bidding at GoC auctions

Although individual persons may apply for a Bidder Identification Number (BINs) and participate in auctions for GoC securities, none currently possess a BIN.

Individuals require the same, if not more, level of due diligence, onboarding, and oversight by the Bank. However, most individuals' participation at auction would be small compared to institutional investors and GSDs. The above points to how Canada's objective to raise low-cost and stable funding is best achieved via auctions to large institutional investors.[3]

Questions:

12. What are your views in removing individuals as eligible BIN holders?
    - Conversely, what benefits do you see in Canada retaining an openness to allowing individuals to apply for BINs?

Re-openings of off-the-run GoC securities

While historically uncommon in the context of the GoC securities market, specific securities can become "special" when the outstanding amount is not sufficient to meet the increased demand for the security.

Securities becoming special is not in itself a sign of material pressures on market well-functioning, and indeed occasional episodes of specialness can be evidence of a normal, well-performing market.

[3] Indeed, a lack of cost-effectiveness was a rationale for Canada's discontinuation of Canada Savings Bonds in 2017, which were retail debt marketed to individuals.

Nonetheless, a benchmark security staying persistently special can impact the broader market. For example, other issuers of Canadian-dollar bonds use GoC securities benchmarks to price their fixed-income securities in the primary market, and a GoC bond on special can complicate this pricing process.

Questions:

13. Should Canada consider creating a standing operation for re-opening off-the-run GoC bonds which have become persistently special?
    - If such an operation were created, what criteria should debt managers prioritize when considering whether to add supply to an off-the-run GoC security?
14. What sorts of risks and unintended consequences could re-openings of off-the-run GoC securities create?
15. Do you have any other comments or suggested design features for any such operation?

Other

Questions:

16. Do you have any other comments on Canada's current DDF? Are there other structural features which could be introduced or modified to improve how Canada's issues its domestic debt?