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**The role and responsibility of the
Ministry of Finance in developing
government bond markets:
the case of Canada**

Pierre Gilbert, CFA
Department of Finance Canada
gilbert.pierre@fin.gc.ca

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Structure and Roles

⇒ Department of Finance

- Responsible for debt strategy development and policy formulation
- Reports to Parliament and the public on debt management activities

⇒ Bank of Canada

- Fiscal agent of the Government
- Responsibility and accountability for implementation of plans and execution of operations
- Market surveillance and strategic advice

⇒ Canada Investment and Savings

- Responsibility for retail debt distribution and marketing (non-marketable savings bonds sold to individual investors)
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Debt Strategy Objectives

Fundamental Objective

- ⇒ Provide stable, low-cost funding to meet the financial obligations and liquidity needs of the Government

Strategic Objectives

- ⇒ Maintain a prudent debt structure
 - ⇒ Maintain and enhance a well-functioning market for Government of Canada securities
 - ⇒ Maintain a diversified investor base
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Maintain and enhance a well-functioning market

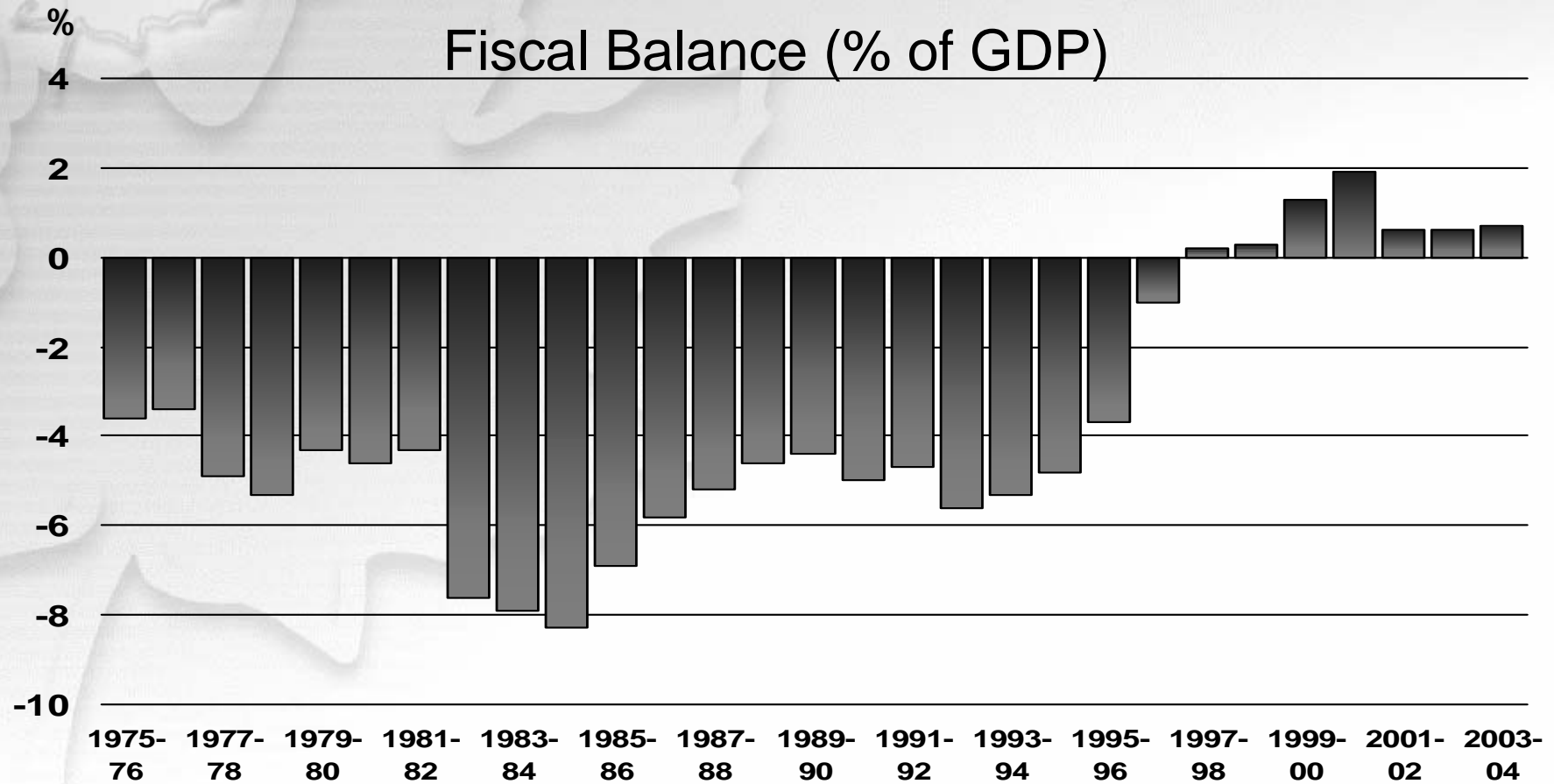
- ⇒ **A liquid and efficient government securities market lowers transaction costs and risk for market participants**
 - Which translates into smaller risk premiums and lower borrowing costs for the Government
 - ⇒ **Government securities are used as:**
 - risk-free instrument for investment portfolios
 - benchmark to price other securities
 - basis of many derivative instruments (e.g., interest rate futures, swaps, etc.)
 - a primary tool for hedging and for collateral
 - instruments used by central banks to implement monetary policy
 - ⇒ **A liquid and efficient government securities market thereby contributes to the development and effective functioning of the broader fixed-income market.**
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Key Factors

⇒ **The development of liquid and efficient government bond markets depends on key factors:**

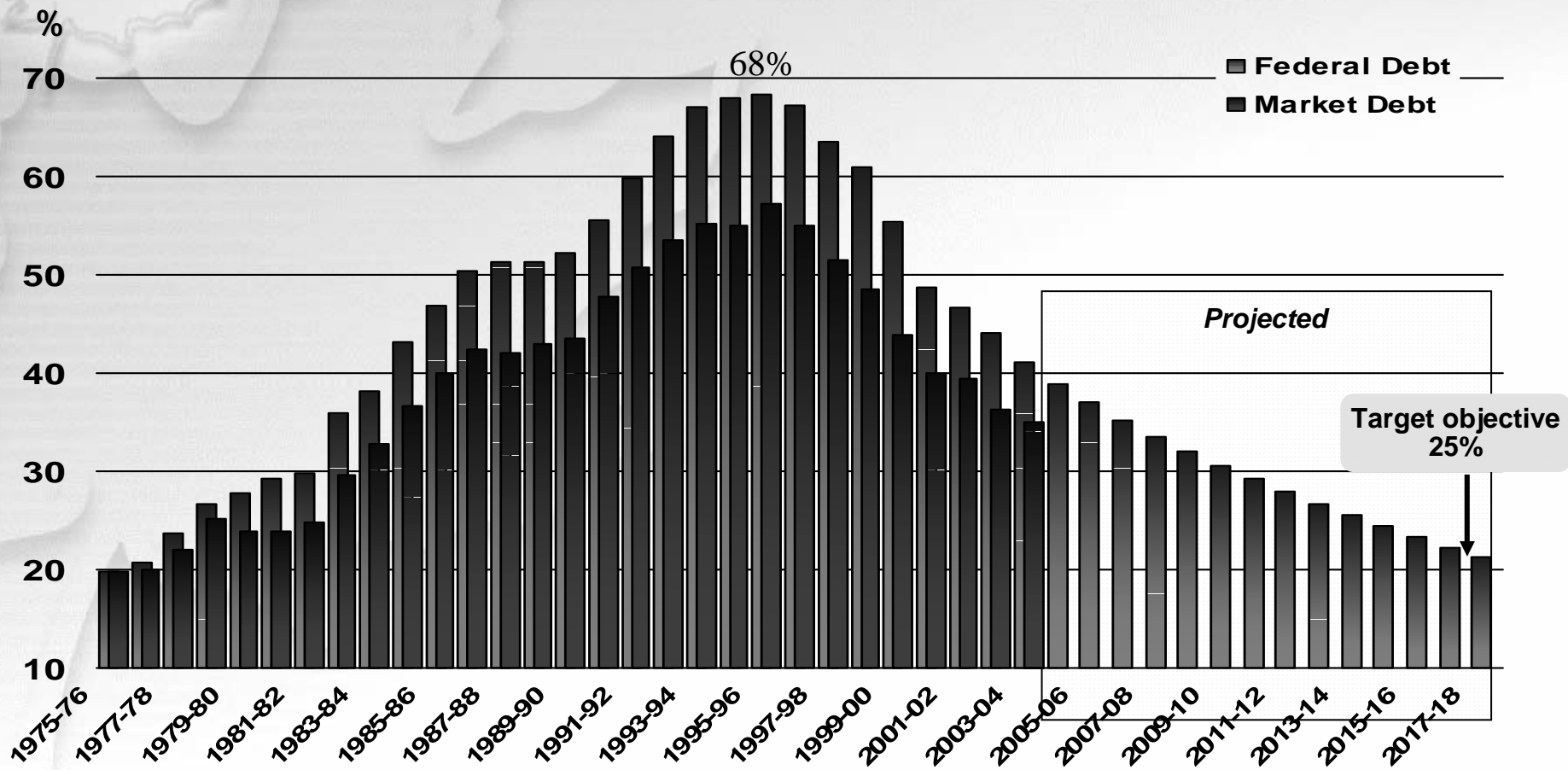
- **Size and issuance**
 - **Diversity and participation**
 - **Market infrastructure and innovation**
 - **Confidence**
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Canada's Fiscal Performance



Source: Department of Finance Canada.

Debt-to-GDP

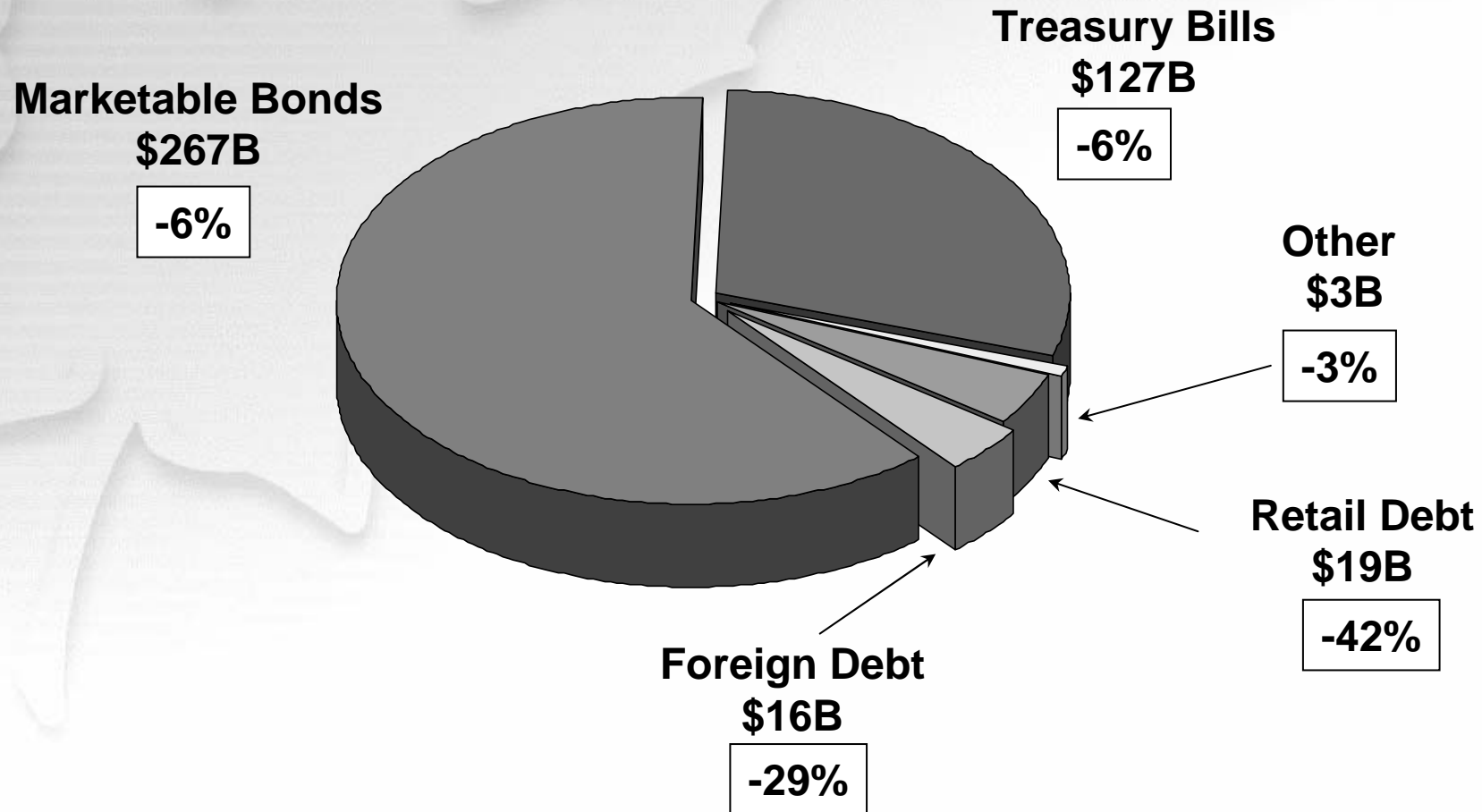


Source: Department of Finance Canada.

Mix of Instruments in Market Debt

Market Debt Composition, 2004-05

Change since end of fiscal 1996-97



Source: Department of Finance. (Est. as of March 31, 2005.)

Building Large Benchmarks

⇒ Benchmark sizes important for liquidity

- Markets with fewer, larger bonds tend to be more liquid than fragmented markets characterized with many small issues
- Allow to trade larger amounts and reduce risk of “squeezes”
- International profile of GoC market

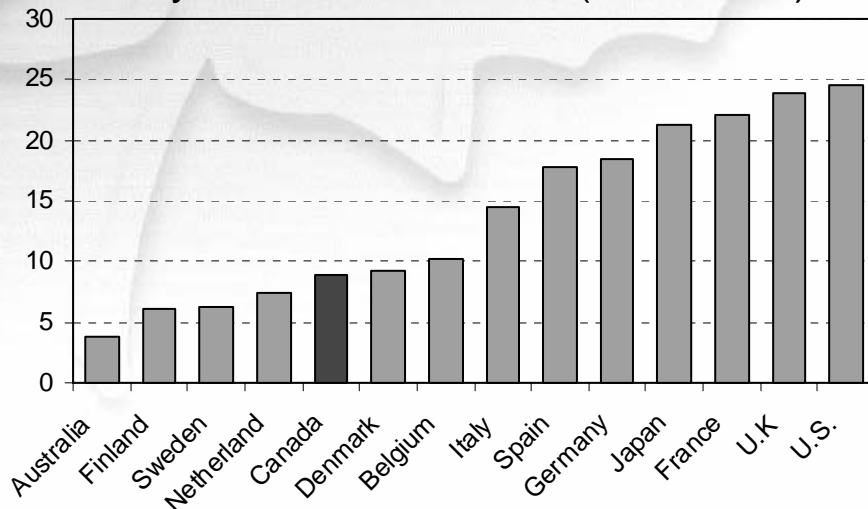
⇒ Strategy for building large benchmarks

- Reopen regularly bond issues until size reaches a certain target range (since 1992)
 - Focus bond issuance in a few, key maturities: 2, 5, 10, 30-year with standardized features (e.g. standard maturity dates)
 - If issuance is limited, introduce a bond buyback program to repurchase old illiquid bonds and reissue benchmark bonds (1998)
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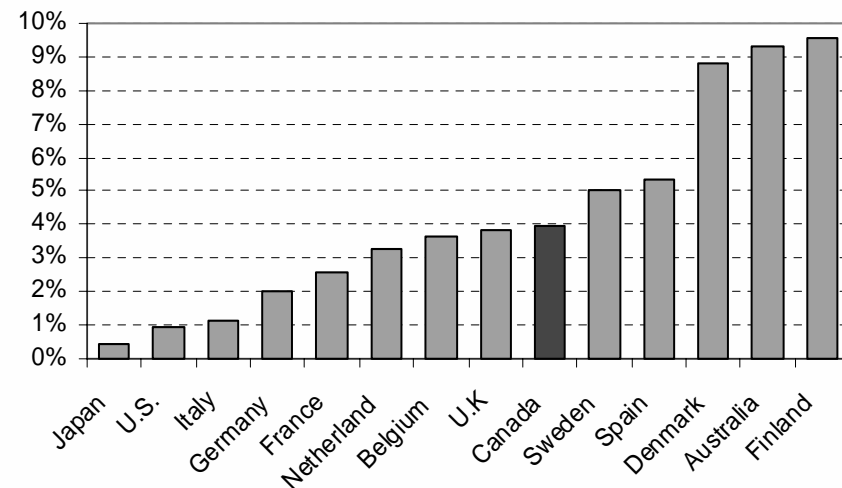
Building Large Benchmarks

- ⇒ **Canada's 10-year benchmark, just below US\$10B, is smaller than the U.S., Japan and the largest European countries**
- This largely reflects the smaller borrowing needs in Canada.
 - Relative to the overall size of the bond market, the size of the Canada 10-year benchmark compares more favourably against the same large issuers.

10-year benchmark size (US\$ billion)



10-year benchmark size (% of market)

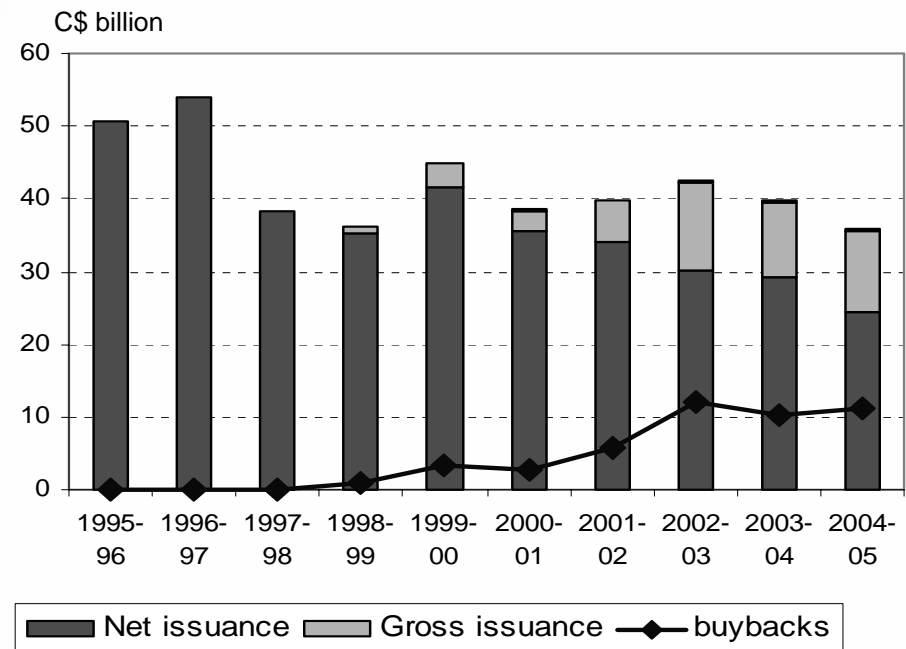


Source: Bloomberg, OECD

Buyback Program

⇒ Buyback program a key initiative in recent years to support bond issuance

- Bond issuance (net of buybacks) has fallen from a peak of C\$54 in 1996-97 to C\$24 billion for the most recent fiscal year (a 56% reduction).
- Buyback program helped maintain gross issuance above C\$35 billion over the same period.
- In 2004-05, 30% of bond issuance was the result of the recycling of old bonds, raising some questions about the impact of the program on liquidity of bonds already outstanding



Source: Department of Finance Canada.

Transparency and Regularity

- ⇒ **Transparency and regularity are two principles contributing to enhance liquidity**
 - ⇒ **Regularity and predictability**
 - **Help market participants to better prepare and plan for the auctions (e.g. to take orders from customers, take short positions)**
 - **Reduce perception of market timing / opportunistic behaviour based on private information**
 - ⇒ **Debt Management Strategy (plans for upcoming year)**
 - **Planned initiatives, indicative size of bond program, target sizes for benchmarks**
 - **Opportunity to explain goals and initiatives, reduce uncertainty and surprises, ensure broad and fair diffusion of information**
 - ⇒ **Quarterly auction calendar; details of operations published in advance**
 - ⇒ **Debt Management Report (report on activities of previous year)**
 - **Results against objectives (accountability)**
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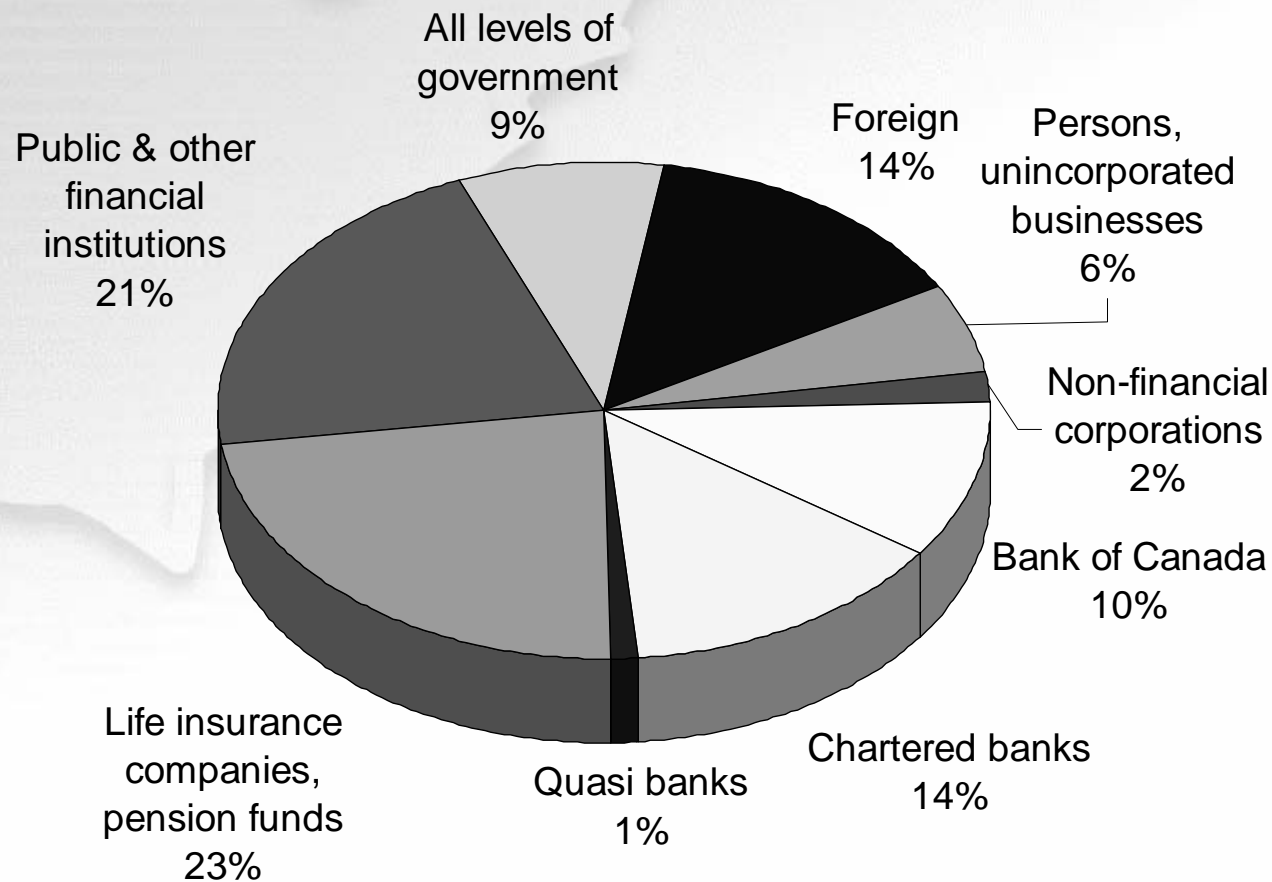
Diversity and Participation

- ⇒ **Active participation of a broad range of market participants is a key condition for market liquidity**
 - ⇒ **An active and diversified investor base, with different views and investment horizons ensure a “two-way” market**

 - ⇒ **Ways to broaden investor participation:**
 - **Respond to demand of various segments of the market by offering a variety of instruments**
 - **Promote market to foreign investors**
 - **Relax restrictions on investors**
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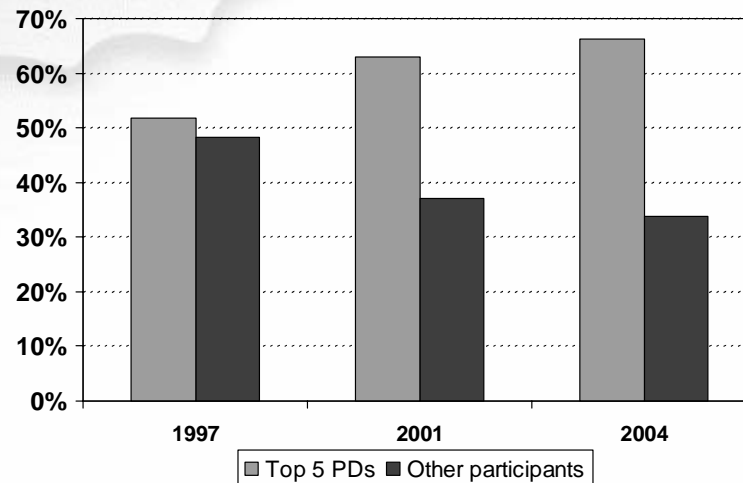
Distribution of holdings of GoC debt

⇒ Investor base in GoC securities is diversified



Government Securities Distributors

- ⇒ Primary and secondary markets are somewhat concentrated in Canada, with the Government and investors largely relying on a small number of large dealers.
- ⇒ Number of Government securities distributors fell from 48 in 1998 to 22 today, as some have joined forces while some foreign dealers have left the Canadian market.



Source: Bank of Canada

Key Factors

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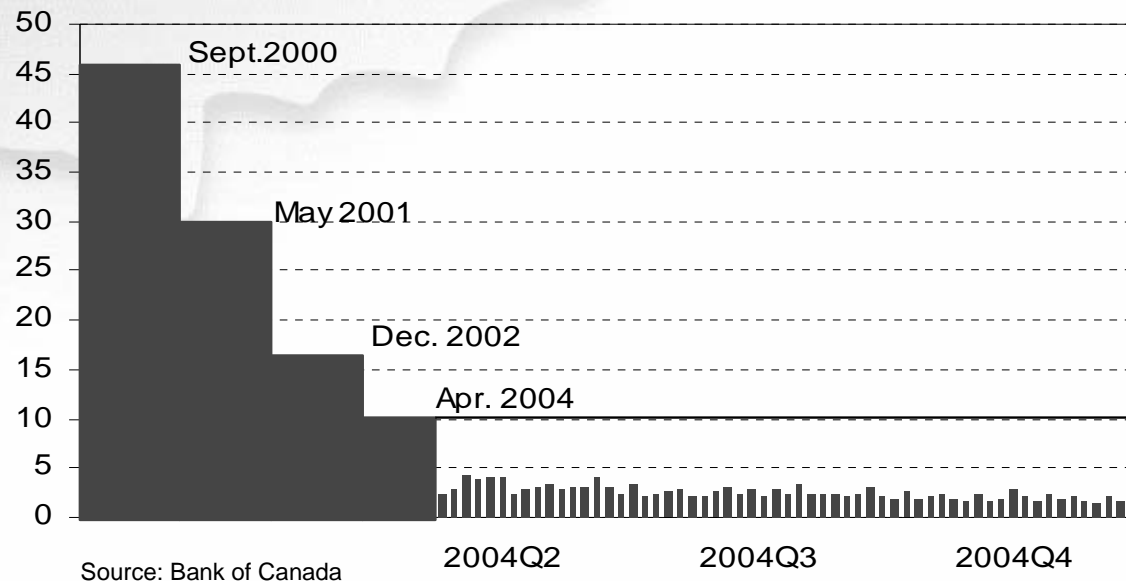
Market infrastructure and innovation

- ⇒ **Standardized market conventions, trading and settlement processes**
 - ⇒ **Effective debt distribution framework**
 - ⇒ **Active repo, futures and strip markets are also necessary for fully liquid market**
 - ⇒ **Support of innovation and market development**
 - e.g. electronic trading systems and futures markets
 - ⇒ **Effective regulation**
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Efficiency in operations

⇒ **Government committed to improve efficiency of its operations**

- **Improvements in auction system: Since April 2004, operations results are released on a best efforts basis (i.e. as soon as available)**
- **Lower turnaround time reduces market risk for participants in government operations**



Key Factors

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- **Confidence**

Confidence

- ⇒ **Confidence in Government's fiscal and monetary policies**
 - Clear commitment to sound fiscal and monetary policies is seen as supporting market efficiency and liquidity
 - In Canada: balanced budgets and low inflation
 - ⇒ **Confidence in market integrity**
 - Confidence can be eroded by manipulation or "squeezes", particularly if supply is small and market very concentrated
 - In Canada, auction rules were changed in 1998 to reduce the scope for possible manipulative behaviour
 - Government worked with industry association to develop a code of conduct for trading in fixed-income markets
 - ⇒ **Price transparency**
 - Improvements to diffusion of market data also supportive of liquidity
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Consultations

- ⇒ **Desire to maintain ongoing relationships with all participants in the Government of Canada market**
- ⇒ **Help issuer to understand the market and the market to understand the issuer**
- ⇒ **Ongoing dialogue is in the best interest of all: the issuer, dealers and investors**

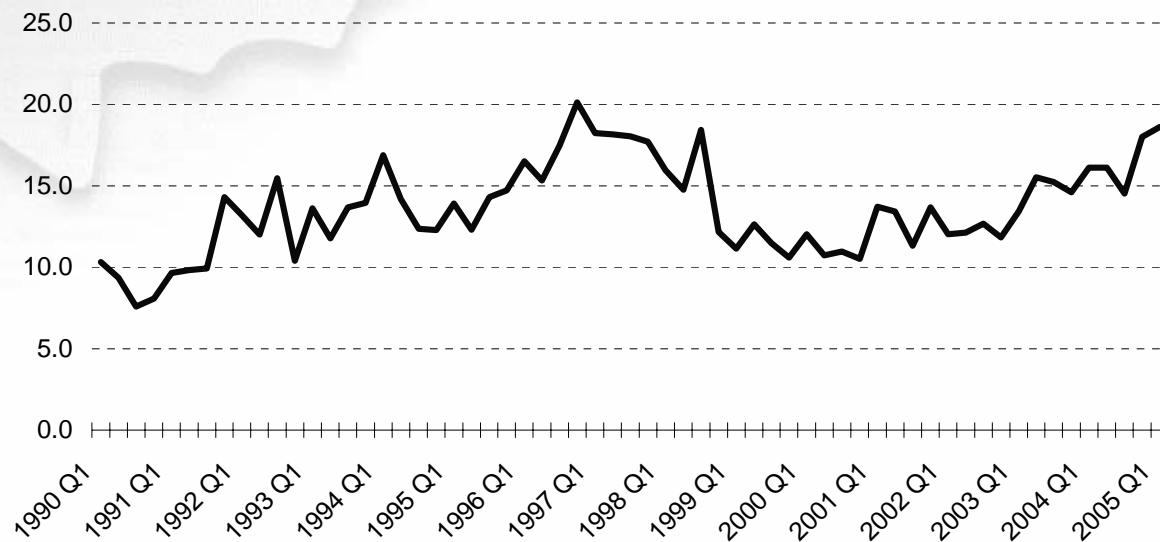
Approach

- ⇒ **Broad-ranging consultations with investors and dealers on formal and informal basis at various levels**
 - ⇒ **Day-to-day contacts at operational level for market intelligence**
 - ⇒ **Annual consultations on debt programs: discussion on potential initiatives and debt program design**
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Results

- ⇒ Liquidity compares favourably to other developed sovereign markets, with high turnover ratio and narrow bid/offer spreads
- ⇒ Turnover ratio close to its best level in fifteen years, despite lower issuance

Annual Turnover GoC Bonds



Source: Bank of Canada

Challenges

- ⇒ **Debt issuance continues to be constrained**
 - Currently reviewing changes to the bond program
 - ⇒ **Concentration in primary and secondary market**
 - Recently made improvements to debt distribution framework, notably by improving access for smaller dealers and investors
 - ⇒ **Pace of market development and innovation**
 - Development of futures bond market
 - Adoption of electronic trading systems compared to the U.S. and Europe
 - ⇒ **Securities regulation**
 - Fragmented regulatory framework in Canada
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Summary

Strategy to develop liquid and efficient bond markets

- ⇒ Regular issuance focusing on liquid benchmarks
 - ⇒ Broadening and promoting participation of investors and dealers
 - ⇒ Effective infrastructure
 - ⇒ Building confidence in policies and market integrity
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