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Experiences with market dislocations in Canadian bond markets

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Outline

- Context – Types of Market Dislocations
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  - Secondary markets
- Availability of GoC securities & link with market efficiency / liquidity
- Measures central bank and debt managers can take to mitigate risks of, and respond to, market dislocations
- Examples of Dislocations

Context – Types of Market Dislocations

- **Primary and secondary sovereign debt market functioning are fundamentally driven by**
  - Stable and reliable legal and political systems
  - Sovereign credit quality
  - Stable macroeconomic situation (inflation, eco cycle)
  - Developed and safe banking and financial sector with intermediaries, pension funds, asset managers, insurance, corp market, derivatives market, etc.
  - Disruptions to any of the above can affect well-functioning markets (regardless of efforts of debt managers and the central bank)

  - **Bond auctions are typically the last stage in evolution of debt issuance**
    - Issue short TBills -> Issue long bonds via Medium Term Notes/Reverse Inquiry -> Global/broad syndicated bond issuance -> Bond auctions
    - Some countries use both syndications and auctions
    - Auctions perform well when there is enough competitive demand. Liquid secondary market supports auctions of large size
    - Auctions can be structured from less rigid (maturity range, flexible size, retention by issuer, no limits, single price) to more rigid (fixed size & maturity, obligations to bid, allocation limits, multiple price)

Context – Types of Market Dislocations (2)

- **Primary market (auctions) dislocations**
  - Poor auction results (wide tails, bidding not competitive, clearing at large discount vs secondary market)
  - Uncovered auction
  - Concentration of auction winners
- **Secondary markets**
  - Cash market
    - Price volatility, uncertainty and lack of transparency
    - Inability to acquire or dispose of securities (quickly, in desired quantity and without moving the price)
  - repo and special repo markets
    - Inability to fund high quality collateral like govt bonds
    - Inability to source a bond for short selling or for market making
    - Price discovery fails to bring lenders and borrowers to trade at market clearing price
  - Settlement fails

Availability of GoC securities & link with market efficiency / liquidity

- Well-functioning GoC securities markets is a key objective of both the issuer and the central bank
  - The fundamental objectives of debt management are to raise stable and low-cost funding to meet the financial needs of the Government of Canada and to maintain a well-functioning market for Government of Canada securities.
  - A stable and efficient financial system (which incudes financial markets) is essential for sustained economic growth and rising living standards
- Strong support for direct link between availability of securities with secondary market liquidity attributes
  - Government deficits and sharp increases in debt outstanding (1980-90s)
  - Government surpluses and sharp drop in availability of securities
  - Increase in holdings of participants that do not lend their securities

Measures central bank and debt manager can take to mitigate risks of, and respond to, market dislocations (1)

- Design of the debt distribution framework
  - Primary Dealer model
  - Auction structure designed to ensure integrity
  - Terms and conditions for GoC auctions
- Alignment of objectives with regulatory and self-regulatory bodies
- Design of the GoC Debt Management Strategy
  - Support development of Canadian Depository for Securities Inc. (CDS) and electronic book entry to support processing of payment / settlement
  - Strives to promote transparency and consistency
    - Annual debt strategy and market consultations
    - Quarterly Bond Schedule and Call for Tender process
    - Timely auction results release (averaged ~2 minutes)
    - Historical auction data available for download
  - Commitment to build large & liquid benchmarks
    - Maturity dating convention, re-openings, GoC Bond Buybacks, financed by larger issuance of benchmarks, minimum benchmark sizes …

Measures central bank and debt manager can take to mitigate risks of, and respond to, market dislocations (2)

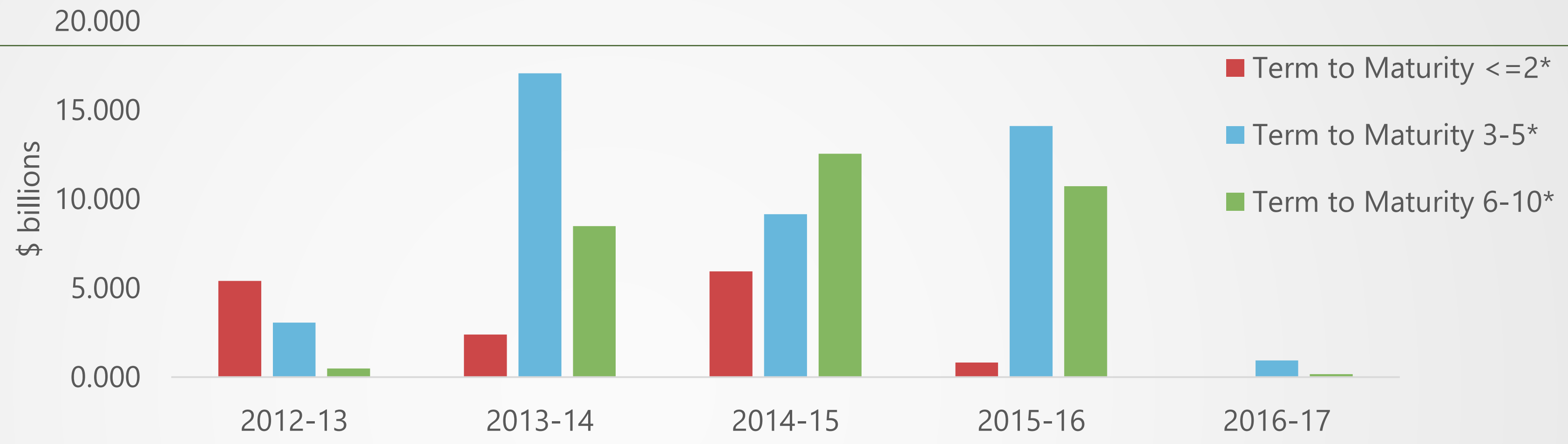
- Bank of Canada measures
  - Tools to implement monetary policy – support development of money markets (80s / 90s)
  - Securities lending program (2001+)
  - Augmenting custodial services provided (2014+)
  - Adjust central bank asset purchases (bonds vs repo, on-going)
  - Provision of liquidity to Primary Dealers upon a market-wide or systemic disruption
  - Reviewing the need for the settlement fail fee
  - Regular monitoring and analysis of fixed income markets

Examples of (minor) Dislocations in Canada

- Primary market
  - Auction participant acquired dominant position in a single GoC bond, and used it to control availability & price of security in special repo
  - Insufficient amount of treasury bill issuance & stock, contributing to the development of alternative reference or ‘risk-free’ securities
- Secondary markets
  - Prolonged period of scarcity of GoC bonds, including benchmarks, in the special repo market (2014-15)

- Side note: GoC securities exhibited resilience throughout the Global financial Crisis.

Examples of Dislocations in Canada – Securities Lending (BoC)



Situation	A number of GoC bonds experienced tightness in repo markets (with impact on cash prices) throughout 2013-16
Drivers of Repo Tightness	Increases in foreign ownership of GoC bonds and increased demand for high-quality collateral
Response	Triggered high usage of securities lending program, alleviating short-term pressures in the market