Primary Dealer System and Market Making in Canada

Training Program – CEMLA

Nassau, Bahamas

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Outline

1. Context: What is the Canadian Primary Dealer (PD) Model?

2. Canada’s Debt Distribution Framework
   ▪ International Context
   ▪ Designation Requirements and Obligations
   ▪ Advantages/Disadvantages

3. Canada’s PD System in Practice
   ▪ Primary Market
   ▪ Secondary Market

4. Summary
The Government of Canada funds itself primarily by issuing Canadian dollar-denominated debt securities.

The Bank of Canada (on behalf of the government) issues securities at auction to a limited market composed of authorized Government Securities Distributors (GSDs) – ‘buy-side’ clients must bid via GSDs.

Primary Dealers are a subset of GSDs who agree to perform additional specific obligations in exchange for specific privileges.

As the government’s fiscal agent, the Bank of Canada also acts as its consultant by providing strategic policy advice on debt management.

Common strategy between issuer and dealers of effective functioning and development of primary & secondary markets for government securities.
Canada’s Debt Distribution Framework

**International Context:**

- **Closed model (PDs only)**
  - Few primary dealers
  - Multiple price auctions
  - Primary market obligations
  - Secondary market obligations
  - Syndications
  - Green shoe
  - Repo, securities lending facilities, etc. for dealers

- **Open model**
  - Anyone can bid directly
  - Single-price auctions
  - No requirements for participants
  - Auctions for all issues
  - Participants have no residency requirement

Countries:
- UK
- Belgium
- Canada
- Australia
- Spain
- Japan
- Denmark
- Italy
- Netherlands
- France
- Germany
- New Zealand
- US
- Sweden
- Germany
- France
- Netherlands
- Denmark
- Italy
- UK
- Belgium
- Canada
- US
- Sweden
- Japan

**International Context:**

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Canada’s Debt Distribution Framework (2)

Why Canada changed to a PD model?

- Concerns around **market well-functioning** in the 1990’s
- **Market ‘squeezes’** had occurred (i.e., difficulty sourcing specific securities due to scarcity or concentration in relatively few participants)
- Questions around **efficiency, liquidity and integrity** of the auction process for GoC bonds

Key Features Implemented:

1. **Tiered system**, only government securities distributors have access
2. **Multiple-price auction** format (with the exception of real return bonds & ultra-long)
3. Primary dealers comprise an elite GSD sub-group
4. **Pre-announcement of planned issuance** in a regular and transparent manner, as opposed to being an opportunistic issuer
5. Coordination with self-regulatory industry group to develop Code of Conduct
PDs in Canada must fulfill several obligations & receive several distinct benefits:

**Obligations:**

- **Primary market** – participate in a ‘substantial and consistent’ manner (meet minimum bidding requirement)

- **Secondary market** – serve as a market maker by providing 2-way quotes on Government of Canada securities

- Provide market intelligence to the Bank of Canada

**Privileges:**

- Able to **bid for a larger share** of Government securities auctions

- **Access to other Bank of Canada operations**, including overnight repurchase operations, securities lending, receiver general auctions
Benefits and drawbacks of the PD model in Canada

**Benefits (from the debt issuer’s perspective):**

- **Primary dealers have well-established networks** to market GoC securities to clients.
- PDs **temporarily hold securities on their balance sheets** when there is not enough end demand for them.
- **Required to participate at every auction** (including during challenging market conditions).
- **Mitigate operational risk** by limiting the number of participants directly interacting with the government.

**Potential Drawbacks:**

- Could be a **less efficient market structure**.
- Possibly **limits competition** amongst participants. Concentrating market in relatively few large dealers, contributing to potential oligopolistic power.
- Potential risk that firms selected to be PDs could be viewed as having an implicit guarantee by the government.
- **Auction clients are bid via (thus reveal bidding information)** PD counterparties.
GoC auctions are dominated by a limited number of large Primary Dealers:

- The market has become slightly more concentrated over the past two decades since the current debt management framework was implemented
- Clients are winning a larger share of auctions by bidding directly through PD’s relative to the past

### Number of Government Securities Distributors

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2009</th>
<th>2012</th>
<th>2016 to present</th>
</tr>
</thead>
<tbody>
<tr>
<td>PD</td>
<td>13</td>
<td>12</td>
<td>12</td>
<td>11</td>
</tr>
<tr>
<td>Foreign PDs</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>GSDs (Includes PDs)</td>
<td>19</td>
<td>17</td>
<td>17</td>
<td>15</td>
</tr>
</tbody>
</table>

### Average Primary Market Auction Distributions (all tenors)

- **1999**:
  - Primary Dealers
  - Other GSD
  - Customers

- **2019 (YTD)**:
  - Primary Dealers
  - Other GSD
  - Customers

**Excludes Bank of Canada purchases for balance sheet**

**Source:** Bank of Canada Calculations
Secondary market trading volumes are dominated by a small group of Primary Dealers

- Secondary market trading volumes are dominated by a small group of Primary Dealers

- However, measures of market liquidity have been stable or shown slight improvement over the past two decades

**Fraction of Secondary Market GoC Trading**

<table>
<thead>
<tr>
<th>Year</th>
<th>Top 5 PDs</th>
<th>Foreign PDs</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>64.8</td>
<td>20.8</td>
</tr>
<tr>
<td>2009</td>
<td>62.3</td>
<td>14.7</td>
</tr>
<tr>
<td>2012</td>
<td>60.8</td>
<td>15.0</td>
</tr>
<tr>
<td>2015</td>
<td>64.9</td>
<td>8.9</td>
</tr>
<tr>
<td>2018</td>
<td>59.8</td>
<td>8.2</td>
</tr>
<tr>
<td>2019 (YTD)</td>
<td>59.6</td>
<td>9.2</td>
</tr>
</tbody>
</table>

**Source:** Bank of Canada and MTRS

**Market Liquidity Proxy: Bid - Ask Spreads**

- Source: Bloomberg

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Minimum bidding requirements ensure auction coverage is strong and stable

- Most GoC primary market auctions are well subscribed, with a coverage ratio greater than 2x - even during the 2008 financial crisis

Source: Bank of Canada calculations
Canada implemented a primary dealer model due to concerns around market well-functioning – current framework functioning very well

Primary dealers have to fulfill several obligations in exchange for unique privileges

Long-term trend of increasing concentration in Canadian bond markets (across GoC, Provincial issuance, corporates)

Secondary markets continue to function normally, with stable levels of liquidity

Looking to the future - Bond markets globally and domestically are changing due to:
1) Implementation of post-crisis regulatory reforms, and
2) Increase in the use of automated, electronic trading

Critical to regularly re-evaluate the effectiveness of the current debt distribution framework
Thank You