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Primary Dealer System and Market Making in Canada

Training Program – CEMLA

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Outline

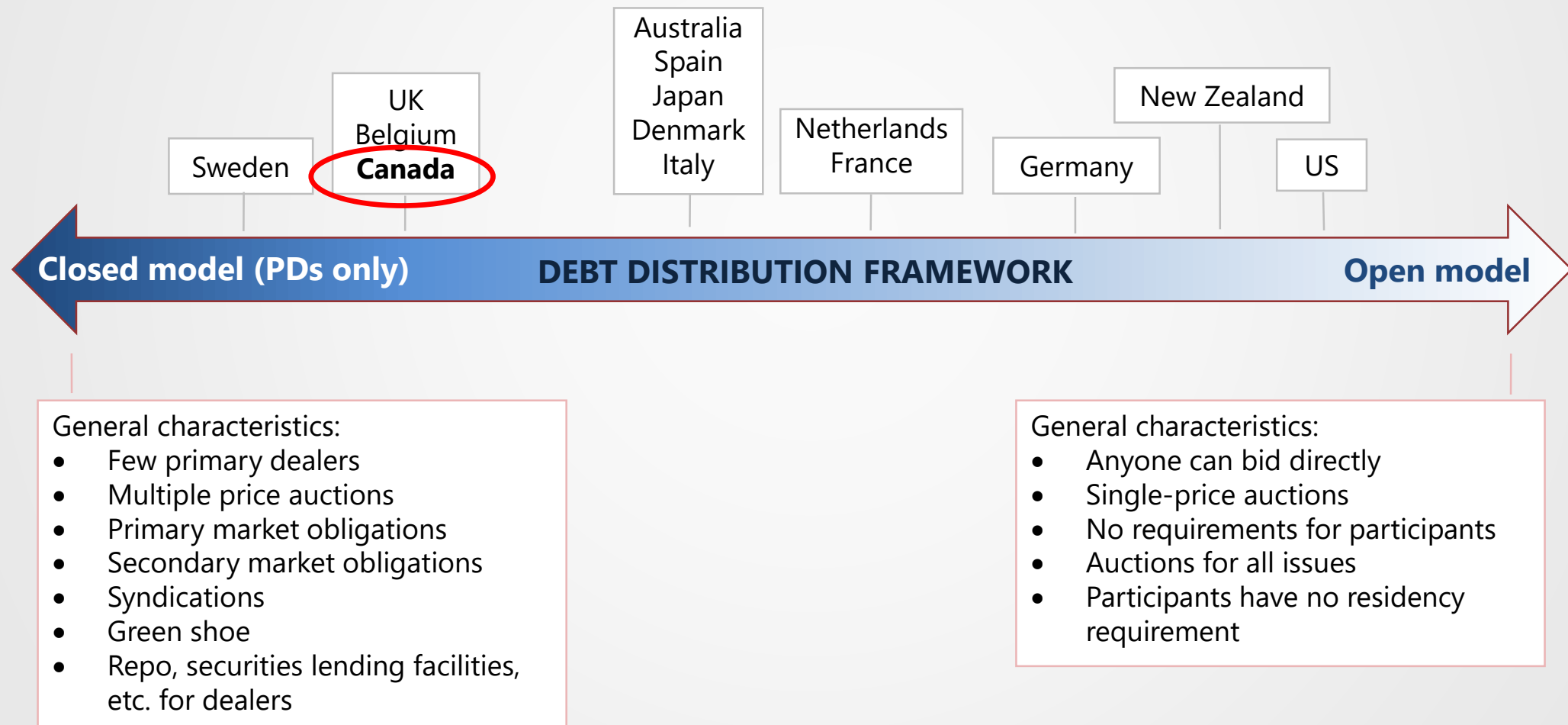
1. Context: What is the Canadian Primary Dealer (PD) Model?
2. Canada's Debt Distribution Framework
 - International Context
 - Designation Requirements and Obligations
 - Advantages/Disadvantages
3. Canada's PD System in Practice
 - Primary Market
 - Secondary Market
4. Summary

Context: What is the Canadian PD Model?

- 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:



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:

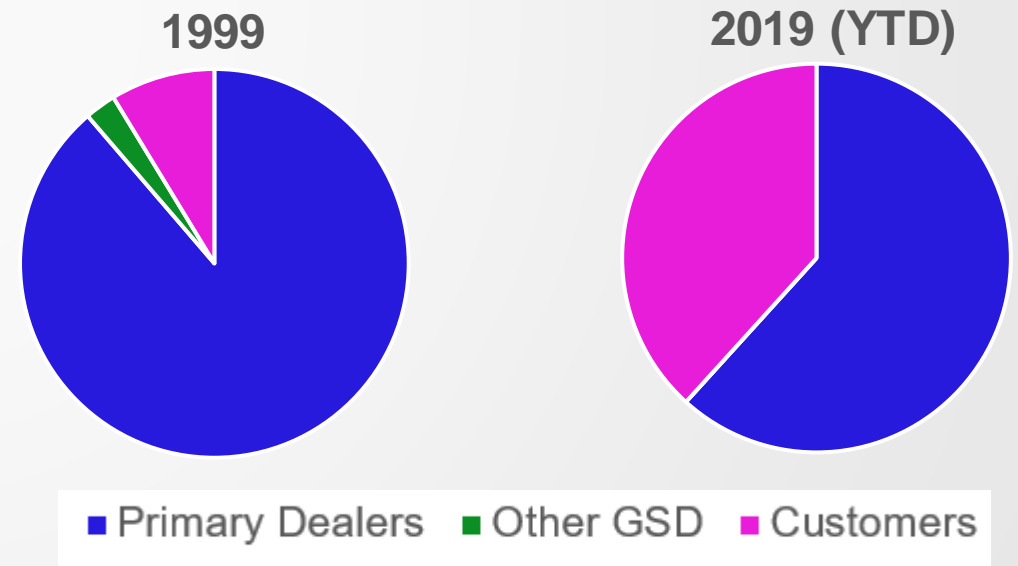
- The market has become slightly more concentrated over the past two decades since the current debt management framework was implemented
- Clients are winning a larger share of auctions by bidding directly through PD's relative to the past

Number of Government Securities Distributors

	2005	2009	2012	2016 to present
PD	13	12	12	11
Foreign PDs	4	3	4	2
GSDs (Includes PDs)	19	17	17	15

Source: Bank of Canada

Average Primary Market Auction Distributions (all tenors)



**Excludes Bank of Canada purchases for balance sheet

Source: Bank of Canada Calculations

Secondary market trading concentrated in a small number of Primary Dealers

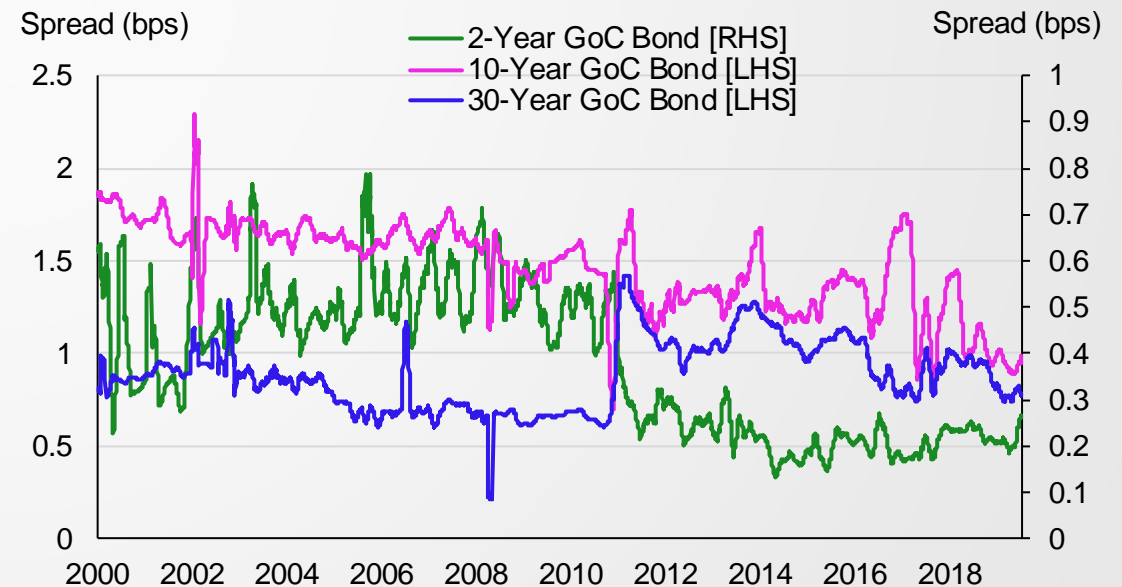
- Secondary market trading volumes are dominated by a small group of Primary Dealers
- However, measures of market liquidity have been stable or shown slight improvement over the past two decades

Fraction of Secondary Market GoC Trading

	Top 5 PDs	Foreign PDs
2005	64.8	20.8
2009	62.3	14.7
2012	60.8	15.0
2015	64.9	8.9
2018	59.8	8.2
2019 (YTD)	59.6	9.2

Source: Bank of Canada and MTRS

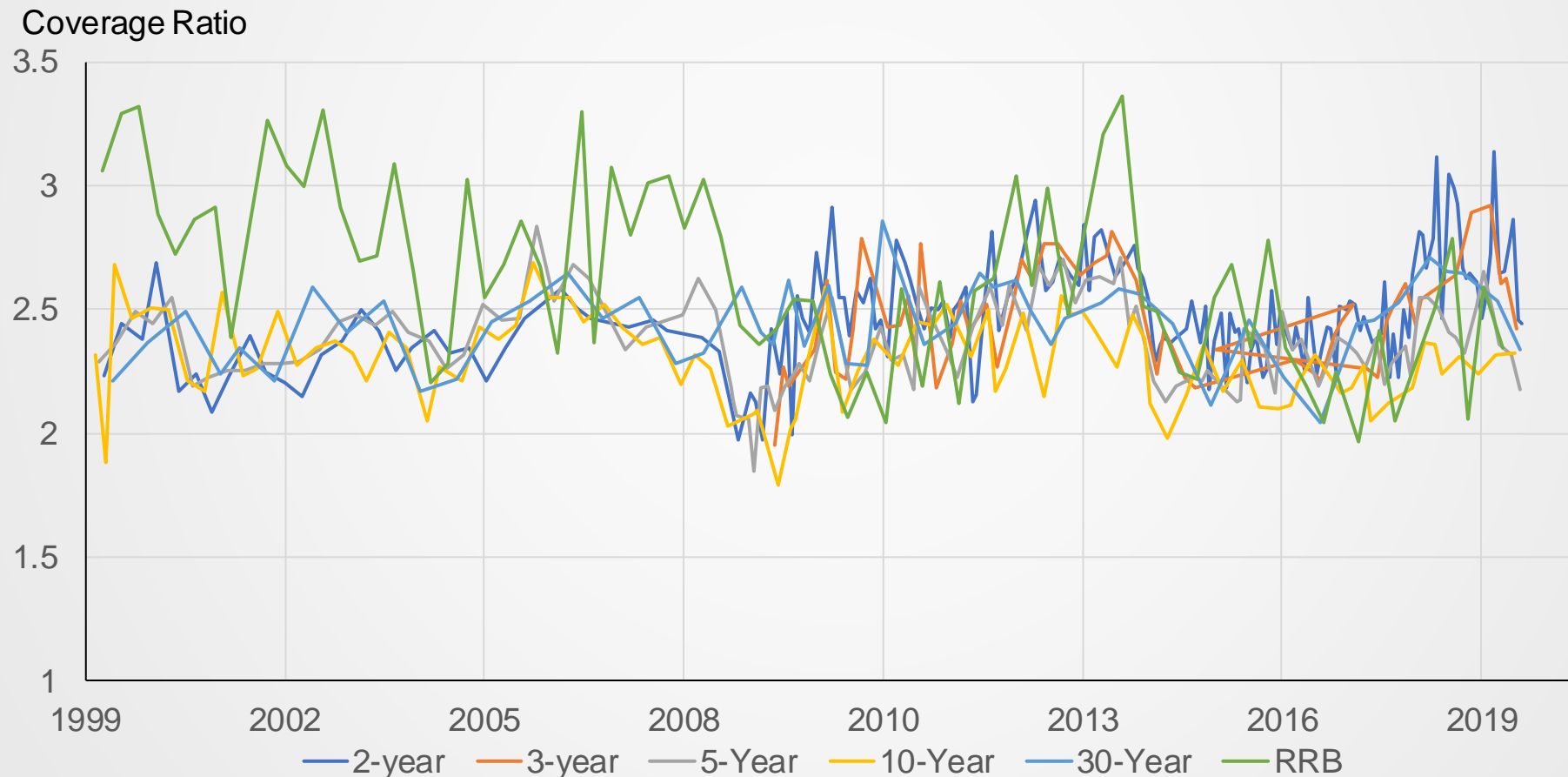
Market Liquidity Proxy: Bid - Ask Spreads



Source: Bloomberg

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

Summary

- 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