Experiences with market dislocations in Canadian bond markets

Training Program – CEMLA

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Outline

- Context – Types of Market Dislocations
  - Primary market dislocations
  - 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
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
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 includes 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)

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

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<th>Situation</th>
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<th>Response</th>
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<tbody>
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