Debt Management Strategy

2006–2007

Canada

Debt Management Strategy

2006–2007

Department of Finance Canada
Ministère des Finances Canada

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Foreword by the Minister of Finance

I am pleased to table before Parliament the Government of Canada's *Debt Management Strategy* for fiscal year 2006–07. This document provides comprehensive information on the Government's debt strategy and objectives for the coming fiscal year.

The debt strategy is an important component of the fiscal planning of the Government of Canada. The strategy is focused on ensuring a low and stable cost of servicing the federal debt. It also contributes to a well-functioning Government of Canada securities market for the benefit of a wide array of borrowers and investors.

The strategy is developed against the background of declining federal debt. Combined with forecast economic growth, the federal debt-to-GDP (gross domestic product) ratio—the level of debt in relation to the country's annual income—remains on a downward track. On an accrual basis, the federal debt as a percentage of the economy is projected to fall to 35 per cent in 2006–07, down from its peak of 68.4 per cent in 1995–96. Canada's total government debt burden is the lowest in the Group of Seven (G7). The Government is committed to further paying down the federal debt.

The debt strategy incorporates the results of consultations with market participants on the development and implementation of policy, consistent with a commitment to openness and transparency. The publication of this document, together with the separate publication during the year of the *Debt Management Report* and the *Report on the Management of Canada's Official International Reserves*, contributes to the accountability of the Government to Parliament and to Canadians on the Government's financial strategy and transactions.

The Honourable James M. Flaherty, P.C., MP
Minister of Finance
April 2006

Purpose of This Publication

The *Debt Management Strategy* is an annual publication of the Department of Finance Canada. It sets out the Government of Canada's objectives and strategies for managing its debt and related financial assets over fiscal year 2006–07.

The Government publishes companion documents, the *Debt Management Report* and the *Report on the Management of Canada's Official International Reserves*, which describe the Government's financial market operations in respect of the debt and reserves, respectively, after the fiscal year has ended.

Focus of the Federal Debt Strategy

The debt strategy focuses on the management of the market debt and associated derivatives transactions of the Government of Canada. The debt strategy also reflects and encompasses in its framework the management of the Government's financial assets.

(At March 31, 2005)	(C$ billions)
Market Debt	
Payable in Canadian currency	
Marketable bonds	266.6
(fixed-coupon bonds with 2-, 5-, 10- and 30-year maturities and Real Return Bonds with 30-year maturities)	
Treasury bills	127.2
(zero-coupon securities with 3-, 6- and 12-month maturities)	
Retail debt	19.1
(Canada Savings Bonds and Canada Premium Bonds)	
Canada Pension Plan bonds	3.4
Obligations related to capital leases	2.9
Payable in foreign currency	
Marketable bonds	12.4
(fixed-coupon bonds, Canada notes and Euro Medium-Term Notes)	
Canada bills	3.9
(zero-coupon securities with 1- to 9-month maturities)	
	435.5
Derivatives Portfolio	
Cross-currency swaps	24.5
Liquid Financial Assets	
Cash	20.6
Foreign exchange reserves	38.9
	59.5

Source: *Public Accounts of Canada*.

Highlights of the 2006–2007 Debt Strategy

Debt Structure and Issuance Plan

- To lower public debt costs, the fixed-rate share of the debt will continue to be reduced from two-thirds in 2002–03 to a target of 60 per cent in 2007–08. The change is being made gradually to facilitate market adjustment. Specifically:
  - The outstanding amount of treasury bills will increase from about $131 billion at the end of 2005–06 to a range of $135 billion to $140 billion by the end of 2006–07.
  - The total amount of marketable bonds issued in 2006–07 will be about $31 billion, $1 billion less than planned for 2005–06. Marketable bond issuance (net of buybacks) of about $23 billion will also be about $1 billion less than in 2005–06.
  - In 2005–06, the Government began to reduce the size of the bond buyback program. This reduction will continue in 2006–07, with a planned amount of bond buybacks in the order of $7 billion to $8 billion, about $1 billion less than in 2005–06.
  - The stock of marketable domestic bonds is expected to decline from an estimated $237 billion at the end of 2005–06 to about $231 billion as a result of maturities and continued cash management buyback operations.

Bond Program Design Changes

- To accommodate the shift to a lower fixed-rate debt structure, the following changes to the bond program's design, developed in consultation with market participants, will be made:
  - The dating of the 5-year benchmark maturity will be changed from September 1 to June 1 to make new 5-year benchmarks fungible with old 10-year benchmarks. The 5-year auction in the fourth quarter will be dropped from the issuance plan.
  - The issuance of 2- and 5-year bonds will be reduced to take advantage of their fungibility with outstanding benchmarks. As in 2005–06, the Government will not conduct a 2-year bond auction in the fourth quarter of the fiscal year.

Operational Enhancements

- The floor for the repurchase of bonds will be reduced from $6 billion to $5 billion in all maturities to increase the amount of bonds eligible for purchase at buyback operations.
- To enhance bidding and participation in domestic debt operations, the Bank of Canada will target average turnaround times (the time from the bidding deadline to the release of auction results and settlement details) of less than 3 minutes for auctions and less than 5 minutes for buybacks. The maximum turnaround times will be reduced from 10 minutes to 5 minutes for auctions and from 15 minutes to 10 minutes for buyback operations.

Policy Initiatives

- The merits of consolidating some or all of the borrowing by major government-backed entities into government debt programs will be assessed, following up on an evaluation done by KPMG LLP in 2005–06 (see www.fin.gc.ca/toce/2005/MFGBE-e.html).
- Research and consultations with market participants and regulators will continue on the transparency of the market for Government of Canada securities.

Funds Management Framework

Funds management is the general term used to describe the wide range of activities related to the management of the debt and liquid financial assets of the federal government. The framework has a number of elements, as explained in the following sections.

Authority and Governance

Debt and Cash Management

The authority for funds management flows from Part IV of the Financial Administration Act (FAA), which empowers the Minister of Finance to borrow money on behalf of Her Majesty in right of Canada. In this regard, the Minister is authorized to issue securities and do any other thing related to the borrowing of money that the Minister considers appropriate. The FAA also states that the Governor in Council may authorize the Minister to enter into any contract or agreement of a financial nature, including cash management arrangements and derivatives transactions, on such terms and conditions as the Minister considers necessary.

Under the FAA the Government has standing authority to refinance market debt maturing in a fiscal year. Parliamentary approval must be obtained to raise new market debt, in the form of a borrowing authority bill. Once obtained, the authority to raise debt levels generally extends through the remainder of the fiscal year and lapses at the start of the next fiscal year. Section 49 of the FAA requires the Minister to table in every fiscal year, in each House of Parliament, a report on the Minister's plans in relation to the management of the public debt in the next fiscal year. This report fulfills that obligation.

Foreign Reserves Management

Canada's official international reserves are held in the Exchange Fund Account (EFA). Authority for the management of the foreign reserves is provided by Part II of the Currency Act. The legislative mandate of the EFA is to aid in the control and protection of the external value of the Canadian dollar. The Minister of Finance can acquire, sell, borrow or lend for the Account those assets that are deemed appropriate for the legislated purpose. The Minister of Finance approves the general policies and strategy related to the investment and risk management of the EFA and establishes the target level of reserves.

Institutional Responsibilities

Responsibility for strategic planning and the operational management of the Government's debt and financial assets is delegated to officials at the Department of Finance Canada and the Bank of Canada. The Bank of Canada acts as fiscal agent for the Minister of Finance in issuing debt and conducting other debt market operations.

Oversight of policy and operations activity is carried out through a Funds Management Committee (FMC), which comprises senior management from the Department of Finance Canada and the Bank of Canada. The FMC advises the Minister of Finance on policy and strategy, oversees the implementation of approved policy and plans, and reviews performance outcomes.

For more information on the funds management framework, see www.fin.gc.ca/treas/Goveev/TMGF_e.html.

Principles and Objectives

Domestic debt and cash management, and foreign reserves management, have distinct objectives and principles. All funds management activities are conducted in keeping with overarching principles (see box on next page).

Domestic Debt and Cash Management

Objective

The fundamental objective of domestic debt and cash management is to raise stable and low-cost funding to meet the operational needs of the Government of Canada.

An associated objective is to maintain a well-functioning market in Government of Canada securities, which helps to keep debt costs low and benefits a wide array of domestic market participants.

Principles

Transparency, Regularity and Liquidity

The design and implementation of the domestic debt program should emphasize transparency, regularity and liquidity to support a well-functioning government securities market. The Government should consult regularly with market participants to ensure the integrity and attractiveness of the market for dealers and investors.

Prudence

Prudence should be maintained by managing the structure of the debt, raising funds for domestic operational needs using a variety of instruments denominated in Canadian dollars, and managing exposure to credit risk through diversification.

Foreign Reserves Management

Objective

The objective of foreign reserves management is to provide general foreign currency liquidity for the Government and to provide a source of funds, if required, to help promote orderly conditions for the Canadian dollar in the foreign exchange market.

Principles

Prudence

The foreign reserves should be managed to limit exposure to financial risk through the matching of assets and liabilities, prudent investment limits and diversification in instruments and currencies held.

Cost-Effectiveness

The reserves investment portfolio should be actively managed such that the net cost to the taxpayer, if any, is minimized.

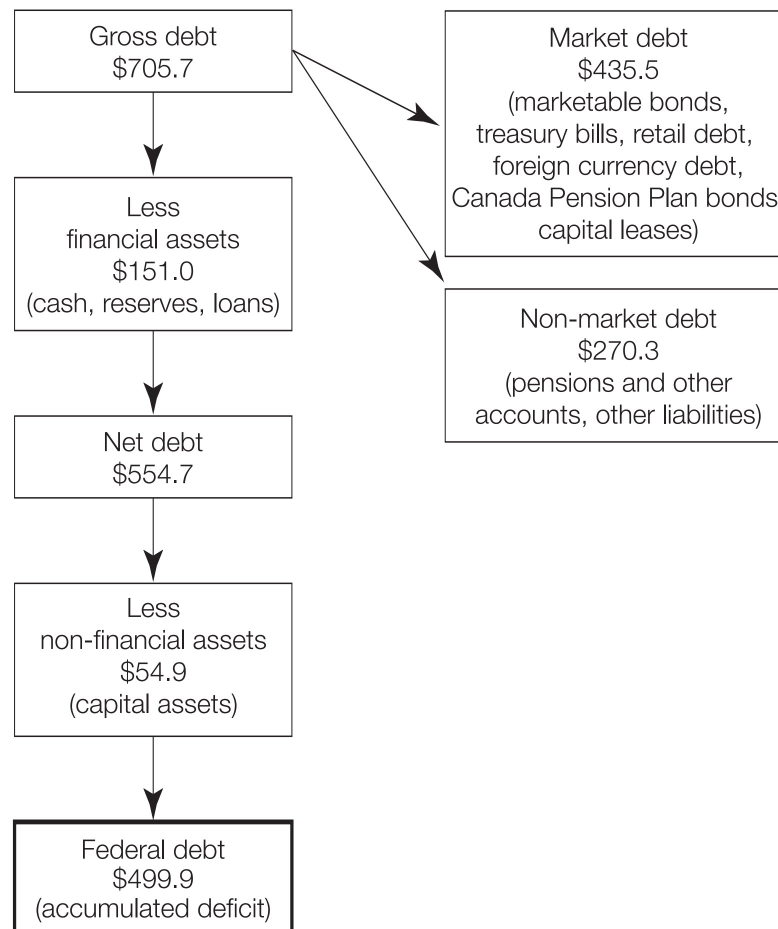
Overarching Funds Management Principles

- Risk management: Debt and asset management activities should be conducted in line with clear operational and risk guidelines, and risk monitoring and oversight should be independent of treasury management operations.
- Efficiency and effectiveness: Policy and operational standards should take into account, to the extent possible, the leading practices of other comparable sovereigns. Regular evaluations should be conducted to ensure the efficiency and effectiveness of the governance framework, policy initiatives and operations.
- Reporting: Information on funds management plans, activities and outcomes should be made publicly available in a timely manner so as to ensure understanding and accountability.

Debt and Assets Managed

The debt strategy plan focuses on the Government of Canada's market debt, which is the largest component of its gross debt. The other component of the gross debt, non-market debt, which includes federal public sector pension liabilities and the Government's accrued liabilities, is not subject to active management. Figure 1 illustrates the relationships between the components of the federal debt at March 31, 2005.

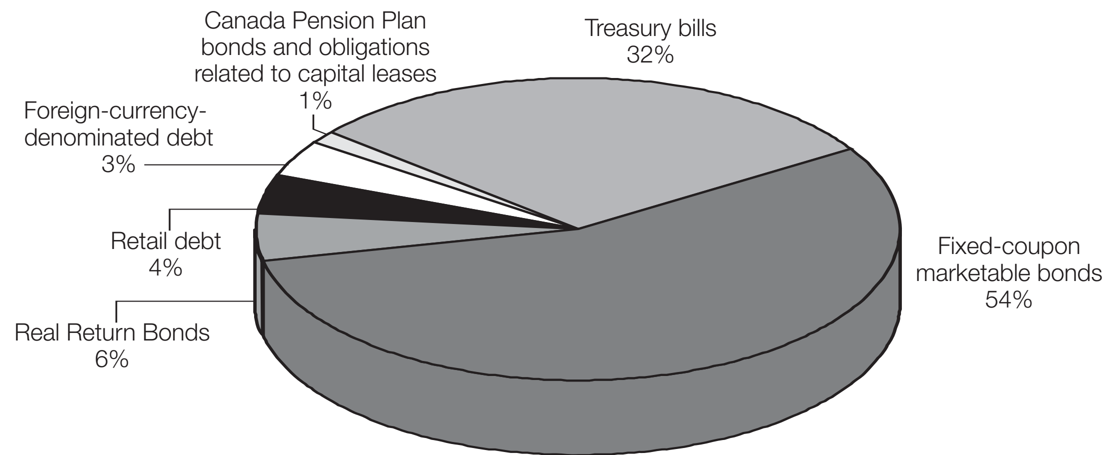
Figure 1
Federal Debt at March 31, 2005
(in billions of dollars)



Note: Numbers may not add due to rounding.
Source: *Public Accounts of Canada.*

The Government’s market debt is the portion of the federal debt borrowed in financial markets and consists primarily of fixed-coupon marketable bonds (2-, 5-, 10- and 30-year), Real Return Bonds (30-year), treasury bills (3-, 6- and 12-month), retail debt (Canada Savings Bonds and Canada Premium Bonds) and foreign-currency-denominated debt. It also includes bonds issued to the Canada Pension Plan and obligations related to capital leases, although these are not borrowed from the market or actively managed. The shares of each of these components are shown in Chart 1.

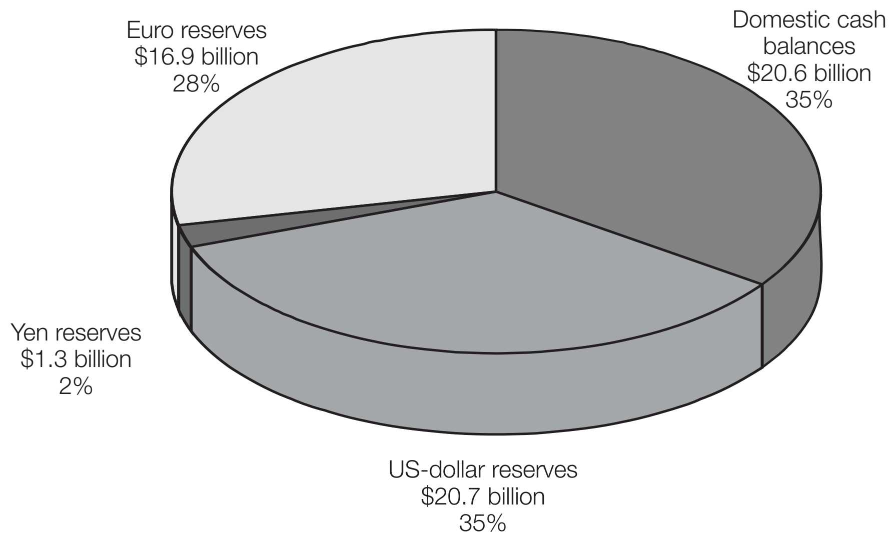
Chart 1
Composition of Market Debt
March 31, 2005



Source: Department of Finance Canada.

The debt strategy plan also addresses the management of the Government's liquid financial assets, which include cash balances (invested with banks for very short terms) and the liquid foreign exchange reserves (as portfolios of deposits and securities). The composition of these assets is shown in Chart 2.

Chart 2
Liquid Cash and Reserves
March 31, 2005



Source: Department of Finance Canada.

Fiscal Policy

The Government's fiscal policy, as set out in the budget, sets the context and operational objectives for debt management operations. The Government has recorded budgetary surpluses over the past eight fiscal years and has reduced the federal debt by $63 billion.

Combined with forecast economic growth, the federal debt-to-GDP ratio—the level of debt in relation to the country's annual income—remains on a downward track. On an accrual basis, the federal debt as a percentage of the economy is projected to fall to 35 per cent in 2006–07, down from its peak of 68.4 per cent in 1995–96.

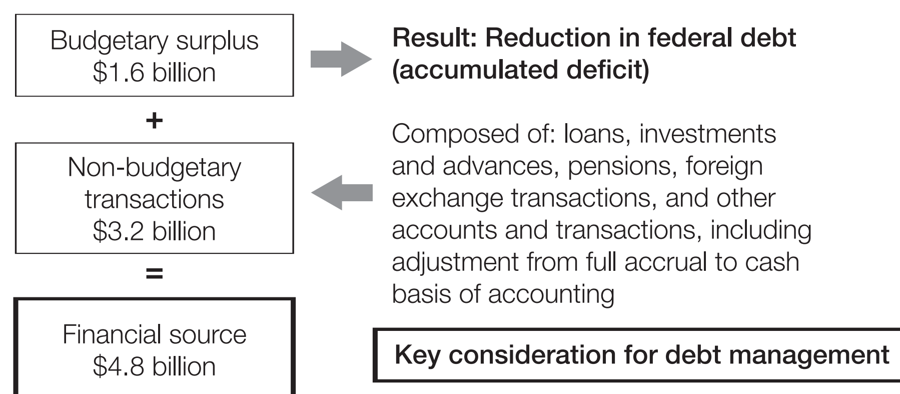
In terms of international debt burden comparisons, taking into consideration the accounting methods of various sovereigns, Canada's total government debt burden is the lowest in the G7.

Financial Requirement/Source

The key budgetary consideration for debt management planning is the financial requirement/source rather than the budgetary balance (see box on following page). The 2006–07 debt strategy plan is based on the assumption of a balanced budget and a near-zero financial requirement/source.

Figure 2 presents the various elements of the Government's budgetary framework for the 2004–05 fiscal year, the last year for which audited Public Accounts financial statements are available.

Figure 2
Financial Source at March 31, 2005



Source: *Public Accounts of Canada.*

Borrowing Authority

Currently available borrowing authority is limited to the standing authority to refinance market debt maturing in a fiscal year, plus a $4-billion non-lapsing contingency from the 1996–97 Borrowing Authority Act. Financial requirements in 2006–07 are expected to be met without seeking new borrowing authority.

Measuring the Government's Fiscal Position: Budgetary Balance and Financial Requirement/Source

The budgetary balance and financial requirement/source measures used in the *Debt Management Strategy* are based on the Public Accounts accounting framework. The Public Accounts provide information to Parliament on the Government's financial activities, as required under the Financial Administration Act. The measures are provided on a fiscal-year basis ending March 31.

The budgetary balance—deficit or surplus—is one measure of the Government's financial situation. Consistent with the recommendations of the Auditor General of Canada, the Government moved to full accrual accounting in 2002–03. The move enhances transparency and decision making by providing a more complete accounting of government activities than under the previous modified accrual accounting framework. Under the full accrual basis of accounting, revenues and expenses are recorded when they are incurred, regardless of when the actual cash flows occur.

The financial requirement/source provides a measure of the net cash position of the Government. In contrast, the budgetary balance also includes obligations incurred by the Government during the course of the year for which the cash transaction does not take place until future years. In general terms, the difference between the financial requirement/source and the budgetary balance is timing (i.e. when funds for budgetary items are committed and the actual cash transaction occurs).

The financial requirement/source includes the cash outlays related to current- and prior-year budget commitments. It also includes transactions in loans, investments and advances, federal employees' pension accounts, other specified purpose accounts, foreign exchange activities, and changes in other financial assets, liabilities and non-financial assets. These activities are included as part of non-budgetary transactions. The financial requirement/source corresponds closely to the unified budget balance measure used in the United States.

2006–2007 Debt Strategy: Major Themes

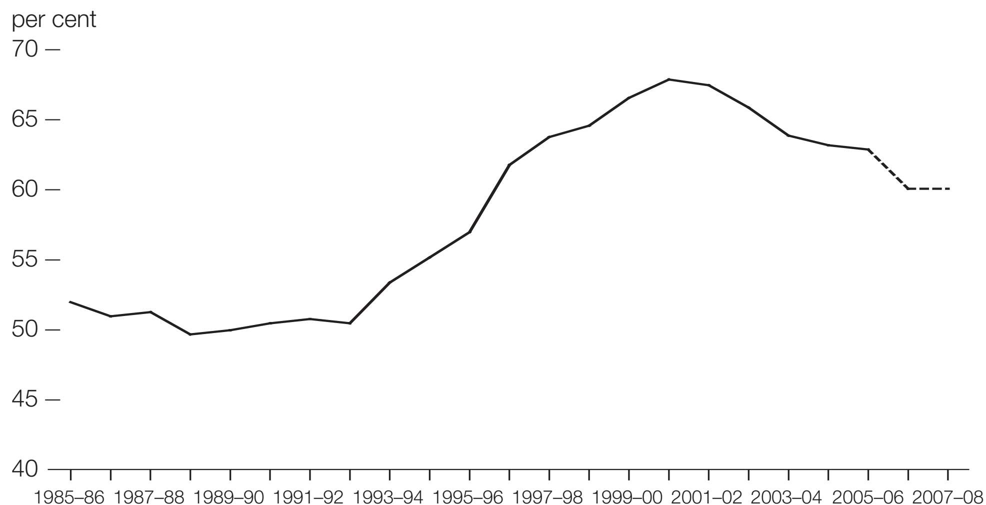
Changing the Debt Structure

The fundamental objective in managing the debt is to strike the appropriate balance between low financing costs and cost stability over a medium-term horizon. The main target in this regard is the fixed-rate share of the debt—that is, the share of the debt that is not maturing or being repriced within a year.

In general, long-term debt is less risky, but more costly, than short-term debt. In an environment of macroeconomic stability and declining debt, the Government has greater capacity to absorb interest rate variability. At the same time, given the level of federal debt, a prudent debt structure is needed to protect the fiscal position from unexpected increases in interest rates and to limit annual refinancing needs.

In 2002–03, the decision was taken to reduce the fixed-rate share of the debt from two-thirds to a target of 60 per cent by 2007–08 (see Chart 3). Given variations in government bond maturities during the year, maintenance of the target on a month-to-month basis will incorporate an operational range of +/-1 per cent. The change is being made gradually to facilitate market adjustment. Updated analysis continues to support the reduction in the fixed-rate share of the debt to 60 per cent, indicating net annual cost savings could reach up to $500 million, on average, when the 60-per-cent debt structure is in place.

Chart 3
Fixed-Rate Share of the Debt



Sources: Bank of Canada and Department of Finance Canada.

Compared to a two-thirds debt structure, the lower fixed-rate structure modestly increases the Government's short-term exposure to adverse movements in interest rates. However, the analysis indicates that, over time, the additional costs of an interest rate shock would be more than offset by the savings associated with a lower fixed-rate structure.

In 2006–07, the Government will continue the transition from two-thirds to the 60-per-cent target by 2007–08 by adjusting the issuance levels of treasury bills and bonds. These adjustments are detailed in the section "2006–2007 Debt Strategy: Program Plans."

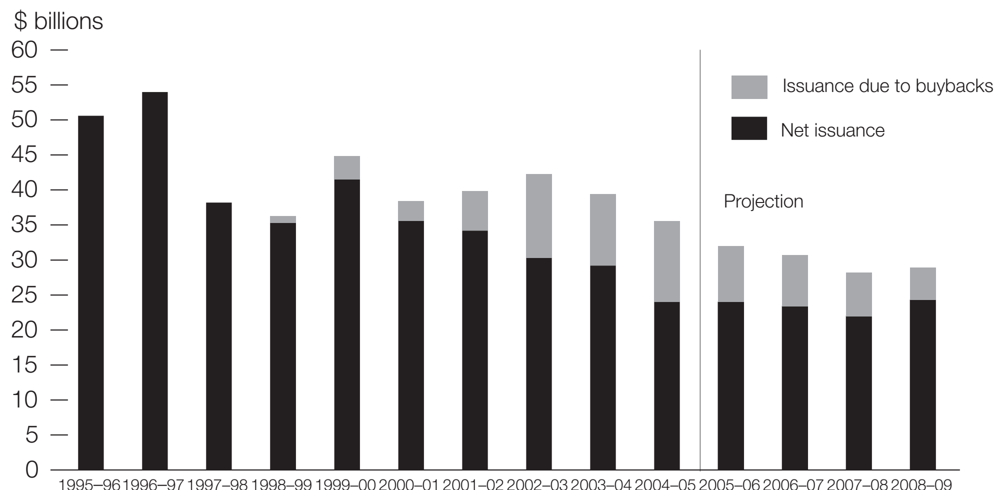
Maintaining A Well-Functioning Bond Market

The Government has a major interest in sustaining a liquid and efficient market for Government of Canada securities. A liquid and efficient government securities market is attractive to investors and thus helps to keep debt costs low. It also provides key pricing and hedging tools for market participants, thereby contributing to the effective functioning of the broader fixed-income market.

One of the key challenges for the Government in recent years has been to maintain a liquid, well-functioning government securities market in the face of declining borrowing requirements and reduced issuance of fixed-rate securities. A key initiative in this regard has been the use of bond buybacks, which have facilitated the maintenance of a higher level of gross bond issuance.

Gross annual bond issuance has declined over the past 10 years, from a peak of $54 billion in 1996–97 to about $32 billion in 2005–06. Assuming continued balanced budgets, annual gross bond issuance is planned to stabilize at about $30 billion once the 60-per-cent fixed-rate target has been reached in 2007–08 (see Chart 4).

Chart 4
Government of Canada Bond Program



Source: Department of Finance Canada.

In view of the outlook, the primary focus of this year's debt strategy is to facilitate a temporarily lower bond issuance for 2006–07 and 2007–08 without making permanent, potentially disruptive changes to the bond program. A key initiative this year is to take greater advantage of fungibility (i.e. the ability to combine different bonds that share the same maturity date) between old outstanding bonds and new benchmark issues. Fungibility will permit key maturities of the current bond program (i.e. 2-, 5-, 10-, and 30-year) to be maintained in the context of smaller total issuance. At the same time, issuance of new 2- and 5-year bonds will be reduced in recognition of large outstanding fungible bonds "rolling down" into those parts of the curve to help support liquidity in all four maturities.

Meanwhile, the size of the buyback program will continue to be reduced based on two considerations. First, while the bond buyback program has helped to support the maintenance of gross bond issuance, the requirement for a transition mechanism to smaller sustainable bond programs is diminishing. Second, a reduction in the size of the buyback program is appropriate as the bond stock becomes concentrated in fewer old benchmark bonds, which remain of value to market participants.

Detailed information on 2006–07 program plans is provided in the following section.

2006–2007 Debt Strategy: Program Plans

Domestic Debt Programs

In November 2005, as in past years, officials from the Department of Finance Canada and the Bank of Canada consulted with interested parties on issues relating to the design and operation of the Government of Canada's debt programs for fiscal year 2006–07 and beyond. This year's consultations addressed a broad spectrum of potential adjustments to the Government's bond program that permit debt structure adjustment while maintaining a well-functioning bond market. A consultation paper (www.bank-banque-canada.ca/en/notices_fmd/2005/not281005_debt.html) set out for comment potential near-term changes that largely preserve the current structure of the bond program as well as more fundamental changes in the design of the bond program over the medium term.

Market participants recognized that the Government faces challenges in maintaining well-functioning markets for Government of Canada securities while continuing to gradually reduce the bond program in a context of lower borrowing needs and moving to a lower fixed-rate share of government debt.

Most participants were of the view that liquidity is adequate along the yield curve, but is sometimes limited at the long end. Market participants indicated that there is a strong demand for Government of Canada securities and noted decreasing supply, especially in the long end, where there is a structural need for bonds and limited substitutes. Liquidity is anticipated to become increasingly under pressure as more investors adopt a buy-and-hold strategy and as demands for collateral become more common.

Market participants strongly supported continuing to take advantage of fungibility in the 2-year sector and changing the 5-year maturity date from September 1 to June 1 to support issuance in other sectors while maintaining adequate liquidity in all four maturities. A majority of market participants were also in favour of a modest reduction of the regular buyback floor below which large off-the-run benchmark bonds are currently not repurchased from $6 billion to $5 billion. Participants also supported the concept of using interest rate swaps as a future means of maintaining gross issuance and benchmark sizes.

More details on the views expressed during the consultations can be found at www.bankofcanada.ca/en/notices_fmd/index.html.

Fixed-Coupon Marketable Bond Program

In 2006–07, gross bond program issuance is planned to be about $31 billion, $1 billion less than planned for 2005–06. Marketable bond issuance (net of buybacks) of about $23 billion will be around $1 billion less than in 2005–06. Taking into account bond maturities and cash management bond buyback operations during the year, the stock of bonds is expected to decline from an estimated $237 billion to about $231 billion.

Quarterly auctions of 2-, 5- and 10-year bonds and semi-annual auctions of 30-year bonds will continue, with quarterly auction calendars issued by the Bank of Canada and posted on their website before the start of each quarter. However, one 2-year and one 5-year auction that are fungible with outstanding bonds will be forgone, both in the fourth quarter of the fiscal year. This will allow appropriate auction sizes to be maintained in all bond maturities in the context of smaller overall bond issuance.

Bond Auctions by Quarter,

Fiscal Year 2005–06				Fiscal Year 2006–07			
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
2-year	2-year	2-year	–	2-year	2-year	2-year	–
5-year	5-year	5-year	5-year	5-year	5-year	5-year	–
10-year	10-year	10-year	10-year	10-year	10-year	10-year	10-year
–	30-year	–	30-year	–	30-year	–	30-year

Source: Bank of Canada.

The maturity date of new 5-year benchmarks will be changed from September 1 to June 1 starting in October 2006 to make the new 5-year bonds fungible with previous 10-year benchmarks.

Given the fungibility of shorter-term bonds with large outstanding issues, there will be a modest reallocation of issuance volume to 30-year fixed-coupon bonds and 30-year Real Return Bonds to support liquidity at the long end of the curve.

The 2-, 5-, 10- and 30-year benchmark target sizes for new issue bonds, which are not fungible with existing benchmarks, will remain unchanged from last year (2-year bonds: $7 billion to $10 billion; 5-year bonds: $9 billion to $12 billion; 10-year bonds: $10 billion to $14 billion; and 30-year bonds: $12 billion to $15 billion).

A list of outstanding Government of Canada bonds, including their maturity dates, is contained in the 2004–05 *Debt Management Report*, which is available on the Department of Finance Canada website at www.fin.gc.ca. The list will also be updated monthly on the Bank of Canada website (www.bankofcanada.ca/en/goc/goc.html) and will be available in the forthcoming annual publication, *Summary of Government of Canada Direct Securities and Loans*, which will be posted on the Bank of Canada's website at www.bankofcanada.ca.

Bond Buyback Programs

Two types of bond buyback operations will continue to be conducted: regular bond buybacks and cash management bond buybacks. Regular bond buybacks permit the maintenance of a liquid new bond issue program by buying existing bonds with a remaining term to maturity from 18 months to 25 years. Cash management bond buybacks aid in the management of cash balances by repurchasing bonds maturing within the next 18 months.

Regular Bond Buyback Operations

Bond buyback operations will continue on both a cash and a switch basis. Bond buyback operations on a cash basis involve the exchange of less liquid bonds for cash and are conducted shortly after auctions of similar maturity bonds. Bond buyback operations on a switch basis involve the exchange of less liquid bonds for new issue bonds on a duration-neutral basis and are conducted at other times in each quarter.

As noted earlier, bond buybacks will be reduced in overall terms, in keeping with their reduced value as a transition mechanism. The target for 2006–07 is to conduct between $7 billion and $8 billion in bond buyback operations, about $1 billion less than in 2005–06. The quarterly maximum repurchase target amounts for the regular bond buyback program and the date of each operation will be announced through the quarterly bond auction calendar published by the Bank of Canada.

For regular buybacks, the existing $6-billion floor will be reduced to $5 billion in all maturities to increase the amount of bonds eligible for repurchase at buyback operations.

Cash Management Bond Buybacks (CMBBs)

The CMBB program helps manage the Government's cash requirements by reducing the high levels of cash balances needed ahead of large bond maturities. No major change is planned to CMBB operations in 2006–07.

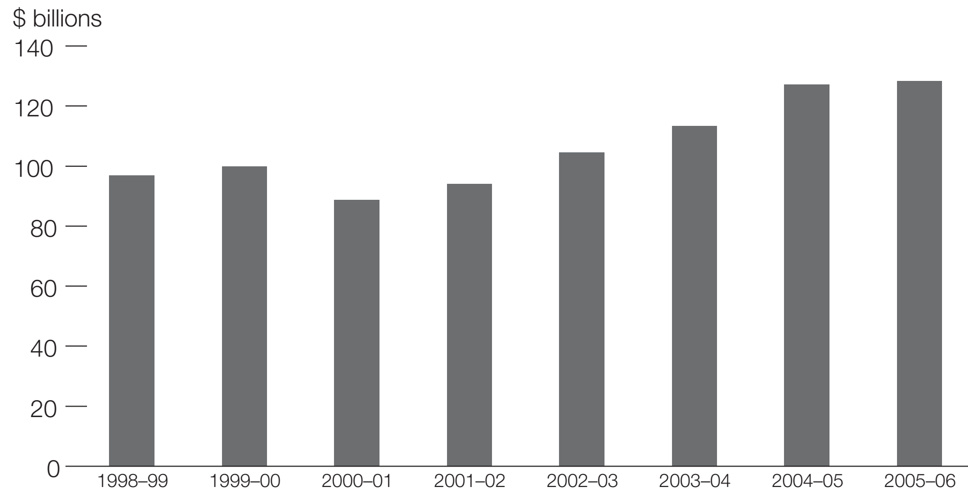
Real Return Bonds (RRBs)

The 2006–07 plan calls for a modest increase in long-term RRB issuance to about $1.6 billion. The level of RRB issuance is being increased slightly in view of market demand, despite a decline in gross bond issuance.

Treasury Bill Program

Based on plans for attaining the 60-per-cent target for the fixed-rate portion of the debt, the stock of treasury bills is expected to increase by around $6 billion to a range of $135 billion to $140 billion by the end of 2006–07. Markets have adjusted smoothly to the growth in the stock of treasury bills, which has increased from less than $90 billion at the end of the 2000–01 fiscal year to approximately $131 billion by the end of fiscal 2005–06 (see Chart 5).

Chart 5
Treasury Bills Outstanding



Source: Department of Finance Canada.

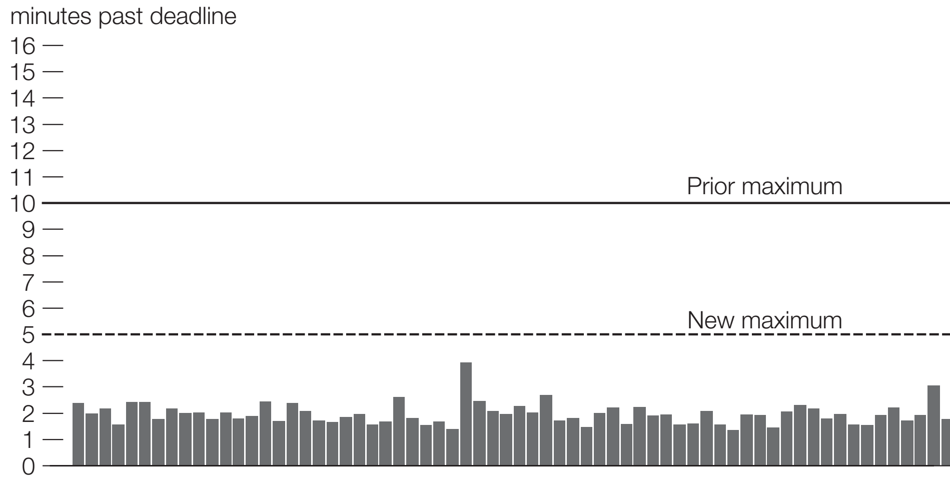
Cash management bills (i.e. short-dated treasury bills) help the Government manage its cash requirements in an efficient manner. The Government intends to continue to actively use cash management bills in 2006–07.

Operational Enhancements

For the past two years, the Bank of Canada's turnaround time for auctions and operations in which bonds are repurchased has been changed from fixed times of 10 and 15 minutes, respectively, to a "best efforts basis" (i.e. as soon as ready). Over this period, turnaround times have averaged less than 3 minutes for auctions and less than 7 minutes for buybacks (see Charts 6 and 7). The reduction in turnaround times has helped reduce market risk for auction participants and has improved the efficiency of the auction process.

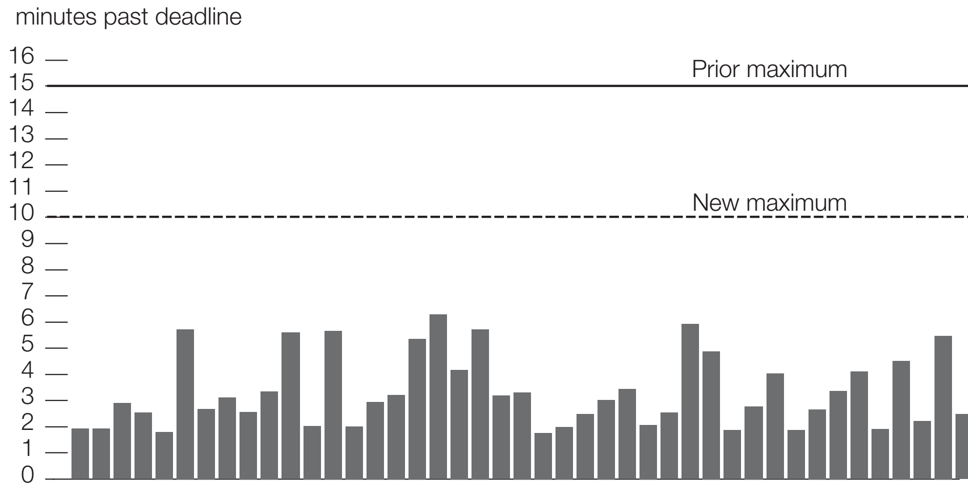
In 2006–07, the Bank is committed to keeping average turnaround times under 3 minutes for auctions and under 5 minutes for buybacks, while maximum turnaround times will be reduced from 10 minutes to 5 minutes for auctions, and from 15 minutes to 10 minutes for buyback operations.

Chart 6
Bill and Bond Auction Turnaround Times
April 2005–February 2006



Source: Bank of Canada.

Chart 7
Repurchase and Switch Auction Turnaround Times
April 2005–February 2006



Source: Bank of Canada.

Policy Reviews

Borrowing Framework Used by Major Government-Backed Entities

The Minister of Finance has statutory responsibility for approving borrowing and debt guarantees issued by a number of Crown corporations and federal government-backed entities. These activities are backed by the full faith and credit of Canada and, as such, are an extension of the treasury management framework of the Government. Given the size and scope of the activities of these borrowers, it is in the public interest that they be managed efficiently within a robust governance and accountability framework.

An external evaluation of the borrowing framework governing borrowing by the Business Development Bank of Canada, Export Development Canada, Farm Credit Canada, the Canadian Wheat Board and Canada Mortgage and Housing Corporation (CMHC), along with the CMHC-guaranteed Canada Housing Trust, was completed by an external evaluator (KPMG LLP) in June 2005 under the auspices of the Department of Finance Canada's treasury evaluation program. KPMG LLP observed that the current governance system is functioning well between the Government of Canada and all of the organizations. However, it advised that consolidating these guaranteed borrowings with the Government of Canada's domestic debt issuance could generate cost savings and enhance the liquidity of the Government of Canada bond market. It noted that there are concerns about the impact of such an approach on the existing borrowers (e.g. impact on client service, loss of market intelligence) and that further work is needed to determine whether these concerns could be addressed through the design of a centralized borrowing regime.

In 2006, the Department of Finance Canada, in conjunction with the borrowers, will be evaluating further the merits of consolidating some or all of federal government-backed borrowings with the Government of Canada debt program.

Transparency of Government Securities Market

Officials of the Department of Finance Canada and the Bank of Canada have been actively supporting the development of enhanced transparency in the Canadian fixed-income market for many years. Transparency (i.e. the dissemination of trading information regarding prices of securities and volumes traded) for both institutional and retail investors is an important contributor to the development and maintenance of well-functioning and efficient capital markets.

In Canada, developments in recent years have enabled the provision of greater transparency to investors. These include the launch of electronic or alternative trading systems (ATSs) on which fixed-income securities can be traded between counterparties and the development of a regulatory framework with transparency standards. As a result, users of ATSs have obtained enhanced transparency on the trading of Government of Canada securities, and there is broad transparency of trading in benchmark corporate securities. Over the past year, discussions have been ongoing among market participants and securities regulators on the evolution of the regulatory framework and ensuring there is appropriate transparency provided on all fixed-income securities for all investors. Developments in Canada and abroad suggest that, while maintaining liquid markets is an important concern, a higher level of transparency could benefit investors in Government of Canada securities.

In 2006–07, the Government will continue to work with market participants and securities regulators to enhance the transparency of the Government of Canada securities market for retail and institutional investors.

Retail Debt Program

The retail debt program strategy is under review in light of the findings of an evaluation conducted by Cap Gemini Ernst & Young in 2004–05 and an internal review, and the evolution of the Government's needs and the retail marketplace. Options are being assessed that align the program with the evolving needs of the Government and Canadians. Further information on the retail debt program and a report of 2004–05 activities are available at www.csb.gc.ca.

Management of Domestic Cash Balances

The Government of Canada manages its cash balances in order to ensure that it has sufficient cash on hand to meet its operating and liquidity requirements. The cash balances are invested through auctions twice daily.

The bulk of the cash balances are invested through a morning auction. This auction incorporates a credit management system, using credit ratings, credit lines and collateral arrangements to manage credit risk, and a broad list of eligible counterparties to encourage more competitive bidding at the auctions. The afternoon auction is used to invest the Government's residual cash balances. This auction is uncollateralized and is limited to Large Value Transfer System participants.

In December 2005, the Government commissioned an external review of its cash management program under the treasury evaluation program. The review is considering the effectiveness of the program in ensuring that the Government has sufficient cash available at all times to meet its operating requirements while maintaining effective low-cost borrowing for the Government. The review is examining, in particular, the structure and operation of the program; participation on the part of banks, dealers and other market participants; and the management of credit risk associated with the investment of cash balances.

Foreign Reserves Management

The Government holds foreign exchange reserve assets in the Exchange Fund Account (EFA) to provide foreign currency liquidity and to provide the funds, if required, to help promote orderly conditions for the Canadian dollar in the foreign exchange market. The Government's foreign currency reserves are funded through foreign currency liabilities. The foreign currency reserve assets, and liabilities financing those assets, are managed within an asset-liability management framework.

This section addresses four areas falling under foreign reserves management: the investment of reserves, the funding of reserves, performance reporting and risk management.

Reserves Investment

In the Budget Implementation Act, 2005, the Currency Act was amended to enhance the management of the Government's foreign reserves portfolio and to reduce the risk of legal issues arising from antiquated drafting of some sections of the previous legislation. The amended act, which came into effect on December 30, 2005, improves the flexibility in managing the EFA by allowing investment in new asset classes, which will improve its risk/return profile. In 2006–07, the primary focus on the investment side will be to implement the new investment regime, as per the amended Currency Act.

A Statement of Investment Policy (SIP) has been developed and implemented, as required by the amended act. The SIP contains policies governing the acquisition, management and divestiture of assets of the EFA. The SIP allows for investment in two new short-term asset classes, commercial paper and certificates of deposits, as alternatives to other forms of short-term investment, particularly unsecured deposits. Investment in the new asset classes will increase the diversification of the portfolio and is expected to lower overall risk. Investment in these asset classes will commence in 2006–07.

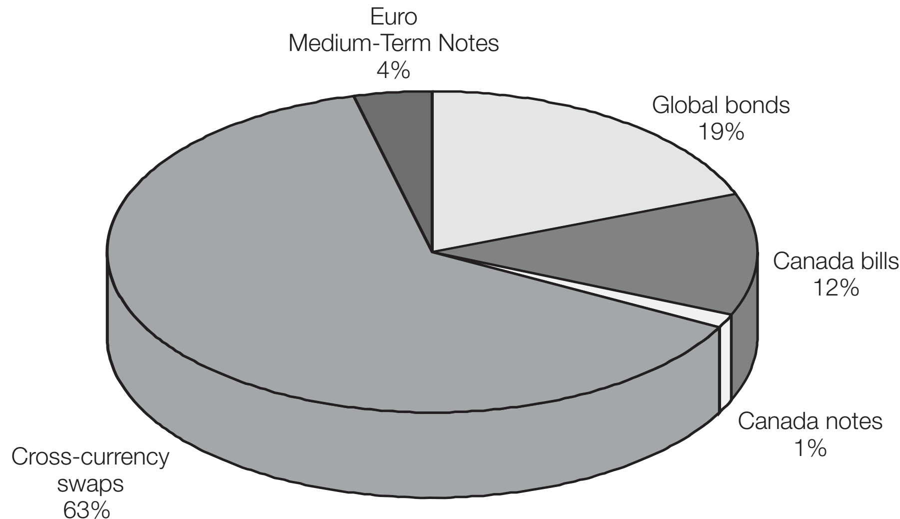
To strengthen the management of the EFA, an external review of the Account is underway under the treasury evaluation program. The focus of the review is to assess how Canada's reserves investment policies and practices compare to the practices of other sovereigns and large institutional investors and to identify areas of improvement.

Reserves Funding

The Government's foreign reserves are financed by foreign currency liabilities. The Government has access to a wide range of sources to fund its foreign currency assets. These sources include a short-term US-dollar paper program, medium-term note issuance in various markets, cross-currency swaps of domestic obligations, international bond issues, and purchases of US dollars in foreign exchange markets. Cross-currency swaps, which involve switching domestic liabilities for US-dollar and euro-denominated liabilities, have proven to be a particularly cost-effective alternative and have been actively used in recent years.

In 2006–07, the precise mix of funding sources will depend on a number of considerations, including relative cost, market conditions and opportunities, and the desire to maintain a prudent foreign-currency-denominated debt maturity structure. It is expected that cross-currency swaps of domestic obligations will continue to be the primary source of reserves funding.

Chart 8
Forecast Composition of Foreign Currency Liabilities
March 31, 2006



Note: Numbers do not add to 100% due to rounding.
Source: Department of Finance Canada.

Chart 8 shows the expected composition of foreign currency liabilities at March 31, 2006.

Performance Reporting

Performance reporting is a framework for measuring, analyzing and evaluating financial performance of the investment and funding of reserves. The policy requires regular and timely reporting to senior management, the Minister of Finance and Parliament of the returns on EFA assets and the costs of associated liabilities.

Two principal measures of performance are used: cost of carry (an accounting-based measure which captures net interest income and realized gains/losses) and total return (a market-based measure that captures net interest income and realized and unrealized gains/losses). Several enhancements to the performance measurement framework were introduced in 2005–06, such as performance attribution analysis and the development of an external asset benchmark. In 2006–07, work will continue to further improve these measures, taking into account the results of the external evaluation.

Risk Management

The Government has in place a comprehensive risk management framework for identifying and managing financial risk, including market, credit, operational and legal risks related to the financing and investment of the foreign exchange reserves. Standards for risk control are high, market risks are immunized to the greatest extent possible, and high standards of credit quality and portfolio diversification are followed.

In recent years, the Government has continued to further strengthen its risk management framework by implementing collateral management frameworks for its cross-currency swap program and US-dollar deposit program. Collateral management systems are increasingly the norm in capital markets as a way of managing risk. Under the frameworks, high-quality collateral (e.g. cash, securities) is posted to the Government when its credit exposure to financial institution counterparties exceeds specified limits.

The Government employs measures of market risk exposure that are considered industry standards: stress testing and Value-at-Risk (VaR). Stress tests are used for evaluating the reserves portfolio performance under extraordinary circumstances in the market. VaR is a statistical measure for estimating potential losses of the reserves portfolio due to normal market movements, i.e. changes in interest and exchange rates. To aid in the measurement and monitoring of credit risk, credit risk measures such as actual and potential exposures and, more recently, Credit VaR, have been adopted. Credit VaR is a statistical measure for estimating potential losses of the reserves portfolio due to credit events, such as a counterparty's credit rating downgrade.

While the primary focus of risk management in recent years has been on market and credit risks, efforts in 2006–07 will be concentrated on developing risk measures for liquidity and operational risks.

Summary of the 2006–2007 Debt Strategy Plan and Intended Results

Debt Structure

Objective: *Gradually reduce the fixed-rate share of debt from two-thirds to a target of 60 per cent by 2007–08.*

Action for 2006–07:	Intended Result:
Continue to reduce the fixed-rate share of debt towards the 60-per-cent target.	Achieve lower debt charges, while continuing to prudently mitigate the risk to the budget framework.
Increase the size of the treasury bill program from about $131 billion in 2005–06 to approximately $135 billion to $140 billion in 2006–07. Issue about $31 billion of bonds in 2006–07, about $1 billion less than in 2005–06. Due to large bond maturities and continued cash management bond buyback operations, the bond stock is expected to decrease by some $6 billion.	Facilitate market adjustment to changes in the bond and treasury bill programs.
Reduce the size of the buyback program, with a planned level of between $7 billion and $8 billion, roughly $1 billion less than in 2005–06.	Prepare for the end of the transition to sustainable bond programs and preserve liquidity in outstanding issues.
Maintain a stable maturity profile.	Limit the need to refinance a large portion of debt in any given period.

Domestic Debt Programs

Objective: *Maintain diversified sources of funding and a well-functioning market.*

Action for 2006–07:	Intended Result:
Continue regular issues of marketable bonds in four maturity sectors, treasury bills in three maturity sectors and a long-dated index-linked bond.	Keep costs low and mitigate funding risk by diversifying borrowing across investor segments, instruments and maturities.
Forgo the 2-year auction in the fourth quarter of 2006–07. Change the dating of the 5-year benchmark maturity from September 1 to June 1 to make the new benchmarks fungible with old 10-year benchmarks, allowing the 5-year auction in the fourth quarter to be eliminated.	Facilitate a reduction in bond issuance and maintain adequate liquidity in other key bond maturities.
Maintain the current new issuance benchmark target sizes for non-fungible 2-, 5-, 10- and 30-year bonds.	Maintain a liquid market for on-the-run issues and building-benchmark issues.
Continue to borrow on a pre-announced basis and provide timely notices of government policy decisions.	Maintain transparency and efficiency.
For regular buybacks, lower the minimum amount of outstanding benchmark bonds above which buyback operations will be conducted from $6 billion to $5 billion in all maturities.	Increase the amount of bonds eligible for repurchase at buyback operations.

Action	Intended Result
Ensure average turnaround times are less than 3 minutes for auctions and less than 5 minutes for buybacks. Reduce maximum turnaround times from 10 minutes to 5 minutes for auctions and from 15 minutes to 10 minutes for buyback operations.	Enhance the bidding process and participation while reducing risk for market participants.
Evaluate the merits of consolidation of some or all of the borrowing by major government-backed entities into government debt programs.	Ensure the borrowing framework used by the Government is effective and efficient.
Continue research and consultations with market participants and regulators on the transparency of the market for Government of Canada securities.	Support an appropriate level of transparency in the Government of Canada securities market.

Foreign Reserves

Objective: *Improve the cost-effectiveness of funding foreign reserve assets.*

Action for 2006–07:	Intended Result:
Continue to use cross-currency swaps as the primary source of reserves funding.	Keep the cost of carrying reserve assets low.
Implement a new investment regime and invest in new short-term asset classes.	Improve the risk/return profile of the portfolio.

Glossary

asset-liability management: An investment decision-making framework that is used to concurrently manage a portfolio of assets and liabilities.

average term to maturity: The average time remaining before debt matures, taking only principal amounts into account.

basis point: One-hundredth of a percentage point (0.01 per cent).

benchmark bond: Specific issue outstanding within each class of maturities. It is considered by the market to be the standard against which all other bonds issued in that class are evaluated.

budgetary surplus: Occurs when government annual revenues exceed annual budgetary expenses. A deficit is the shortfall between government revenues and budgetary expenses.

buyback on a cash basis: The repurchase of bonds for cash. Used to maintain the size of bond auctions and new issuance.

buyback on a switch basis: The exchange of outstanding bonds for new bonds in the current building benchmark.

Canada bill: Promissory note denominated in US dollars, issued for terms of up to 270 days. Canada bills are issued for foreign exchange reserves funding purposes only.

Canada Investment Bond: A non-marketable fixed-term security instrument issued by the Government of Canada.

Canada note: Promissory note usually denominated in US dollars and available in book-entry form. Canada notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. Canada notes are issued for foreign exchange reserves funding purposes only.

Canada Premium Bond: A non-marketable security instrument issued by the Government of Canada, which is redeemable once a year on the anniversary date or during the 30 days thereafter without penalty.

Canada Savings Bond: A non-marketable security instrument issued by the Government of Canada, which is redeemable on demand by the registered owner(s), and which, after the first three months, pays interest up to the end of the month prior to cashing.

Contingency Reserve: Is included in the budget projections primarily to cover risks arising from unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and unpredictable events. If not needed, it is used to pay down the public debt.

Cost-at-Risk: A measure based on the statistical distribution of debt charges that enables risk to be quantified in terms of the maximum costs that could occur within a specified probability range in a particular year.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

duration: Weighted average term to maturity of a bond's cash flow, used as a measure of interest rate sensitivity.

electronic trading system: An electronic system that provides real-time information about securities and enables the user to execute financial trades.

Exchange Fund Account: A fund maintained by the Government of Canada for the purpose of promoting order and stability of the Canadian dollar in the foreign exchange market. This function is fulfilled by purchasing foreign exchange (selling Canadian dollars) when there is upward pressure on the value of the Canadian dollar and selling foreign exchange (buying Canadian dollars) when there is downward pressure on the currency.

federal debt: Total liabilities less financial and non-financial assets.

financial requirement/source: Measures the difference between cash coming in to the Government and cash going out. In the case of a financial requirement, if cash on hand is not used, it is the amount of new borrowing required from outside lenders to meet the Government's financing needs in any given year.

fixed-coupon marketable bond: Market debt instrument issued by the Government of Canada and sold via public tender. These issues have a specific maturity date and a specified interest rate. All Canadian-dollar marketable bonds pay a fixed rate of interest semi-annually and are non-callable. They are transferable and hence can be traded in the secondary market.

fixed-rate debt: The share of the gross debt that is maturing or being repriced in more than 12 months.

fungible bond: A bond that has the same financial attributes as another. Fungible bonds are interchangeable.

government securities distributor: Member of a group of investment banks and dealers through which the Government distributes Government of Canada treasury bills and marketable bonds.

gross public debt: Total amount the Government owes. It consists of market debt in the form of outstanding securities such as treasury bills, marketable bonds and Canada Savings Bonds, non-market debt owed mainly to the superannuation accounts for government employees, and other current liabilities.

interest-bearing debt: Consists of unmatured debt, or market debt, and the Government's liabilities to internally held accounts such as federal employees' pension plans.

marketable debt: Market debt that is issued by the Government of Canada and sold via public tender or syndication. These issues can be traded between investors while outstanding.

market debt: The portion of debt that is funded in the public markets. It consists primarily of marketable bonds, treasury bills, retail debt and foreign-currency-denominated bonds and bills. It also includes bonds issued to the Canada Pension Plan and obligations related to capital leases, although these are not borrowed from the market or actively managed.

net debt: Gross debt, net of financial assets.

non-marketable debt: Market debt that is not tradable and that is issued to retail investors (Canada Savings Bonds and Canada Premium Bonds).

non-market debt: Consists of the Government's internal debt, which is, for the most part, federal public sector pension liabilities and the Government's current liabilities (such as accounts payable, accrued liabilities, interest payments and payments of matured debt).

primary market: The market in which securities are initially sold or offered.

Real Return Bond (RRB): Government of Canada RRBs pay semi-annual interest based upon a real interest rate. Unlike standard fixed-coupon marketable bonds, interest payments on RRBs are adjusted for changes in the Consumer Price Index.

secondary market: The market in which previously issued securities are traded, as distinguished from the new issue or primary market.

sovereign market: Market for the debt issued by a government.

treasury bill: Short-term obligation sold by public tender. Treasury bills, with terms to maturity of 3, 6 or 12 months, are currently auctioned on a biweekly basis.

turnover ratio: Volume of securities traded as a percentage of total securities outstanding.

yield curve: Graph based on the term structure of interest rates, plotting the yield of all bonds of the same quality with maturities ranging from the shortest to longest term available.