

Year 2000 and Contingency Arrangements for the Provision of Liquidity by the Bank of Canada

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The financial sector is a crucial part of the Canadian economy and is well prepared for the year 2000. The Bank of Canada and the country's financial institutions recognized early the need to address potential problems associated with the calendar date change at the beginning of the year 2000 and they have devoted considerable time and resources to this issue. The Bank of Canada and other financial sector participants fully expect that it will be "business as usual" heading into the year 2000 and beyond.

Accordingly, there should not be any extraordinary liquidity needs in the financial sector during this period. Nonetheless, contingency arrangements are being put in place to provide a further measure of confidence. The Bank of Canada today announced three such arrangements.

The Bank is establishing a Special Liquidity Facility for financial institutions that participate directly in the Large Value Transfer System (LVTS) to facilitate access to liquidity in case of any extraordinary needs during the century date change period. The existence of this special facility will assure financial institutions and users of the financial system that if any unusual demands for liquidity associated with the year 2000 rollover should arise, they will be accommodated. This facility will be available from 1 November 1999 to 31 March 2000.

The Bank also announced two other contingency measures. It will be prepared to accept a wider-than-usual range of collateral to support any liquidity loans it makes to payments system participants during the 1 November to 31 March period. This will apply to the routine provision of overnight loans to LVTS direct participants and to direct clearers in the Automated Clearing Settlement System (ACSS), as well as loans to institutions borrowing under the Special Liquidity Facility. In addition, to keep the average interest rate for overnight funds from moving above the Bank of Canada's operating band as a result of technical factors and possible year 2000 concerns in the period immediately around year-end, the Bank will, if necessary, provide a positive level of settlement balances in the LVTS and extend its use of Special Purchase and Resale Agreements (SPRAs).

Background Information on the Special Liquidity Facility

While financial institutions are primarily responsible for having contingency plans to deal with possible year 2000 problems, including plans that address possible liquidity needs, the Bank of Canada, like other central banks around the world, has examined the role that it could play in dealing with potential needs for extraordinary liquidity at financial institutions. The central bank has the discretionary power to make secured loans to direct participants in the LVTS.¹ The Bank can take a wide range of collateral from borrowing institutions for such loans, the loans can be made for periods not exceeding six months (and such loans can be renewed), and the minimum rate of interest charged is the Bank Rate. The purpose of such lending is to provide liquidity to and preserve confidence in solvent LVTS participants, as well as to permit such institutions to provide liquidity to other deposit-taking institutions, the financial sector generally, and to non-financial entities.

Liquidity needs of the direct participants in the LVTS are usually met in the market and through overnight loans by the Bank of Canada. The terms and conditions of the Bank's overnight loans are designed to encourage the direct participants to adjust their liquidity positions primarily in the market. Direct participants also serve as a source of liquidity to other deposit-taking institutions and in turn all deposit-taking institutions can be a source of liquidity to their customers. The Bank of Canada expects that these arrangements will meet the various demands for liquidity in Canada's economy during the century date change period.

There is nonetheless a concern that there should be in place a means to cope with any possibility of unusual increases in the demand for liquidity during the century date change period. Financial institutions and their customers are therefore reviewing and modifying contingency plans to meet possible liquidity demands, even those that are deemed to be highly unlikely.

To help ensure that there will be an adequate supply of liquidity to meet any unusual demands associated with the year 2000, the Bank, in consultation with the direct participants in the LVTS, is establishing a Special Liquidity Facility for a limited period. This facility should provide greater confidence to the direct LVTS participants, other financial institutions and customers of these institutions, as well as market participants generally, that any unusual liquidity demands associated with the year 2000 can be met.

The broad characteristics of this facility are as follows:

Eligible borrowers:

The facility will be available to any direct participant in the LVTS that is solvent and can provide acceptable collateral.

Term of the facility:

The Special Liquidity Facility will be available from 1 November 1999 to 31 March 2000.

Interest rate:

The interest rate charged on any loans drawn under this facility will be Bank Rate plus 125 basis points. This rate will encourage institutions to use the market to manage their liquidity needs and represents a reasonable charge for loans provided through this facility, in the unlikely event that they become necessary.

Collateral:

As with all loans provided by the Bank of Canada, loans provided under the Special Liquidity Facility will have to be fully collateralized. The Bank can take a wide range of collateral including securities and assignments of the loan portfolio of the borrowing institution.

Terms and conditions for the provision of the liquidity:

All loans will be in Canadian dollars. The size of the loan will be determined by the borrowing institution, to the extent that it can provide acceptable collateral to the Bank of Canada. The term of these loans can be up to five months, and loans can be repaid before the due date. This contrasts with the usual situation, in which loans from the Bank of Canada to direct participants in the LVTS are made for one day and are intended to cover overnight shortfalls in funds that the direct participants were unable to accommodate through market sources.

The Bank of Canada will be asking all direct LVTS participants that may wish to draw on this facility to put in place certain legal and administrative arrangements in advance. In cases where direct LVTS participants are providing liquidity to institutions that are not direct LVTS participants, they may secure liquidity loans received from the Bank of Canada by re-hypothecating collateral received from these other institutions, provided that the Bank of Canada is satisfied that this collateral is not subject to any prior claims of these other institutions. The Bank is working with eligible borrowers to refine the legal, operational, and administrative details of the facility.

Any loans provided by the Bank of Canada under this facility will be reported on the Bank's balance sheet under the item "Advances to members of the Canadian Payments Association." The Bank of Canada's balance sheet is made available each Friday as at the previous Wednesday (and is published in the *Weekly Financial Statistics*, which is released every Friday). The Bank of Canada's balance sheet as at the end of each month is available within a few days of the month-end.

Background information on the expansion of eligible collateral for LVTS advances

As part of the usual operations of the LVTS, direct participants may require overnight liquidity loans from the Bank of Canada. As with all lending by the Bank, such loans must be fully secured by collateral provided by the borrowing institution. Typically, this collateral consists of securities issued or guaranteed by the Government of Canada and provincial governments, Special Deposit Accounts held at the Bank of Canada, and certain mortgage-backed securities. From 1 November 1999 until 31 March 2000, the Bank of Canada is prepared to accept a wider-than-normal range of collateral to support the routine provision of liquidity to LVTS participants. The expanded range of collateral will include securities such as asset-backed securities, commercial paper and corporate debt as well as assignments of parts of the loan portfolio of borrowing institutions. The expanded range of collateral will also be accepted for overnight loans to direct clearers in the ACSS and for loans under the Special Liquidity Facility. The Bank is putting in place measures to mitigate any additional risks associated with the expansion of eligible collateral.

Background information on the provision of settlement balances and the extended use of SPRAs

The LVTS is the central mechanism through which the Bank of Canada implements monetary policy.² The Bank establishes a target for the overnight interest rate at the midpoint of a 50 basis point operating band. This in turn influences other short-term interest rates and the exchange rate.

Typically the Bank of Canada sets the level of settlement balances in the LVTS at zero. Therefore, any participant in the LVTS with a surplus funds position will be aware that there will be one or more participants with offsetting deficit positions that are potential counterparties for transactions at market rates. The Bank of Canada encourages these transactions by paying an interest rate on positive balances held overnight by LVTS participants at the lower limit of its operating band and charging an interest rate on overdraft loans to LVTS participants at the upper limit of the band (which is also the Bank Rate). Thus, the overnight rate will typically stay within the operating band, since participants are aware that they can earn at least the lower limit of the band on positive balances and need not pay more than the upper limit of the band to cover shortfalls.

Some concern has been expressed that, leading up to the end of 1999, normal year-end technical pressures magnified by year 2000 concerns might lead to a demand for positive settlement balances by LVTS participants and cause the overnight rate to move above the top of the Bank's operating band. Therefore, in order to keep the average interest rate for overnight funds within the operating band during the period immediately around year-end, the Bank will, if necessary, supply the settlement balances in the LVTS needed to meet this extra demand and extend its use of SPRAs.

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Footnotes

1. See "**The LVTS—Canada's large-value transfer system**" in the *Bank of Canada Review*, Autumn 1998 for a detailed description of the LVTS.[←]
2. See "**A primer on the implementation of monetary policy in the LVTS environment**" in the Autumn 1998 *Bank of Canada Review* for a detailed description of the implementation of monetary policy in the LVTS environment.[←]