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Changes to the Bank of Canada's Framework for Financial Market Operations

September 30, 2015

On 5 May, 2015, the Bank of Canada published a consultation paper outlining proposed changes to its framework for financial market operations. Interested parties were invited to provide comments, and the Bank also held a series of meetings with industry associations and other stakeholders.

Summary of comments received

Respondents were supportive of the overall direction of the Bank's proposed changes. The comments acknowledged the Bank's efforts to enhance certain areas of its financial market operations to improve the effectiveness of the overall framework in light of ongoing and expected changes in the external environment. Respondents also acknowledged the Bank's efforts to manage its balance sheet in a manner appropriate to achieving its monetary policy and financial stability objectives.

Respondents supported the Bank's intention to reduce its participation at primary auctions of nominal Government of Canada bonds to help increase the tradable float of those benchmark securities and hence support their secondary market liquidity. They also welcomed the proposed introduction of a regular program of term repos as a viable tool for the Bank to achieve this reduction, and generally commented that the size being considered could be increased. However, they highlighted that the secondary market might not have the capacity to accommodate significant purchases of non-benchmark Government of Canada securities by the Bank without further reducing the liquidity of those securities.

Several respondents cited the lack of participation of some large holders of Government of Canada securities in the securities lending or repo markets, together with the relatively small size and high degree of concentration of the market as important factors contributing to the persistence of bonds trading on special. Respondents cautioned that the adoption of a market-wide settlement fail fee in Canada is not an appropriate mechanism to deal with this situation, given the current market context and typically low level of settlement fails in Canada. In most respondents' view, a fail fee would not help reduce the persistence of bonds trading on special in the repo market and could in fact have negative implications for market functioning and liquidity.

There was also general support for the proposed refinements to the Bank's special purchase and resale agreements (SPRAs) and sale and repurchase agreements (SRAs). However, respondents expressed some concern that the proposed auction format for those operations could contribute to greater volatility in the overnight market. With regard to the tiered remuneration of excess settlement balances, there was minimal support: respondents cited both the infrequent occurrences of large excess balances left in the system and the potential for this scheme to reduce existing incentives for participants in the Large Value Transfer System (LVTS) to appropriately forecast and manage their daily cash positions.

Resulting changes to the Bank's framework for financial market operations

Taking into consideration the feedback received, the Bank of Canada has decided to implement the following changes to its framework for financial market operations:

- introduce a regular program of term repo operations as proposed
- reduce the Bank's purchases at primary auctions of nominal Government of Canada bonds from 20 per cent to 15 per cent beginning in 2015Q4, with a view to lowering it further to 10 per cent by end-2016[1]
- refine operational parameters for SPRAs and SRAs, with some adjustments relative to the original proposal
- refine some of the operational parameters of the Bank's Securities Lending Program
- introduce a Contingent Term Repo Facility (CTRF) as described in the consultation document

The Bank expects to introduce secondary market purchases of Government of Canada debt securities, if necessary, at a later date. However, for reasons cited below, the Bank of Canada will not be implementing a tiered remuneration of excess LVTS settlement balances. At this time, the Bank will not pursue a market-wide settlement fail fee but it may revisit those proposals or consider other measures at a later date should conditions warrant, such as if there was a marked increase in settlement fails.

The Bank is grateful to the respondents for their valuable feedback. Effective 1 October 2015, new terms and conditions reflecting the above changes will apply. These new terms and conditions are referenced below and can be found together with the terms and conditions of the Bank's other **financial market operations**. Reflecting these changes, the Bank has amended and restated the **Bank of Canada Policy for Buying and Selling Securities Under Subsection 18.1(1) of the Bank of Canada Act**. This policy will be published in the Canada Gazette on 3 October 2015 and will take effect seven days thereafter. Further details on the feedback obtained and any refinements introduced to the individual proposals follow.

Refinements to the Operating Framework to Reinforce the Target for the Overnight Rate

Refinements to SPRAs and SRAs

In the Bank of Canada's consultation document, it proposed refining the format of SPRAs and SRAs to an auction on a cash-value basis, where counterparties could bid for a larger portion of the total operation than is currently the case, up to a given limit. The type of auction proposed was a discriminatory price auction. However, the Bank is changing the type of auction for these operations to a uniform price auction. Some respondents expressed concern that the clearing rates of a discriminatory price auction could contribute toward the overnight rate persistently trading off target, and generate increased rate volatility in the overnight market. While it is not certain that these operations would clear significantly off target under most circumstances, a uniform price auction is expected to clear fairly close to target under similar circumstances. In a discriminatory price auction, the auction results would reflect aggressive bidding which despite potentially being due to idiosyncratic factors, could be interpreted as signalling more broadly the cost of overnight funding. Hence, a uniform price auction with its single clearing rate will help mitigate respondents' concerns while still allowing counterparties to compete for funding and increasing the effectiveness and allocation efficiency of the operation. As part of this new auction format, the Bank is increasing the maximum aggregate amount offered per operation, and allowing counterparties to bid on larger portions of the total operation, up to a given limit. Limits will be based on the institution's market share in primary, secondary and repo markets for Government of Canada securities, and will be set at either $500 million or $150 million. This new auction format will be implemented on a pilot basis until such time that the Bank can assess its effectiveness and the overall impact on the overnight rate and the implementation of monetary policy.

To better align these operations with the new *term repo operations*, they are also being renamed *Bank of Canada Overnight Repo* (formerly SPRA) and *Bank of Canada Overnight Reverse Repo* (formerly SRA) operations.

Reflecting these changes, the revised **terms and conditions for Bank of Canada Overnight Repo (OR) and Bank of Canada Overnight Reverse Repo (ORR)** operations are effective as of 1 October 2015.

Tiered Remuneration of Excess LVTS Settlement Balances

Respondents commented that the Bank's current framework for the operating band that is set around the target for the overnight rate, and reinforced by the existing standing deposit and lending facilities, works well. They noted that depending on how a tiered remuneration scheme is designed, it could potentially introduce uncertainty into daily cash management practices, which could affect the pricing of overnight deposits. Furthermore, respondents indicated that such a scheme could introduce disincentives for LVTS participants to distribute liquidity and offset positions with one another. Overall, respondents noted that, since the LVTS seldom ends up in an aggregate end of day surplus position that is significantly larger-than-intended, the potential drawbacks of such a scheme outweigh the potential economic benefits of helping to mitigate potential downward pressure in the overnight rate late in the day and being compensated at the target for the overnight rate on a portion of their settlement balances in such cases. Therefore, based on these comments, no change to the current remuneration of LVTS settlement balances is being made at this time, but the Bank may choose to revisit this proposal at a later date.

Changes in Support of Well-Functioning Markets

Term Repo Operations and Secondary Market Purchases of Government of Canada Securities to Reduce the Bank's Purchases at Primary Bond Auctions

Respondents supported the Bank's proposal to implement a regular program of term repo operations, but comments were mixed on the introduction of secondary market purchases of Government of Canada securities. Respondents acknowledged that, by allowing the Bank to reduce its participation in primary bond auctions and therefore its holdings of benchmark securities, these tools could help improve the liquidity of benchmark Government of Canada debt securities. However, concerns were raised that, in the current market environment, the level of secondary market purchases that might be required to achieve the proposed reduction in primary market purchases of nominal bonds to 10 per cent could impair liquidity in the non-benchmark segment and exacerbate the widespread and persistent incidence of these securities trading on special in the repo market. Respondents indicated that such an increase in bonds trading on special would likely occur even if the Bank took precaution to structure its purchases so as to limit adverse impacts on the functioning of the Government of Canada securities market.

In light of these comments and given the recently increased prevalence of bonds trading on special, the Bank has decided to take a more staged approach by initially reducing its participation at primary auctions of Government of Canada nominal bonds to 15 per cent, effective immediately. This initial reduction will mainly be achieved through the planned introduction of term repos. The Bank will continue to monitor market developments and liquidity with the intent of further reducing its purchases at auctions, to 10 per cent by end-2016, either by increasing the amount of term repos; initiating secondary market purchases of Government of Canada securities; considering other means, including secondary market purchases of other marketable debt securities; or a combination of these measures. Further details on term repos and secondary market purchases of Government of Canada securities are provided below.

Term Repos

Respondents commented that in order for the Bank to foster a longer-term repo market in Canada, the Bank's term repo portfolio would likely need to be larger than envisioned in the consultation document. However, consistent with its intention to take a staged approach, the Bank maintains the original proposal to target an initial amount of term repos outstanding of between $7 and $10 billion, to be phased in over a sixth-month period. This amount may increase further thereafter depending on the Bank's assessment of the prevailing market conditions and potential effects, and its balance-sheet requirements. Any further changes would be publicly announced ahead of implementation.

The maturities of the term repos will be approximately one and three months, as originally envisioned in the consultation paper. Some respondents indicated a preference for longer terms, but given the initial size of the program that is contemplated, the Bank judges that terms of one- and three-months are appropriate and provide more flexibility in the management of its balance sheet.

Primary Dealers will be the eligible counterparties for those term repo operations, and individual counterparty limits will be based on the institution’s market share in primary, secondary and repo markets for Government of Canada securities, similar to what is proposed for the ORs and ORRs. The individual counterparty limits for term repos will be set initially at either 25 per cent or 15 per cent of the total amount outstanding, with awarded amounts to any institution not exceeding 50 per cent of the amount offered at a given operation. The Bank will also be providing some increased flexibility with regard to security substitution, on the basis of respondent comments that this would be beneficial for market functioning and participation at the Bank’s term repo operations.

The **terms and conditions for the Bank's regular term repos** are effective as of 1 October 2015.

Also available is a preliminary **schedule of upcoming term repo operations**.

Secondary Market Purchases of Government of Canada Securities to Reduce Primary Market Purchases

Consistent with the Bank’s decision to reduce its participation at primary auctions of Government of Canada securities to 15 per cent initially with the intent to further reduce it to 10 per cent by the end of 2016, the Bank will carefully consider its balance sheet requirements and the potential market impacts of its potential secondary market purchases before undertaking such transactions. This responds to comments by a number of industry participants indicating that the secondary market may not have the capacity at this time to accommodate significant purchases by the Bank without further exacerbating liquidity issues and the persistence of bonds trading on special.

The Bank will issue a market notice within the coming year outlining its plan regarding secondary market purchases of Government of Canada securities. Should these purchases be implemented, terms and conditions would also be published ahead of time.

Securities Lending Program

Some respondents commented that the Bank’s proposal to revise its intervention threshold provides greater scope for markets to clear without interventions from the Bank, while preserving the intended role of the program to act as a secondary source of securities that are in high demand. They also indicated that the revised threshold could translate into an increase in costs to security borrowers. Other respondents did not view the proposed revision to the intervention threshold as materially addressing the broader issue of a lack of participation in the Canadian securities lending market by some large holders of securities.

The Bank’s primary objective in proposing to revise its intervention threshold is to reinforce the intended backstop nature of its Securities-Lending Program as a secondary source of securities. Any increase in participation in the securities lending market by large holders of securities from a revised intervention threshold would be seen as a positive development. Considering all the comments received, the Bank has decided to revise the intervention threshold as proposed. Other terms and conditions of this program will remain unchanged for the time being.

However, respondents also indicated that a greater proportion of the Bank's holdings of Government of Canada securities available under its Securities-Lending Program for terms longer than overnight would help support market functioning. In response, the Bank is considering whether to make more than 50 per cent of its Government of Canada securities available, and is considering the possibility of increasing the term of the securities lending to beyond overnight. Any further changes would be announced at a future date, if needed.

Reflecting the change to the intervention threshold, the revised **terms and conditions for the Bank's Securities-Lending Program** are effective 1 October 2015.

Market-Wide Settlement Fail Fee

Regarding the possible introduction of a market-wide settlement fail fee, respondents believed that, overall, such a fee would be more harmful than beneficial to the liquidity and functioning of the Canadian fixed income market. Respondents cited the relatively small size of the Canadian market, its high degree of concentrated holdings, and the lack of participation by some of these large holders in repo or securities-lending markets as the main factors for not implementing a market-wide settlement fail fee. They also underlined that settlement fails are not a persistent problem in Canada. However, it was noted that a market-wide settlement fail fee might be appropriate under certain circumstances, such as if settlement fails increased markedly; however, given the anticipated negative consequences, other measures to help improve the functioning of the Government of Canada securities market should be considered first. In light of these comments, the Bank will not be pursuing a market-wide settlement fail fee at this time, but may revisit this proposal at a later date should conditions warrant, such as if there was a marked increase in settlement fails.

Contingent Term Repo Facility

Respondents supported the introduction of the CTRF as a flexible tool to help the Bank respond to severe market-wide liquidity stress. However, concerns were raised regarding a potential negative stigma associated with accessing the facility. If conditions warrant and the Bank activates the CTRF, the Bank will undertake disclosure procedures consistent with mitigating the potential negative stigma (preserve confidentiality) while providing an appropriate degree of transparency to the public (e.g., publish dates, amounts, terms and rates). Terms and conditions for the CTRF will be published in advance of it being activated.

Footnotes

1. Represents total annual reductions of roughly $4 billion and $9 billion, respectively, based on 2015-16 fiscal year nominal bond issuance of $88 billion.[←]