BANK OF CANADA
BANQUE DU CANADA

Overview of the Bank of Canada's Consultation Regarding Its Framework for Financial Market Operations and Emergency Lending Policies

The Bank of Canada (the Bank) has a responsibility to conduct monetary policy to maintain a low and stable rate of inflation and, in co-operation with other agencies, to promote the stability and resilience of Canada's financial system. In the course of executing its monetary policy and financial system responsibilities, the Bank undertakes a range of financial market operations as part of its regular operating framework and provides liquidity to the Canadian financial system as required. The Bank provides routine liquidity to facilitate settlement in the payments system and has various tools at its disposal to respond to situations where exceptional or emergency liquidity is required, either on a bilateral basis to specific entities through the provision of Emergency Lending Assistance (ELA) or on a market-wide basis through the use of extraordinary liquidity facilities.

Framework for Financial Market Operations

The Bank implements monetary policy by setting a target for the overnight rate (often referred to as the policy rate), which directly influences the rates at which banks and other financial market participants are able to borrow and lend for a term of one business day.[1] The level of the overnight rate and expectations about its future path also influence other short-term and longer-term interest rates, as well as a broader range of asset prices.

The Bank's operating framework to achieve the target for the overnight rate includes an operating band reinforced by standing deposit and lending facilities available to participants in Canada's main payments system.[2] The Bank also has the ability, as needed, to vary the amount of settlement balances (or overnight funds) available in that system and to conduct repo-type transactions to further reinforce the target overnight interest rate.

The Bank's monetary policy framework, together with its objective to foster a stable and efficient Canadian financial system, requires the Bank to transact in financial markets from time to time to

- reinforce the target for the overnight rate
- provide liquidity to the financial system
- acquire and manage assets on the Bank's balance sheet, and
- make available for securities lending a portion of the Bank's government securities holdings when they are in high demand.

[1] See the Backgrounder "Target for the Overnight Rate" at http://www.bankofcanada.ca/wp-content/uploads/2010/11/target_overnight_rate_sept2012.pdf.

[2] This operating band is one-half of a percentage point wide and has the Target for the Overnight Rate at its centre. See "A Primer on Canada's Large Value Transfer System," available at http://www.bankofcanada.ca/wp-content/uploads/2010/05/lvts_neville.pdf, and "A Primer on the Implementation of Monetary Policy in the LVTS Environment," available at http://www.bankofcanada.ca/wp-content/uploads/2010/07/lvts_primer_2010.pdf.

In conducting these activities, the Bank interacts with market participants using regular, or standing, facilities. The Bank also has a number of additional market-wide facilities at its disposal to provide liquidity to the financial system in exceptional circumstances.

The Bank has been reviewing its framework for market operations to take account of lessons from the global financial crisis and the way the market environment is evolving. Factors being taken into account include changes in the ways financial institutions manage their liquidity needs; changing dynamics in funding and government debt markets; the likely future growth in the stock of bank notes in circulation and, hence, in the size of the Bank's balance sheet; and a range of factors contributing to the persistent and widespread incidence of Government of Canada securities trading at repo rates well below the general collateral rate. In conducting the review, the Bank has looked at experience both in Canada and in other jurisdictions and at evolving operational practices at other major central banks.

The Bank believes that its operating framework has generally been effective in achieving the Bank's objectives, but that it would be prudent to make some enhancements in various areas. In some cases, changes are being proposed to routine operations. In others, the proposals relate to introducing new tools to manage exceptional circumstances. The underlying objective of the enhancements is to increase the effectiveness of the overall framework in response to the ongoing and expected changes in the external environment, while managing the Bank's market presence in an appropriate manner. No inferences should be drawn from these proposals about the current or future stance of monetary policy.

Framework for Central Bank Emergency Lending Assistance

Similar to central banks in other jurisdictions, the Bank of Canada acts as a "backstop" provider of liquidity to the Canadian financial system. This "lender-of-last-resort" function has been a fundamental role of central banks since at least the nineteenth century.

The objective of the Bank's lender-of-last-resort role is to prevent or mitigate financial instability through the provision of liquidity support, either to particular financial institutions and financial market infrastructures (FMIs) or to financial market participants more broadly. Financial institutions that fund illiquid loans with redeemable deposits or short-term wholesale funds can face liquidity risks, and even a well-run bank could suffer an unexpected shortage of liquidity.

FMIs also face liquidity risk,[3] since they protect themselves from credit risks by taking collateral and mutualizing the residual risks through default procedures. If a member defaults, however, an FMI may need to liquidate collateral to satisfy its obligations.

FMIs manage liquidity risk by putting in place contractual liquidity arrangements with financial institutions. In turn, financial institutions generally use financial markets to manage their liquidity risks.

[3] FMIs are payment clearing and settlement companies that channel the vast majority of financial transactions within financial markets. See "Guideline Related to Bank of Canada Oversight Activities Under the Payment Clearing and Settlement Act," available at http://www.bankofcanada.ca/core-functions/financial-system/oversight-designated-clearing-settlement-systems/oversight-and-legislation/guideline-related-oversight-activities/.

However, there may be situations when markets, which facilitate the distribution of liquidity within the financial system, are impaired due to a generalized increase in uncertainty. As a result, this can increase liquidity risk at financial institutions and make it difficult for them to finance their contractual liquidity arrangements with FMIs, should the need arise.

The central bank has a unique ability to create liquidity instantaneously and can provide this liquidity to the financial system, mitigating the adverse consequences of liquidity shortages. Liquidity provision by central banks is not without costs, however. The most notable of these costs is moral hazard, which can encourage financial institutions to hold too little liquidity and to take on excessive risk. Such situations may result because financial institutions expect to have ready access, if needed, to relatively inexpensive liquidity from the central bank.

Concerns about moral hazard mean that the Bank of Canada's liquidity interventions have to be targeted and limited, and the Bank's lending policies are designed to encourage financial institutions to manage their liquidity needs. The Bank is required to secure its lending operations with collateral and charges a lending rate that would be unattractive relative to rates that prevail in normal times. Furthermore, the Bank sets conditions for eligibility to access its Emergency Lending Assistance (ELA). These conditions include increased supervisory scrutiny under a sound recovery and resolution framework for financial institutions and are described in detail in the consultation paper on the Bank's emergency lending policies. By ensuring that banks meet minimum standards with respect to liquidity, the new Basel III regulations, notably the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NFSR), also help to mitigate moral hazard and reduce the probability that banks will require ELA.

While ELA remains an effective tool, the Bank regularly reviews its lending policies. To that end, the Bank has undertaken a comprehensive review and is updating and improving its ELA policy to reflect lessons learned from the 2007–09 financial crisis, clarify the scope of its lending policies for certain institutions and strengthen the resilience of Canada's financial sector. The last comprehensive review of the Bank's ELA policy was completed in 2004.

The Bank of Canada's Tools for Financial Market Operations and Liquidity Provision

The Bank of Canada Act and the Payment Clearing and Settlements Act (PCSA) together give the Bank the power to make secured loans or advances to members of the Canadian Payments Association (CPA) and operators of FMIs designated for oversight under the PCSA.[4] The Bank can also purchase debt securities from any counterparty for the purposes of conducting monetary policy or promoting the stability of the financial system, subject to the policies established by the Bank.[5] In conditions of severe and unusual stress on the financial system, the Bank also has the power to buy from and sell to any person any securities and any other financial instruments (including equities).

The Bank has a number of tools in place to operationalize these powers in support of both monetary policy and the stability of the financial system, both as part of its routine operations and in exceptional

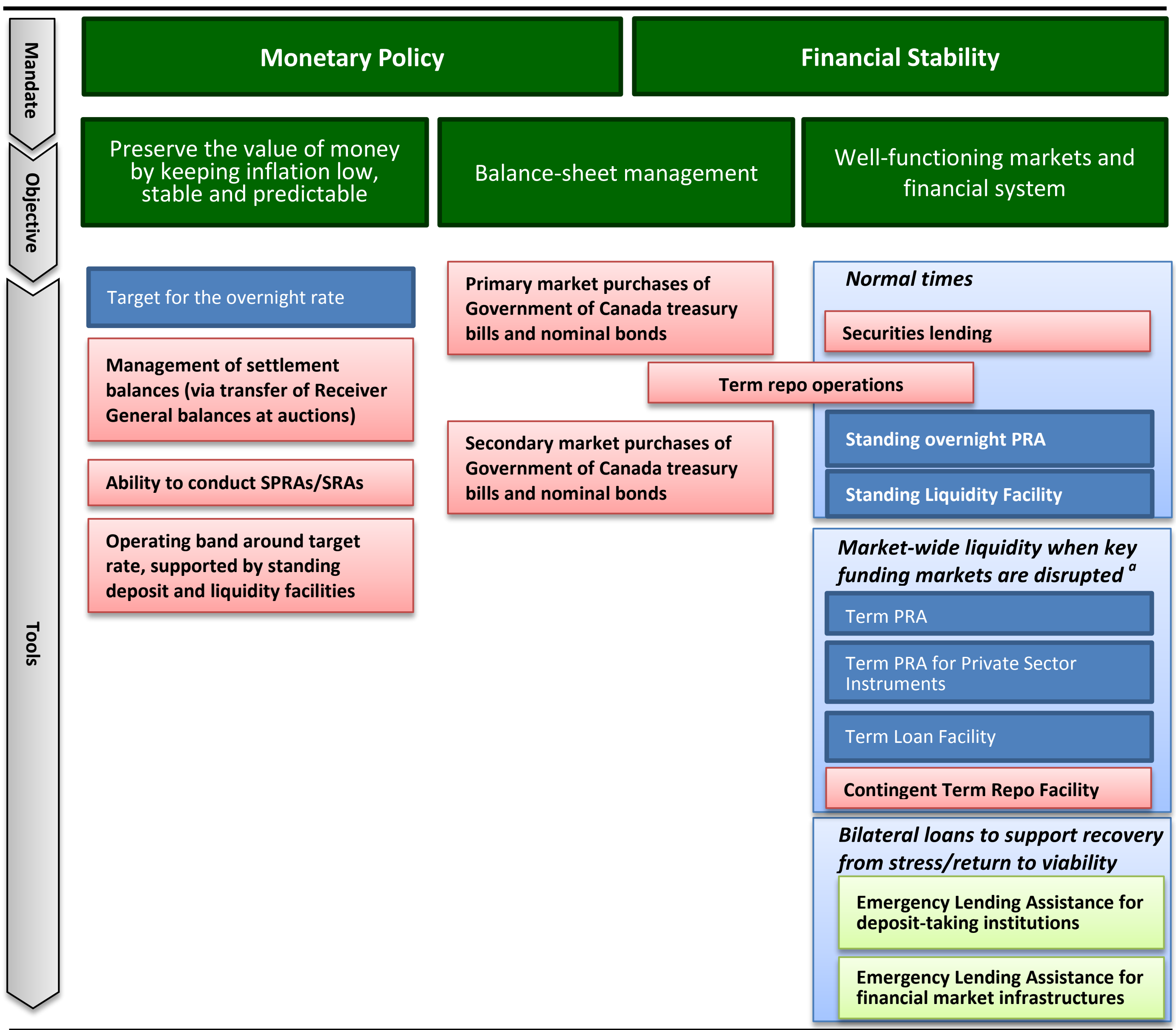
[4] Paragraphs 18(h) and 18(l.1) of the Bank of Canada Act; section 7 of the PCSA.
[5] Paragraph 18(g)(i) of the Bank of Canada Act; the Bank's policy for buying and selling securities under the Bank of Canada Act is available at http://www.bankofcanada.ca/wp-content/uploads/2010/09/policy_gazette_09.pdf.

circumstances (**Table 1**). The consultations that the Bank is undertaking in regard to these tools are set out in two papers, as shown in Table 1:

1. **A consultation paper that proposes refinements to the Bank's framework for financial market operations** (consulting on the tools shown in **red** in Table 1)**.**

2. **A consultation paper setting out proposed changes to the Bank's Emergency Lending Assistance (ELA) policies to individual financial institutions and FMIs** (shown in **green**)**.**

Table 1: Bank of Canada Tools for Market Operations and Liquidity Provision



[a] These were temporary facilities activated during the financial crisis.

Consultation paper 1 Consultation paper 2