Proposed revisions to the rules pertaining to auctions of Receiver General term deposits

Discussion Paper

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Introduction

This discussion paper proposes changes to the framework for the management of the federal government's cash balances. The main objectives of the cash management function are to ensure that the government has sufficient cash available to meet its operating and liquidity requirements, and to invest the cash balances in a prudent, cost-effective manner. This paper is principally concerned with the framework for the investment of the cash balances. The paper outlines the current framework and proposes some modifications, principally in the areas of access and the management of credit exposures.

The federal government approaches the investment of cash balances as would any other investor – it seeks to obtain the best possible yield on its funds without undue assumption of risk. The proposals in this paper are designed to increase competition and to strengthen the management of risks, in particular the credit risks involved in the investment of these funds. The federal government is making these proposals as part of its ongoing efforts to ensure that its financing and investing operations meet the standards of best practices appropriate for a sovereign government. The proposals are motivated by a desire to improve the business model governing these operations, and not by particular concerns about the risks associated with the government's current counterparties.

The framework for the investment of federal government cash balances is of interest to market participants given the role that these balances play in the market for overnight and short-term funds and in the implementation of monetary policy. The shared objective of all market participants should be that the market for federal government cash balances be transparent, active and competitive, and contributes to the efficient functioning of the domestic financial system.

The government therefore welcomes reactions to its proposals.

Current Framework for the Investment of Cash Balances

The investment of the federal government's cash balances is a significant financial operation. The average level of cash balances invested in the market during 1999 was about $7.9 billion (with a high of $15.7 billion and a low of $400 million). Although cash balances are inherently volatile, the average level of balances is likely to be modestly lower over the next few years than in 1999. The size of the government's cash balances is a natural outcome of two main factors. First, the federal government has substantial operational requirements, which can be volatile and difficult to forecast at times, and cash is also used for general liquidity purposes. Therefore, a substantial cash position is required. Second, the importance

of maintaining regular, predictable market funding operations affects the pace at which the cash position can be adjusted. For example, the government may need to build up its cash balances gradually over many weeks ahead of large, known disbursements, such as benchmark bond maturities, if markets are not to be disrupted. Some major developments in the cash management process are summarized in the box below.

Developments Related to Cash Management

The framework for managing cash balances has evolved over the years, both with changes in the financial sector and with changes to the framework for implementing monetary policy.

Prior to April 1986, almost all federal government cash balances were held as demand deposits with the directly clearing members of the Canadian Payments Association (CPA). In April 1986, a two-tiered approach was undertaken; balances needed on a day-to-day basis were invested as demand deposits, at a specified discount to the Prime Rate, while funds not expected to be needed for short periods of time were auctioned to the direct clearers as term deposits. In September 1989, the government began auctioning shares of Receiver General demand deposits. Before then, each direct clearer's share of the daily drawdown or redeposit was allocated in accordance with its CPA ratio. These changes were undertaken with the main purpose of earning a higher rate of interest on a portion of the government's balances. Practices for the auctioning of term deposits have evolved since their introduction in 1986. Further details on the early development of this framework are available in O'Connor (Bank of Canada Review, August 1991).

In February 1999, a number of changes were made to the process coincident with the introduction of the Large Value Transfer System (LVTS) and a new monetary policy framework. In particular, the list of institutions eligible to bid for balances was expanded to include LVTS participants that are not direct clearers, and a second daily auction was introduced. All balances are now invested with LVTS participants on a term basis through the daily auctions. Under the new regime, the Bank of Canada continues to neutralize the net impact of any public sector flows through the transfer of government deposits. However, the transfer is now achieved through the twice-daily auction of government balances to LVTS participants, as opposed to the drawdown/redeposit mechanism used before the change.[1]

1. The new monetary policy framework is described in D. Howard, "A primer on the implementation of monetary policy in the LVTS environment", Bank of Canada Review (Autumn 1998).

Cash balances are invested through a competitive auction process. Auctions are conducted twice daily, at 9:15 a.m. and 4:15 p.m. each business day, although on some occasions there may be no balances available to tender. By their nature, these investments are short-term, most often less than 10 days, although funds may be invested for 30 days or more on occasion. Funds may be auctioned in a single tranche or in multiple tranches (each with a different term) depending on the size of the auction and the forecasted profile of the government's cash needs. Currently, access to the auctions is limited to participants in the Large Value Transfer System (LVTS), a group of deposit-taking institutions, and balances are invested in the form of uncollateralized loans, much like wholesale deposits.

Bidding limits exist for each counterparty based on what are known as the Canadian Payments Association (CPA) ratios – essentially the market share of Canadian dollar deposits attributable to each institution. In the current system, the calculation of the bidding limits for each tranche offered at an auction depends on the participant's CPA ratio and the size of the tranche.[1] These bidding limits generally ensure (depending of the size of the auction) that the auction is covered by more than one participant. There are no formal bidding obligations on participating institutions.

Rationale for Changes

The framework for the investment of federal government cash balances functions well in terms of meeting the needs of the government. For example, the investment of balances through an auction process ensures that the government earns a competitive, market-driven return on its assets. The system is flexible, and the Bank of Canada is able to easily and quickly adjust the size and term to maturity of the funds on offer to take into account the government's operational requirements. Finally, the system is reasonably efficient – demand for balances is generally good and the market has considerable depth in terms of being able to absorb significant amounts of funds without disruption.

Restrictions on Access

As noted, access to federal government cash balances is currently limited to LVTS participants. While this includes many of the largest participants in the market for overnight and short-term funds, there are important participants in this market that cannot participate under the current regime. To the extent that demand from these participants exists, the return on the government's cash balances may suffer by restricting access to a narrower list. Hence,

1. More precisely, the bidding limit for each tranche offered is the CPA ratio times 2.5 times $2 billion for tranches up to $2 billion. For larger tranches, the bidding limit is the CPA ratio times 2.5 times the amount of the tranche. Participants who do not have a CPA ratio have a flat limit of $50 million per tranche.

broadening access to the auctions could be expected to increase competition at auctions and thereby have a positive impact on the return on term balances, and to broaden the diversification of the federal government's counterparties. Moreover, to the extent that these term deposits represent an attractive source of financing for a broader range of market participants, a further benefit of broader access might be a more efficient overnight market.

Credit Risk Management Framework

Another element of the current regime that merits change is the framework for managing credit risk, as the main mechanisms for controlling credit risk are indirect. For example, the restrictions on access to LVTS members have served to limit participation to a relatively small group of generally high quality counterparties. The bidding limits that are in place have also served to diversify the government's credit risk to some extent.

Nonetheless, the current framework requires strengthening relative to best practices for credit risk management. For example, there are no explicit minimum credit standards applied to participants to gain or maintain access to federal government cash balances. Further, there are no aggregate limits on the government's exposure to individual institutions and, indeed, individual exposures can at times be very large. The government has, for example, assumed exposures to individual institutions approaching $6 billion for short periods of time in the past year. Moreover, given the dominant position of the larger banks in the overnight market, the government's credit exposures can be heavily concentrated. The absence of such limits stands in contrast to best practices for credit risk management. The Bank for International Settlements (BIS), for example, states in its guidelines on credit risk management that "an important element of credit risk management is the establishment of exposure limits on single counterparties".[1]

These considerations are more pronounced given the trends in best practices that are emerging in financial markets. In domestic and international wholesale markets, for example, there is a trend towards increased credit risk mitigation (via increased collateralization), including exposures among high quality counterparties. The regime for the investment of federal government domestic cash balances also stands apart from the approach that the federal government has long applied to the investment of foreign currency term deposits held in the Exchange Fund Account, which are subject to a credit framework governing access and exposure. Finally, the current practice also differs from the cash management practices of other G-7 sovereigns who generally assume little or no credit risk as part of their investment of cash balances (see box below).

1. Basle Committee on Banking Supervision, *Principles for the Management of Credit Risk*, July 1999.

Key Features of Cash Management Practices: Canada versus Other G-7 Sovereigns

Cash management practices vary across countries reflecting, among other things, different domestic institutional arrangements and the nature of the domestic financial systems. The following are some of the key features that distinguish Canada's framework for investing cash balances from other G-7 countries.

Direct Market Investment: While all federal receipts and disbursements flow through the government's accounts at the Bank of Canada, the accounts are managed such that the balances at the central bank are essentially nominal. As a result, the federal government invests effectively all of its cash balances in the market. This is unlike practices in most other G-7 countries where substantial balances are generally maintained with the national central bank. Japan and Italy, for example, maintain all government balances at the central bank. France and the United States maintain a significant working balance at the national central bank while amounts beyond the targeted working balances are invested in the market by the government. The United Kingdom recently changed its cash management framework such that market investment of funds is done directly by the Debt Management Office. Germany invests cash surpluses in the market only on rare occasions.

Direct Auction by Government: Canada is currently the only G-7 country where the central government auctions its balances to market participants. Those countries that keep balances at the central bank of course rely on the central bank to invest the funds. The United States allocates its balances to market participants on a pro rata basis at a fixed reference rate of interest (currently 25 basis points below the Federal Funds rate), while France and the United Kingdom deal directly with market participants.

Credit Risk Management: Most other G-7 countries operate with little or no credit risk in the investment of government cash balances. Balances invested at national central banks of course involve no credit risk. The United States requires full collateralization of all market investment of its cash balances while France and the United Kingdom invest mainly through the repo market. Germany, on occasion, invests excess cash balances in the banking market.

Proposed Changes

The government is proposing changes to the framework for managing its cash balances that are designed to: (i) broaden participation in the investment process in order to increase competition for balances; and (ii) strengthen the credit risk management framework in order to prudently manage its exposures.

The government invites expressions of interest by parties that have significant domestic money market operations and that might wish to participate as counterparties in the cash auctions. Institutions will be required to have a minimum acceptable long-term credit rating of BBB (or equivalent). The Minister of Finance will have full discretion with respect to the selection of any potential participants.

The government proposes to introduce a credit framework based on credit ratings, credit limits and collateral. Participants that are deposit-taking institutions operating and regulated in Canada (Schedule I and II banks, trust and loan companies, credit union centrals, Canadian branches of authorized foreign banks) would have access to balances without collateral up to certain limits based on their credit ratings. Participants could bid for balances beyond their credit limits, but the amount allocated in excess of the credit limit would have to be fully collateralized. It is proposed that the minimum acceptable long-term credit rating for access to uncollateralized funds be a low A (or equivalent). For participants that are not regulated deposit-taking institutions, or for deposit-taking institutions that do not meet the low A (or equivalent) credit rating requirement, access would be granted on a collateralized basis only with no access to uncollateralized balances. As noted, the minimum acceptable credit rating for access by any participant is BBB (or equivalent).

The government proposes to maintain some uncollateralized access for regulated deposit-taking institutions with acceptable credit ratings for a number of reasons. The government wants to strike a prudent balance between risk and return, and it is recognized that the introduction of collateral will impact the returns that participants are prepared to offer for balances. Therefore, the maintenance of an acceptable amount of uncollateralized access could be beneficial in terms of returns and provide a prudent risk management framework as the uncollateralized limits would be kept at a moderate level. Also, broadening participation will potentially expose the government to counterparties with different types of risks and one can point to general market practice whereby investors distinguish between counterparties based on the type of institution. Deposit-taking institutions, for example, generally have readier and more cost-effective access to inter-bank and other short-term paper markets. The government also recognizes that deposit-taking institutions have historically had uncollateralized access to its balances and that a move to a fully collateralized system,

although it would be consistent with the practice of most other G-7 sovereigns, might involve a greater adjustment for the market.

Uncollateralized credit limits will be established to provide a meaningful amount of unsecured access to cash balances, but given the size of the overall balances, it is expected that the use of collateral will constitute a regular part of operations. The government proposes that the credit line for a regulated deposit-taking institution with a long-term credit rating equivalent to a low AA or better not exceed $500 million in total holdings, while the credit line for a deposit-taking institution with a long-term credit rating between a low A and a high A (or equivalent) not exceed $250 million in total holdings.

The government will rely on third party credit assessments (long-term credit ratings) as provided by recognized credit rating agencies as the principal means for assessing credit quality. While these are not perfect indicators of credit quality, third party credit ratings have the benefit of being transparent, determined by neutral third parties and widely accepted and used in financial markets. The government will require a credit rating from two agencies.

The government is open in principle to accept a broad range of collateral for these operations, subject to appropriate risk and liquidity standards. A broader range of eligible collateral could facilitate more efficient inventory management by participants, reduce costs, and mitigate potential impacts on the collateral markets. However, there are important operational issues related to collateral that need to be reviewed, which are discussed in an annex.

The current bidding limits based on CPA ratios described above will also be reviewed.

Summary of Proposals

1. Access to federal government cash balance auctions would be broadened. The government invites expressions of interest from parties with significant Canadian dollar wholesale funding operations that might want to participate.

2. Access for non deposit-taking institutions will be on a fully collateralized basis. These participants must have an acceptable minimum credit rating (a long-term rating of BBB or equivalent).

3. Deposit-taking institutions operating and regulated in Canada with an acceptable minimum credit rating (a long-term rating of low A or equivalent) would be allowed to bid up to authorized credit limits on an uncollateralized basis. For all deposits allotted above authorized credit limits, bidders would be required to provide collateral.

4. Long-term credit ratings provided by third party credit rating agencies would be the basis of credit assessments. The government would require two credit ratings.

5. The government will review the bidding limits that would apply under the new framework.

Consultation Process

The government welcomes responses on all aspects of these proposals and plans to consult with market participants on the proposals and the issues related to implementation. Comments on the draft revisions to the terms and conditions for Receiver General term deposit auctions must be received on or before 31 August 2000. Comments received will be available for public inspection on the Bank of Canada's Internet Home Page (http://www.bank-banque-canada.ca) in mid September 2000.

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The government proposes to finalize the revisions to the current framework by Fall 2000 and implement the changes in early 2001.

Annex

Operational Considerations

The government is reviewing the operational issues involved with implementing the proposals. The key operational issues are related to collateral and settlement.

In terms of acceptable collateral, the principal requirements are that the collateral types have acceptable risk characteristics, and resource implications are manageable. In particular, collateral must be highly liquid, of acceptable credit quality, and have a transparent market for valuation. Certain types of collateral may be easier to manage on a same-day basis (i.e. accepted on the same day as funds are delivered) depending on the ease with which the securities can be valued. For example, the repo market tends to be dominated by transactions involving Government of Canada securities given their prevalence and liquidity. For some types of collateral, however, it might be necessary to consider an arrangement whereby participants would pledge collateral to the government on a standing basis and thereby be eligible to win funds up to the amount of collateral pledged, given that same-day valuation may be difficult.

With regards to settlement, it is expected that uncollateralized deposits would continue to settle via LVTS as per current arrangements. For collateralized transactions, it seems appropriate that the morning and afternoon auctions settle in a different manner. For the morning auction, same-day collateralized transactions should settle as delivery-versus-payment through the Canadian Depository for Securities (CDS), which is the standard structure for the repo market. This arrangement would not be possible for the afternoon auction given that it settles late in the day, after the 4:00 p.m. end of the DCS cycle. Therefore, a two staged settlement process, whereby securities are delivered “free” via CDS and funds are delivered via LVTS, would appear most appropriate. Such a two-staged settlement process might also be appropriate for any arrangement whereby market participants pledge collateral to the government on a standing basis.

It is also critical that operational failures do not occur, in particular during the afternoon auction, as this could cause a deviation in the actual LVTS setting from the setting desired by the Bank of Canada for monetary policy purposes. For example, if a market participant won funds at the afternoon auction but was unable to receive those funds due to an operational inability to deliver the appropriate collateral in a timely manner, LVTS would be left short of its desired setting, which could have implications for LVTS participants.

The government welcomes comments on these operational considerations and will be consulting further with market participants on these issues. The government is particularly interested in the assessment of market participants as to whether a facility whereby collateral is pledged on a standing basis would be advantageous from an operational perspective. The government will also be reviewing whether it would be more cost-effective and efficient to have a third party manage aspects of the settlement of the auctions in a collateralized regime.