Proposed repurchase program for the Bank of Canada’s holdings of Government of Canada securities

Discussion Paper

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Introduction

A number of initiatives have been undertaken in recent years to enhance liquidity in the market for Government of Canada securities. A repurchase (repo) program for a portion of the Bank’s portfolio of Government of Canada bonds and bills would be a further means of enhancing the liquidity, efficiency, and integrity of the primary and secondary markets. Market participants have suggested that the Bank consider implementing such a program.

Rationale and Objectives

The objective of a Bank of Canada repo program would be to enhance the liquidity of Government of Canada securities by augmenting the available supply of certain bonds and bills when there is material demand for these securities in the repo market. The Bank has significant ($500 million to $1 billion or more) holdings of many issues, particularly benchmarks. When certain securities are in short supply, such a program would make additional amounts of those securities available in the repo market. This, in turn, could improve the functioning of the marketplace and encourage a higher degree of liquidity in the secondary market for Government of Canada securities. An increase in liquidity would tend to increase investor confidence and promote broader market participation. Having a liquid and efficient market for Government of Canada securities is also important to the government and other borrowers in their financing activities, as well as to the Bank of Canada in the transmission of monetary policy.

A key issue for consideration is the appropriate level of repo activity by the Bank. The Bank’s intention would be to repo securities in a manner consistent with being a secondary source of securities, so that the Bank will not be a “price setter” in this market and will not alter the economic incentives for participants under “normal” market conditions. Such a program would not interfere with the normal activities of current lenders or discourage new participation in this market. The program would offer securities held by the Bank of Canada when market pricing moves beyond a specified point. The Bank would establish this hurdle rate, below the Target for the Overnight Rate, in a way that best meets the program’s objectives.

A number of other central banks lend or repo securities from their balance sheet. For example, in April 1999, the U.S. Federal Reserve initiated a revised securities lending
program. The program is intended to provide a secondary, and temporary, source of securities for the treasury-financing market and uses a hurdle rate of 150 basis points. At this rate the Fed is active on virtually a daily basis given the high degree of “specialness” in the U.S. Treasury market. The Bank has closely reviewed the Fed’s program and proposes to follow many of its operational procedures.¹ Other central banks or debt agencies, such as those in Australia and Sweden, have similar programs.

Program Parameters

The Bank is seeking comments on the following key parameters of the program:

i) Level of Bank of Canada Activity

A certain degree of specialness is expected to occur as part of normal trading, but when the shortage is more pronounced the Bank would make securities available from its portfolio. This approach would be consistent with the Bank acting as a secondary source of securities in the repo market. The intention is for the Bank to make securities available from its portfolio when a shortage exists, as determined by a specified threshold below the Target for the Overnight Rate. After the threshold is reached, the securities would be traded at a market rate as determined by bidding at a Bank of Canada repo auction.

ii) Eligible Counterparties

The Bank is considering providing access only to Primary Dealers. Primary Dealers are the dominant market-making force behind primary distribution and secondary market liquidity, and they are expected to have the strongest need for the securities in question. The Bank currently conducts certain repo operations with Primary Dealers (SPRA and SRA) and has agreements in place for these purposes.

¹ The original terms and conditions of the Fed’s program can be found at http://www.newyorkfed.org/pihome/news/announce/attachment1.pdf; subsequent revisions announced in September 1999 can be found at http://www.newyorkfed.org/pihome/news/announce/publictnc.html; Primary Dealer FAQs can be found at http://www.newyorkfed.org/pihome/news/announce/1999/an990907.html.
iii) Allocation by Auction

The Bank is considering an auction process using the Communication, Auction and Reporting System (CARS) to allocate its securities. The auction would be conducted after the normal peak trading period (perhaps at 11 am). An auction process has the advantages of being transparent and equitable.

iv) Use of Agents

It is possible that an agent will be engaged to manage the securities and the settlement of the repo transactions. The Bank of Canada uses agents in its lending operation for U.S. dollar securities held by the Exchange Fund Account, initiated in 1996. The agent relationship has minimized the need for significant investment in systems and other resources within the Bank. Overall, there are possible advantages to managing operations internally or through an agent, and the Bank has yet to decide on this aspect of the program.

v) Transaction Structure

The structure would make use of back-to-back repurchase transactions. The Bank of Canada would enter into a repurchase transaction, selling the special securities and receiving cash from its counterparty. The Bank would simultaneously enter into a reverse repurchase transaction with its counterparty; investing the cash at the Target for the Overnight Rate and receiving securities from the counterparty. Legal agreements, using the industry standard forms (modified as necessary), would be put in place with each counterparty to the repo transactions. Securities lending against acceptable instruments would be the more convenient framework, but under the Bank of Canada Act, the Bank is permitted to lend securities only to members of the Canadian Payments Association.

vi) Eligible Securities

The list of securities eligible to be sold to the Bank of Canada would be consistent with the securities listed under Section 18 of the Bank of Canada Act, namely bankers’ acceptances and Government of Canada and provincial issues and guarantees. Alternate transaction structures are being investigated as a possible means of broadening the list of eligible securities (with the goal of making this list consistent with the LVTS collateral list).
Draft terms and conditions for the repurchase program are attached.

**Consultation Process**

The Bank is seeking comments on the benefits or drawbacks of such a program for the market, as well as on the program parameters and draft terms and conditions. Comments on additional operational issues are also welcome. Comments must be received by 31 October 2001 and will be made public on the Bank’s Web site unless confidentiality is requested. The Bank will also arrange meetings to consult directly with market participants.

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Draft Repurchase Program Terms and Conditions

• Transaction structure: The structure will make use of back-to-back repurchase transactions. The Bank of Canada will enter into a repurchase transaction, selling the “special” securities and receiving cash from its counterparty. The Bank of Canada will simultaneously enter into a reverse repurchase transaction with the same counterparty; investing the cash at the Target for the Overnight Rate and receiving securities from the counterparty. Transactions will be conducted pursuant to repo agreements entered into with each counterparty based on the industry standard forms of agreements.

• Minimum bid: A hurdle rate will be established (defined as a spread between the Target for the Overnight Rate and the “specials” rate) and will represent the minimum rate at which the Bank of Canada will enter into transactions. Transactions will be done at a market rate as determined by bidding at a Bank of Canada repo auction.

• Terms to maturity: Repurchase transactions will be conducted on an overnight basis only. Transactions in which the securities are not returned the following day by the Bank’s counterparties will be considered fails. In addition to whatever remedies it has available under the repo agreement, the Bank of Canada reserves the right to suspend the participation in the repurchase program of counterparties that fail.

• Limit on Bank holdings available: A maximum (to be determined) of between 25 per cent and 45 per cent of the Bank’s holdings of a security will be made available for repurchase transactions. Only securities with at least two weeks to maturity will be eligible. The Bank will make available (on its Web site) details of its holdings of Government of Canada securities by issue.

• Access limits: Counterparties will be limited to 25 per cent of the amount of a security being made available for repurchase transactions and to $500 million in total Bank of Canada repurchase transactions outstanding. Net positions must be reported to the Bank of Canada as part of the allocation process. Counterparties that have net long positions in certain securities will not necessarily be restricted in bidding for those securities at a Bank of Canada repo auction. However, the Bank of Canada will expect counterparties with net long positions prior to the auction to relend securities awarded at auction. The Bank of Canada reserves the right to reject bids in whole or in part at its sole discretion.

• Failure to redeliver securities: If a counterparty fails to redeliver securities on the maturity
date, a fee will be assessed equal to the Target for the Overnight Rate.

• Auction process: Securities will be allocated on any business day based on competitive bidding at an auction. The auction will be conducted in a multiple-yield format, and dealers may submit up to two bids per issue. Bids will be accepted in declining order of yield (expressed in basis points) until the available securities have been allocated.

• Auction results: Auction results will be made available within 15 minutes of the bidding deadline.

• Modifications to terms and conditions: As the Bank of Canada gains experience with the repo program, these terms and conditions might be modified.