Bank of Canada initiative to allow substitution of Canadian-dollar non-mortgage loan portfolio for current LVTS collateral

This note briefly explains the Bank of Canada initiative to allow Large Value Transfer System (LVTS) participants to substitute their non-mortgage loan portfolio for current LVTS collateral, which is composed of marketable securities that have collateral value outside of the LVTS.

The purpose of this initiative is to temporarily provide LVTS participants with greater flexibility in managing their collateral. This, in turn, would support institutions' efforts to efficiently generate liquidity.

Acceptance of the non-mortgage loan portfolio on a temporary basis as collateral in the LVTS would enable institutions to use marketable securities that are now pledged to the LVTS for other purposes. That is, these securities could be pledged in the market to support borrowing, or they could be used in term PRA with the Bank of Canada. Further, this initiative would directly reduce the funding costs of LVTS participants by allowing participants to substitute their non-mortgage loan portfolio for current LVTS collateral.

The following are key considerations that apply to this initiative.

- This is a temporary arrangement, and can be terminated at any time at the Bank of Canada's discretion, should the Bank judge that financial conditions no longer warrant extraordinary facilities.

- The relevant loan portfolio to be taken as security for LVTS collateral is the non-mortgage, Canadian-dollar loan book to Canadian residents. For banks, this would be based on a specific regulatory report provided to the Office of the Superintendent of Financial Institutions (OSFI). More specifically, collateral value for banks will be based on the OSFI Return M4, Consolidated Monthly Balance Sheet, non-mortgage loans, less allowance for impairment, to individuals for non-business purposes, and to individuals and others for business purposes; that is, Section 1 (assets), lines 11(f) and 11(h). For non-bank LVTS participants, the relevant loan portfolio will be the same, as defined by reference to how those loans are reported to the participant's regulator.

- The Bank would provide a collateral-to-portfolio value of 60 per cent. That is, the collateral value provided by the Bank would be 60 per cent of the reported value of the loan portfolio, implying a haircut of 40 per cent. This is equivalent to the valuation indicated by the Bank for the temporary Y2K liquidity facility. A collateral-to-loan value of 60 per cent reflects the unique risks associated with accepting the non-mortgage loan book as collateral, including those related to valuation and to the costs of having to realize on those assets.

- Institutions would be able to dispose of, and otherwise deal with, the loans in the ordinary course of business, on customary terms.

- To assist the Bank in monitoring the changing value of the loan portfolio, institutions would be required to inform the Bank each time that dispositions of loans from the

portfolio, or other influences, result in a reduction of 5 per cent or more in the total book value of the portfolio.

To complete the arrangements necessary for the Bank to accept a non-mortgage loan portfolio as LVTS collateral, LVTS participants will be required to sign the appropriate legal documentation with the Bank of Canada. The Bank of Canada is providing the legal documentation to LVTS participants today (Friday, 17 October 2008).

Before the Bank will begin accepting a participant's non-mortgage loan portfolio as LVTS collateral, the Bank will also need to be assured that its security is registered in the personal property security registry of the participant's home jurisdiction, thereby giving the Bank a first priority security interest.

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