Remarks by Agathe Côté
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to the Association of Quebec Women in Finance
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Strengthening Financial Infrastructure: The New Canadian Central Counterparty

It gives me great pleasure to address the Association of Quebec Women in Finance.

You are all aware that we are once again in the midst of a period of heightened financial turbulence. This current episode reminds us—if that was necessary—of how important it is to have a robust financial system.

Today, I will briefly talk about the risks to which Canada's financial system is currently exposed. However, my main focus will be on a major step that we have taken to strengthen our financial system against future shocks.

I am referring to the new central counterparty service for repo transactions, which was launched on 21 February. This service, operated here in Montréal by the Canadian Derivatives Clearing Corporation (CDCC), is a key initiative designed to improve the infrastructure of Canadian core funding markets.

Recall that our short-term funding markets, like those of many other countries, were severely battered in 2008. These markets are not immune to further turbulence, so it is important that we take measures to increase their resilience.

CDCC worked closely with the Investment Industry Association of Canada, stakeholders in the financial industry, the Bank of Canada and other regulatory authorities to create this new central counterparty.

However, much remains to be done. It is my hope that, by the time I conclude my comments, you will have a greater understanding of why it is essential that we continue with the next phases of implementation, in which the volume of transactions and the number of participants with access to the counterparty will be expanded.

Risks Presented in the *Financial System Review*

But first, let's talk about risk. Today, the Bank of Canada is releasing the latest issue of its *Financial System Review*, in which it analyzes the principal risks weighing on our country's financial system.

I am sure it's not news to you that these risks remain high.

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After a period of calm earlier this year, global financial conditions have deteriorated markedly in recent weeks as the debt crisis in Europe has intensified. Markets are skeptical about the capacity and resolve of policy-makers to address unsustainable fiscal situations, the capital adequacy of some euro-area banks and the underlying balance-of-payments problems within the euro area. If these issues are not dealt with in an orderly way, the contagion effects on global financial conditions could be significant.

While less urgent than the situation in Europe, the risks surrounding sovereign debt are also affecting other regions. In particular, in the United States the spectre of a “fiscal cliff” looms over that country’s prospects for growth.

More generally, weakness in global demand that is partly due to international current account imbalances continues to represent a major source of risk.

Moreover, in several advanced economies, keeping policy rates low over an extended period of time may stimulate excessive risk-taking.

Here in Canada, the high level of indebtedness and the potential for a correction in the housing sector are the principal domestic risks facing the financial system. As well, the fragile situation abroad increases the probability of a negative shock to the incomes and wealth of Canadian households.

To date, the crisis in Europe has had a limited impact on our financial system. Canadian markets have remained relatively stable, and our banks continue to have good access to wholesale funding markets. Nonetheless, a deterioration in the situation could have a considerable effect on Canada through trade, confidence and financial channels.

Even though our financial system is solid, it is important to take further steps to bolster its ability to absorb shocks. The creation of a central counterparty for the repo market is a step in that direction.

With your permission, I will now turn to the crucial role played by the repo market in Canada.

The Repo Market

Repos—transactions that involve selling a security while concurrently committing to repurchasing it at a later date for the sale price plus interest—are the economic equivalent of secured loans.

Investment dealers and banks use the repo market as a source of low-cost secured financing to fund long positions and hedge short positions on securities. These activities allow market-makers to generate liquidity for the broader financial system and maintain liquid secondary markets. Other institutions, such as insurance companies and pension funds, also use the repo market as a tool to manage cash balances.

Since a very large proportion of repo transactions are short term, the turnover rate in this market is high. These transactions provide the immediate margin of adjustment for financial institutions' funding structures.

To give you a sense of magnitude, on 30 March 2012, the repo positions on the securities of Canadian banks were valued at a total of Can$90 billion (approximately 5 per cent of their Canadian-dollar-denominated assets). Government of Canada securities provided the underlying collateral for almost 70 per cent of transactions. Hence, the repo market supports the functioning of crucial cash markets.

In sum, the repo market is considered a core funding market in Canada, because it represents a major source of funds for financial institutions. In addition, there is no immediate substitute for this market, so if it were to cease operating, significant contagion would likely result.[1] This is why we must make every effort to ensure that it remains continuously open.

Risks Brought to Light by the Crisis

During the financial crisis of 2007–08, weakness in the infrastructures of some financial markets contributed to uncertainty and, although not the cause of the crisis, intensified the systemic risk.

This was notably the case in repo markets. In fact, participants' uncertainty about the valuation of collateral and the network of bilateral exposures among financial institutions exacerbated their aversion to counterparty risk, to the point that many reduced the number of trades and, in some cases, even left the market.

Recall that illiquidity in the repo market was an important contributor to the near-collapse of Bear Stearns in March of 2008.

Repo markets in Canada suffered a severe liquidity crunch in the autumn of that year. Following the bankruptcy of major financial institutions abroad, concerns about counterparties spread, and balance sheets were subject to severe strains. In the absence of a CCP that would allow its members to ease their balance sheets through balance-sheet netting, banks drastically curtailed their repo activity.

The crisis clearly demonstrated the need for action to bolster the resilience of this market.

In Canada, the Investment Industry Association of Canada, with the support of the Bank of Canada, issued a request for proposal for the development of CCP services for repos. In December 2009, CDCC was selected to provide these services.

The CCP for Repo Transactions and Risk Management

How does this central counterparty work?

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[1] J.-S. Fontaine, J. Selody and C. Wilkins, “Improving the Resilience of Core Funding Markets,” Bank of Canada *Financial System Review (*December 2009): 41–46.

Put simply, a central counterparty functions as an intermediary in financial transactions. Through a legal process called “novation,” it becomes the buyer for every seller and the seller for every buyer.[2]

In other words, a very complex network of bilateral exposures is replaced by one exposure to a hub, the central counterparty. This process does not, however, eliminate risks– risks that are now concentrated in a single institution. As a result, for a central counterparty to contribute to reducing systemic risk, it must have solid risk-control mechanisms in place and be subject to rigorous oversight.

CDCC has implemented mechanisms to manage the various risks confronting it, notably, legal, operational and financial risk. With regard to financial risk, controlling both credit and liquidity risk is key to containing overall counterparty risk in the system.[3]

The legal rules that govern CDCC’s management of defaults, together with the financial resources available to it for addressing credit risk and liquidity risk, enhance the stability of the repo market by ensuring an orderly winding down in the event that a major institution defaults, while also ensuring that all novated transactions are settled.

During the crisis, the benefits of a central counterparty became apparent with the bankruptcy of Lehman Brothers. Thanks to the participation of Lehman in a central counterparty for derivatives, its positions on interest rate swaps—which were enormous (US$9 trillion and more than 66,000 transactions)—were unwound in an orderly and timely fashion. Thus, the market for interest rate derivatives—another core market—continued to function smoothly despite the Lehman collapse.

The Role of the Bank of Canada

In light of the crucial role played by this central counterparty service in the efficient functioning of the repo market, the Bank of Canada considered that the Canadian Derivatives Clearing Service (CDCS) might pose a systemic risk, whereupon it designated the CDCS under the Payment Clearing and Settlement Act. Consequently, CDCS has been subject to oversight by the Bank since 30 April 2012.

The Bank’s oversight process includes reviewing significant changes to both the system and its operating rules, reviewing the results of audits, and defining standards.

In carrying out its oversight mandate, the Bank works closely with the relevant financial market regulators, the Autorité des marchés financiers and the Ontario Securities Commission.

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[2] N. Chande, N. Labelle and E. Tuer, “Central Counterparties and Systemic Risk,” Bank of Canada *Financial System Review*, (December 2010): 43–50.

[3] P. Chatterjee, L. Embree and P. Youngman, “Reducing Systemic Risk: Canada’s New Central Counterparty for the Fixed-Income Market,” Bank of Canada *Financial System Review* (June 2012): 43–49.

This oversight will soon be based on new international standards developed with the participation of the Bank. It is worth noting that lessons learned during the creation of Canada's central counterparty for repo transactions were very useful in the development of these new standards.

Implementation of the Central Counterparty

The metaphor frequently used by the industry to describe the financial system infrastructure is simple and appropriate: it's called "plumbing." Why? Because it is essential to the viability and efficient functioning of markets.

As for our financial system, the plumbing is quite complicated.

Hence, developing this new infrastructure took a great deal of time. It is a complex process, in terms of both creating and implementing adequate and robust risk- control mechanisms. Moreover, time is required to resolve operational issues, such as the development and testing of required software for both the central counterparty and the participants, and issues associated with the interaction between new software and existing systems.

The launch of the first phase of the service therefore represents a major step. But much remains to be done. Delivery will take place in three phases. Phase one deals with bilateral repo transactions on a single Government of Canada security, although these represent only a small fraction of the market.

Phase two, planned for the end of this year, will incorporate cash transactions on fixed-income securities and repo transactions negotiated by intermediaries, including those with anonymous counterparties.

Finally, phase three, proposed for 2013–14, will target general-repo transactions in which any security in a predetermined basket of instruments can serve as collateral. The introduction of this last phase is expected to significantly increase the volume of trades made through the central counterparty, as well as the liquidity and efficiency of the repo market.

International Efforts to Mitigate Risk in Short-Term Funding Markets

In Canada, the creation of a central counterparty will contribute significantly to limiting the risk of instability emanating from the repo market.

At the international level, the Financial Stability Board is currently assessing potential reforms of repo markets and for loans of securities in the context of its work on the shadow banking sector.[4]

The repo market is part of this sector because it is a form of credit intermediation which, like banking intermediation, rests on maturity transformation and may include leverage effects.

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[4] Financial Stability Board, "Securities Lending and Repos: Market Overview and Financial Stability Issues," Workstream on Securities Lending and Repos, Interim Report of the Shadow Banking Workstream 5, 15 March 2012.

There are a number of possible reforms.

One of the specific measures under consideration is the increased use of central counterparties. Another promising avenue addresses the regulation of margins to mitigate the problems associated with procyclicality. Adopting minimal, or countercyclical, margins could help to curb excessive leveraging during periods of exuberance and lessen the extent of a disruptive curtailment of leveraging during difficult periods.

Moreover, increased use of central counterparties for repos could facilitate the implementation of this type of regulation.

Conclusion

It was my intention today to talk about risks, but even more to shed some light on the significant strides taken in Canada to improve the resilience of our financial system. One tangible, and local, example of this progress has been the creation, right here in Montréal, of a central counterparty for repo transactions.

Transactions executed by this counterparty are completely transparent and well capitalized, and there are rules and procedures in place in the event of default. Today, Canada's experience is benefiting other countries and authorities.

However, it’s worth emphasizing that it was the willingness of the private and public sectors to work together that led to the creation of this counterparty. It is essential that this spirit of co-operation be maintained, because much remains to be done. The success of this counterparty depends on the subsequent phases of implementation, which will broaden its sphere of influence.

We will never have a risk-free financial system. That’s why we need to take measures to render it more resilient to shocks that may occur, either from abroad or domestically.

Let us make the financial system stronger to build a more stable future.

Thank you for your attention.