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Initiatives to enhance GoC market functioning

April 9, 2019

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Presentation outline

- This deck covers the following:
  - An identified issue: There is a market inefficiency, a price cap, in the market for borrowing securities
  - A possible solution: Introducing a minimum cost for failing to deliver GoCs, along with other potential policy measures
  - A proposal for an in-depth workshop in May to flesh out the salient issues (nominations to be sought)

Evolving policy measures aimed at improving the functioning GoC debt markets

- To maintain a well-functioning market for GoC securities, the Department of Finance (DoF) and the Bank regularly review its issuance structure and policies.

- Set of policy changes aimed at enhancing the functioning of GoC markets:
  1. Introduction of the Bank's Securities Lending Program (SLP) (2002)
  2. Updates to the SLP (2015);:
     - a new intervention threshold, to provide greater private sector incentives to lend;
     - allowing partial settlements, to support borrowing from the SLP;
  3. Reduced Bank purchases at auction (2015) from 20% to 13% takedown; allowing much larger benchmark float;
  4. Gradual annual GoC bond issuance adjustments, or mid-year (e.g., in response to bill market stress in 2018).

Potential issue with GoC SFT and cash market functioning…

- The market for securities financing transactions (SFTs) is a "core" funding market, supporting cash market liquidity and helping investors engage in trading strategies.(1)
  - SFTs provide a means to borrow and short-sell a specific security for market-making and hedging purposes.

- **Issue** – current market convention for settlement fails is not well-suited for a low rate environment:
  - Can "delay settlement to the next day and maintain the original terms of the transaction"
  - Implies that the opportunity cost of delaying is the foregone interest at the overnight rate.

(1) See Fontaine, Garriott and Gray (2016), Securities Financing and Bond Market Liquidity.

… leads to an impaired price mechanism that could inhibit market functioning

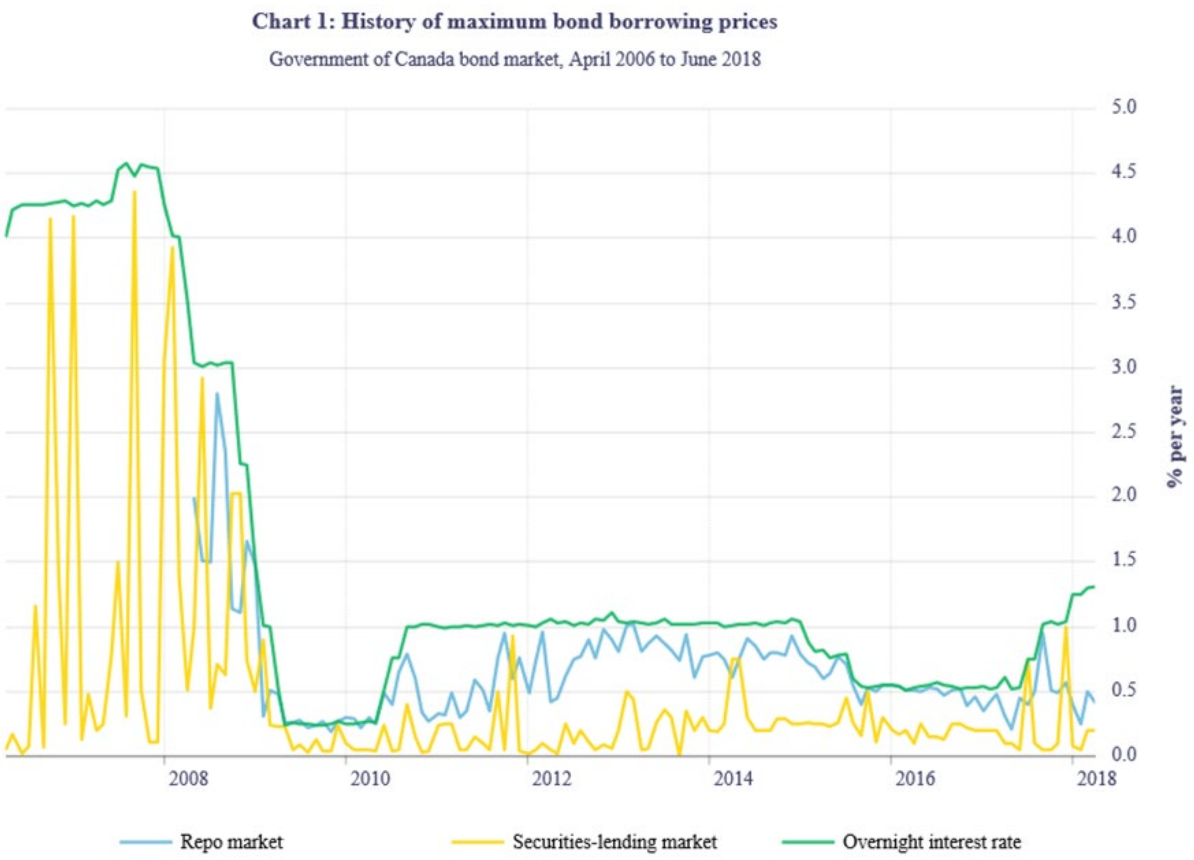
- In a low interest rate environment, there is an *inefficiency* that becomes apparent as securities borrowing costs of bonds fail to adjust with scarcity:
  - ➡ No financial incentive to pay more to borrow than the (low) opportunity cost of failing.
  - ➡ The price mechanism that signals bond scarcity can break down.

- In turn, an unreliable price mechanism could affect market functioning by:
  - ➡ Impairing market clearing and discouraging participation in the SFT market;
  - ➡ Diminishing the efficient allocations of securities in the GoC cash market,
  - ➡ Negatively affecting broader markets, e.g., by reducing traders' abilities to effectively use GoC benchmark bonds to manage interest rate risk.

Illustrating the issue: 1. A price cap exists in securities borrowing markets

- Borrowing prices are generally at or below the green line (representing the O/N rate).

- **The O/N rate can act as a price cap** and restrict the range of prices to borrow bonds. (2)

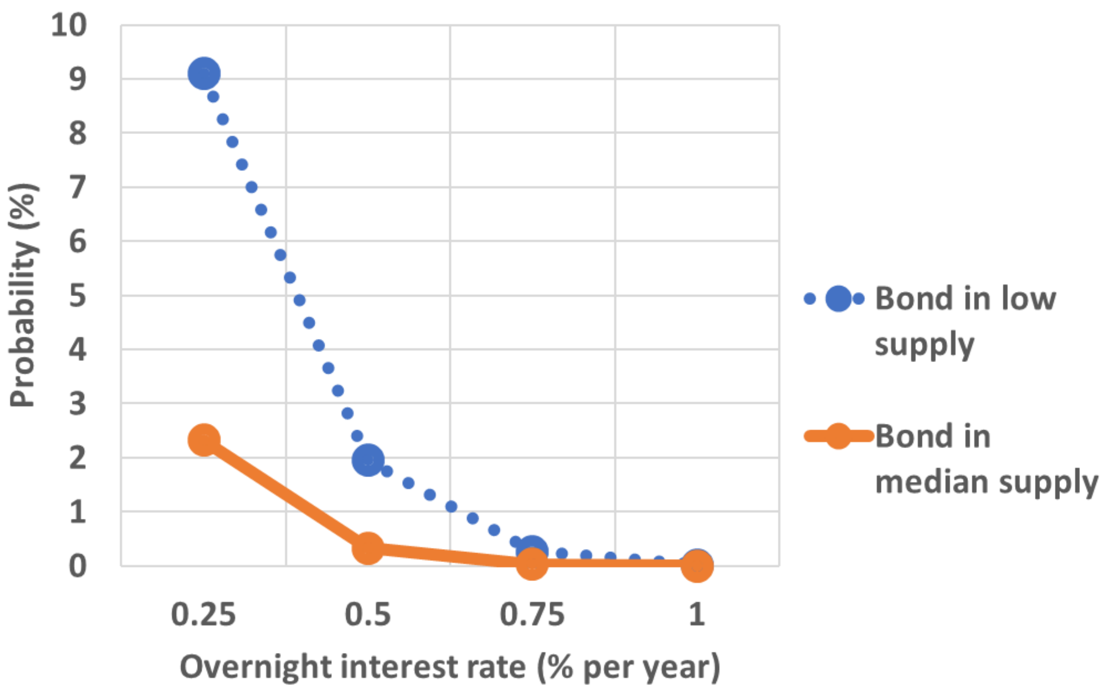


(2) See Berger-Soucy, Fontaine and Walton (2019), [Price Caps in Canadian Bond Borrowing Markets](#).

Illustrating the issue: 2. Price cap more likely to bind (i.e., limit the cost of failing) when rates are low

- The probability of borrowing prices being capped is higher **when the overnight rate is lower**.
- The probability of borrowing prices being capped is higher **for relatively scarce bonds**.

Probability of repo borrowing prices being close to the price cap



Potential solution: raise the price cap

- An explicit minimum cost for failing can lift the cap on prices when the *implicit* cost of failing to deliver a security (as proxied by the O/N rate) is low.

- When O/N rates are low, a minimum cost can enhance market well-functioning by allowing for a wider range of borrowing prices in the specific repo market.
  - This would encourage holders of securities to lend their inventory.

- To date, many jurisdictions (incl. the US, EU, and Japan) have put in place different forms of minimum costs for failing to deliver on-time.

Implementation considerations and complexities

- To be most effective, *the minimum costs should be faced by key market participants:*
  - Would require in-depth conversations with FMIs and market participants;
  - May need additional measures to promote the broad adoption of a minimum cost of failing.

- The minimum cost mechanism would need to be carefully calibrated.

- Additional policy measures to complement the minimum cost could include changes to the Bank's SLP to make securities more readily available.

Proposal for discussion: In-depth workshop

- **Location and time**: Toronto, May 2019 (details TBD),

- **Objectives**:
  1. to present policy analysis and research since the 2015 consultations;
  2. to have an in-depth dialogue on the considerations for implementation and broad adoption of a minimum cost of failing.

- **Chairs**: Co-chaired by a BoC and industry representative

- **Participation** (20-25 participants):
  - BoC, DoF, CDS, IIROC and relevant stakeholders (PDs and clients, custodian banks)

Appendix

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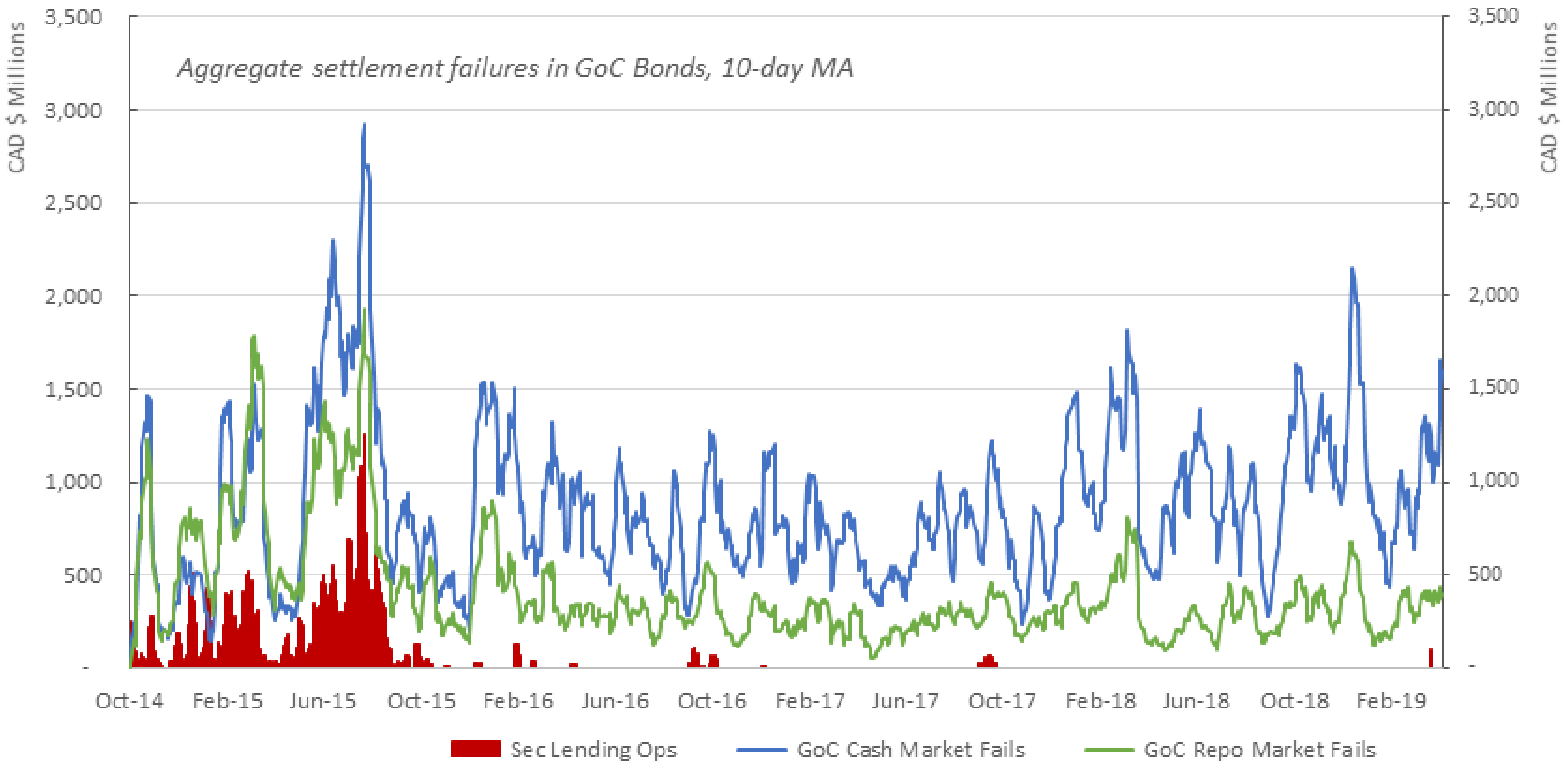
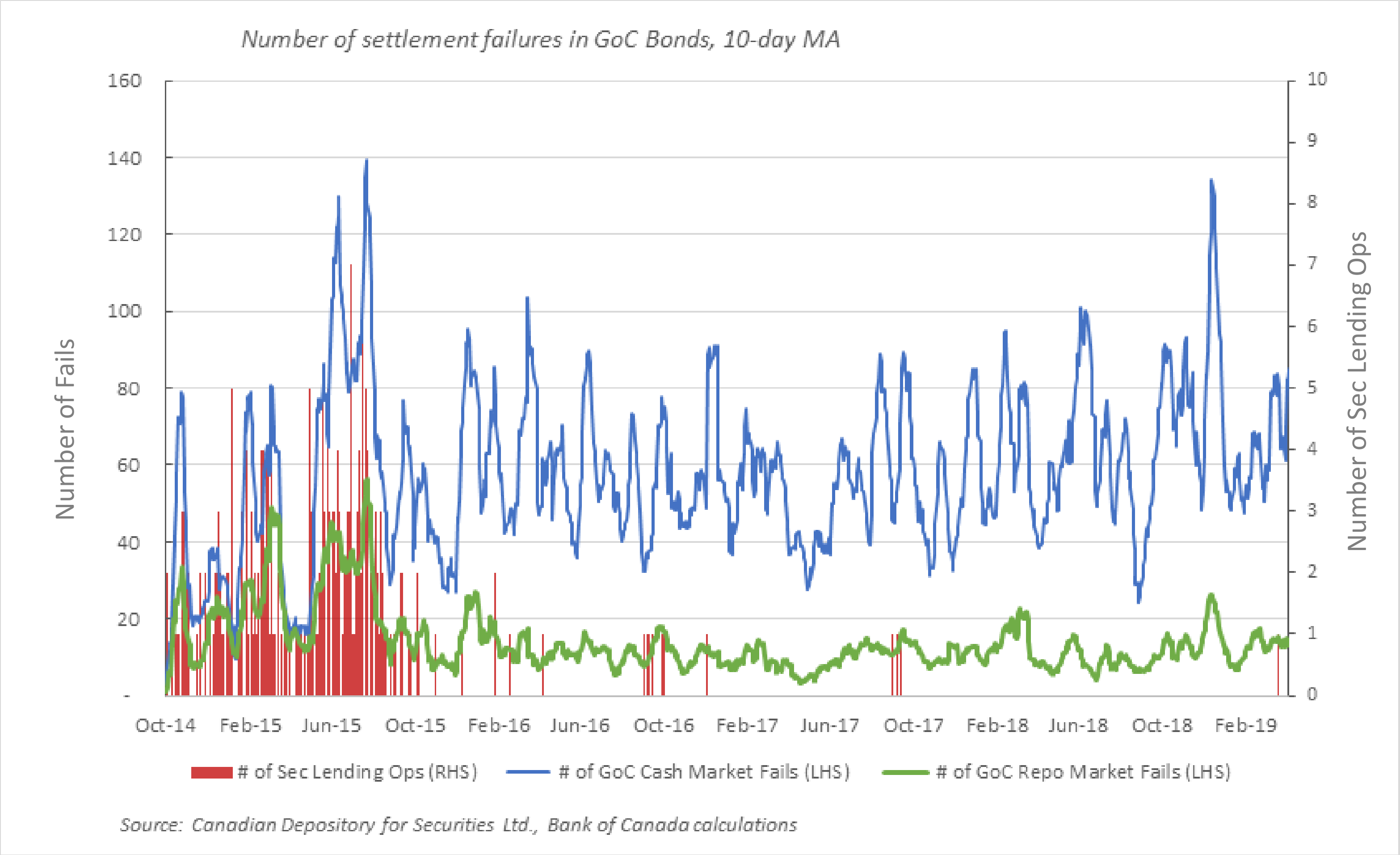
Fails do happen in Canada – volume of fails



Source: Canadian Depository for Securities Ltd., Bank of Canada calculations

Fails in both GoC cash and repo markets tend to spike at the same time

Fails do happen in Canada – number of fails*



*The chart may overstate the actual number of fails, because large trades in CDS are divided into lots of $50 million.