



GoC market functioning framework – industry outreach

Oct 16, 2019

Overview

- ❖ At the last meeting, CFIF agreed that the Bank reach out to participants of the GoC market functioning workshop:
 - To elicit considerations for a framework to support market functioning in a low rate environment.
 - To assemble a more comprehensive picture of settlement frictions in GoC markets.

- ❖ The Bank visited market participants in Montreal and Toronto, including:
 - Pension funds
 - Asset managers and hedge funds
 - Custodians
 - A prime brokerage

Main themes from outreach

1. Nearly all market participants see the benefits of a framework that supports market well-functioning in a low-rate environment.
2. The framework's fail fee component could also promote market discipline in other interest rate environments.
3. Design and calibration of the framework's components (including a fail fee) would need to be appropriate to the Canadian marketplace.

Theme 1: Market participants recognize that a fail fee could help support market functioning in a low-rate environment

- ❖ Market viewed as functioning well in the current environment.
 - Demand for securities met by lendable supply, lenders' hurdle rates low and stable.
- ❖ But acknowledgment that this could change at very low or negative rates.
 - Lenders may potentially be unwilling to lend (scarce) bonds if:
 - The special spread cannot adjust due to cap (as outlined in previous presentation to CFIF), and securities demand no longer easily meets lendable supply;
 - Fails were to rise materially.
 - Implication: activities such as shorting GoCs could become difficult.
- ❖ Recognition that fail fee can raise the cap on the special spread, promote the supply of securities, and help maintain a continuous market for shorting securities in low-rate environments.

Theme 2: A framework could help promote settlement discipline in other interest rate environments

- ❖ Market participants think a fail fee would improve settlement discipline in low rate environment.
- ❖ But market participants also see the possibility for a fee to improve market discipline outside of low-rate environments.
- ❖ Improved discipline can lead to better outcomes, especially for smaller market participants with low transparency into the settlement process:
 - Currently, those without access to straight-through processing may not have a good view into what will settle until late in the day, and may be more exposed to potential fails.

Theme 3: A framework would need to be carefully designed, calibrated and applied

Participants highlighted that:

- ❖ The fail fee level and conditions that activate it are not necessarily carbon copies of other jurisdictions' approaches.
- ❖ Consistent and symmetrical application of the framework across market participants and transaction types is needed.
- ❖ The fail fee framework and the associated policies should be designed to limit the market power of holders of securities:
 - Some tools already exist for certain types of market participants.
- ❖ Bank of Canada should, in the context of implementing a fail fee, review the role of securities held on its balance sheet.

Potential considerations for an implementation blueprint of the framework

- ❖ How to achieve broad market coverage and consistent impact?
- ❖ How to modify existing settlement infrastructure for fee calculation and broad application, and whether new infrastructure is needed for payments?
- ❖ What would be the fail fee level and should there be a trigger?
- ❖ What additional measures (such as rule changes) can alleviate implementation concerns, including about concentrated ownership of securities or general shortages?
- ❖ How could the Bank of Canada's securities lending facility contribute to market functioning with a fail fee?

Discussion on next steps

- ❖ Outreach participants acknowledged that setting up and calibrating the framework in advance is preferable to rushing measures into place during a time of stress.
 - Should further steps towards designing a framework be taken?
 - If so, should design and calibration (an “implementation blueprint”) reflect views from a broad set of stakeholders? How would the work best be steered (e.g., by a CFIF industry working group similar to CARR)?
 - Would another CFIF workshop (similar to the May 28 workshop) be well-suited for drawing out the design considerations for the framework’s key components?