# Workshop on Collateral and Securities Financing Markets in Canada

May 26, 2021

**Background:**

Collateral and securities financing markets are the backbone of securities markets. These markets support a wide range of activities including funding and market liquidity, margin and regulatory liquidity requirements, protection against counterparty credit risk, dealers' market making activities, and for any other collateralization requirement arising in the course of doing business. Market participants are striving to better utilize collateral within the firm, improve collateral mobility across business lines, establish new sources of securities financing and develop access to collateral up- and downgrading. Collateral markets thus link many business lines and technology systems which makes them operationally intensive and expensive to develop and support.

Workshop goal was to **identify potential improvements** in the functioning of the collateral and securities financing markets for Canadian fixed-income assets and to surface new issues/trends for CFIF members to consider.

There were over 40 participants representing various functional areas at banks, asset managers, custodians, agent lenders, infrastructure providers, and the Bank of Canada.

**Workshop Summary:**

1. Participants indicated that although the Canadian market has sophisticated institutions and is generally well-developed, Canada's collateral and securities financing infrastructure has material gaps and is behind other countries in several areas
2. Potential areas of improvement raised at the workshop included:
    i. Improving interconnectedness, standardization, and automation of securities flows between domestic collateral pools, including with cash trade settlement, to facilitate easier collateral movement
    ii. Unlocking collateral by
        - creating general collateral baskets
        - setting up better infrastructure for reuse and rehypothecation of collateral
        - encouraging adoption of NHAMBS and other non-Government of Canada securities as eligible collateral
        - promoting Canadian assets in foreign markets
    iii. Improving cross border securities flows
    iv. Expanding central clearing, where possible
3. Participants agreed that strong industry cooperation is needed to achieve the above goals

## 1. Canadian infrastructure is significantly behind other countries

- Canadian securities market (repo, securities lending, derivatives and cash trading) is well-developed and consists of sophisticated institutions with strong in-house trade processing and risk management systems. However, there is no common infrastructure in Canada to connects different collateral pools, trade types and market participants in a highly automatic and efficient way.
  - Collateral landscape is fragmented consisting of bilateral trades, centrally cleared trades, custodians, agent lenders, private sector tri-party systems, payment system, security clearing system and central bank operations
  - Unlike most foreign markets Canada does not have traded and settled general collateral baskets[1]
  - Settlement and collateral management flows require a relatively high level of manual processing / intervention
- Most popular asset types such as government securities are used across collateral pools and to cash settle regular trades. These two categories of securities flows suffer from the lack of substitution and standardization between each other. Connectivity between collateral pools and linking these pools into the cash settlement world is needed to unlock collateral and improve the velocity of collateral in the market.
- This gap in common infrastructure is in contrast to small (Australia, Switzerland) and large (US, Europe) markets that rely on significantly more developed collateral and securities financing infrastructure. In each example there is good public and private sector co-ordination on an infrastructure level to solve these problems (Reserve Bank of Australia & Australian Securities Exchange, Swiss National Bank & Swiss Stock Exchange, etc.)
- This lack of efficient infrastructure leads to:
  - a-synchronicity between collateral and settlement needs which causes delays, inefficient and costly non-cash settlement and potentially settlement fails in some circumstances
  - reliance on manual processing
  - bottlenecks and delays in the flow of securities
  - inefficient movement of collateral across domestic collateral pools
  - limitations for optimizing collateral usage within a firm
  - overall higher costs of collateral management
- Given the current challenges, how will the possible future developments be impacted by the infrastructure gap:
  - industry practice changes such as T+1 settlement
  - innovative technology such as tokenization for settlements
  - liquidity crises requiring rapid re-sourcing of securities financing

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[1] General collateral consists of many securities satisfying some criteria such as securities issued by the federal government. This is in contrast to specific collateral that is limited to a particular security.

## 2. Improve interconnectedness between domestic collateral pools

Interoperability is key to unlocking the benefits of the connected ecosystem. It is important for the 'rails' to connect collateral pools, unlock unlimited movement and substitution of collateral and to connect collateral and cash settlement obligations. Participants expressed the need for a market-wide centralized tri-party service (see poll question 4) that would improve interoperability and interconnectedness between major domestic collateral pools.

- This is a popular setup in many other foreign markets and experience shows that it works well.
- A centralized domestic tri-party service should create rails to connect major collateral pools including bilateral transactions, cleared transactions, central bank operations, custodians, agency lenders and interoperating with private sector tri-party services, and major financial institutions.
- Such service should bring significant operational efficiencies based on standardization of communication protocols and collateral schedules, automation of trade flows, real-time risk and settlement monitoring, offering unlimited substitutions, processing corporate actions, providing reliable legal structure to deal with defaults, etc
- The service should allow for creation and management of general collateral baskets
- The service will also bring significant operational improvements for processing hard to price and value collateral such as NHAMBS

## 3. Unlocking collateral

Participants argued that existing inefficiencies, including having multiple distinct collateral pools/systems, and accumulation of assets on central bank balance sheets create the need to unlock more collateral and utilize collateral more efficiently.

- Sometimes a firm owns collateral but it is unable to utilize it in time due to technologically slower counterparty for bilateral trades, certain operational limitations of custodial services, and differences in technology, automation, processing time, cut-off times, etc between major collateral pools.
- Participants encourage wider adoption of NHA-MBS as eligible collateral. This will require a multi-pronged approach that may include restructuring the security for ease of processing, increased trading to provide better price transparency, improved understanding (marketing) of the product especially abroad, including them in general collateral baskets, enabling service providers to process this security type, broaden ownership of securities
- In some cases foreign investors treat provincial securities as corporate securities for collateral purposes. Some education may be needed to change this practice.

### 4. Improve cross border securities flows and expand central clearing

Most Canadian financial firms are active in both domestic and foreign securities markets. Participants noted (see poll question 1) that cross border collateral and securities financing flows represent a significant operational challenge, e.g. due to different cut off times and connectivity between systems.

- However, it was noted that domestic infrastructure should be improved first as a necessary condition for improving cross-border flows.
- Central clearing brings certain operational efficiencies via novation, netting and standardized processing protocols. The benefits from clearing increase with number of participants. Specifically, it was noted that the Bank of Canada should consider joining CDCC and that cash trade settlement should also be centrally cleared.

### 5. Strong industry coordination is needed

Workshop participants unanimously indicated that strong industry-wide cooperation is required to improve existing infrastructure and implement future technological innovations (see poll question 3) given the substantial work/cost involved.

- While individual firms continue to make technological improvements for in-house systems, certain areas of market-wide infrastructure can only be improved by coordinating efforts.
- Experience of other countries suggests that cooperation is needed across market participants, infrastructure providers and public sector institutions including the central bank.

### Potential next steps

1. Seek support from the industry to form a Working Group on improving collateral mobility, interconnectedness between domestic pools flows.
    - define areas for improvement and prioritize
    - facilitate industry cooperation
    - seek industry consensus on how general collateral baskets can be created
2. Explore options to improve eligibility of Canadian non-government collateral in foreign and domestic markets
    - promote adoption of NHA-MBS as eligible collateral, potentially in partnership with CMHC and MBS Issuer Association
    - review options to improve price transparency and liquidity

# Appendix 1: Workshop participants

Bank of America Merrill Lynch
Bank of Canada
BMO
BNP Paribas
CAAT Pension
Caisse de dépôt et placement du Québec
Canadian Derivatives Clearing Corporation
Casgrain & Company Limited
CIBC Capital Markets
CN Investment Division
CPP Investment Board
Credit Benchmark
Department of Finance Canada
eSecLending
Euroclear
Fiera Capital
Health Care of Ontario Pension Plan
National Bank Financial
Ohio Public Employees Retirement System
Public Sector Pension Investment
RBC Capital Markets
RBC Investor Services
Scotiabank
State of Wisconsin Investment Board
State Street
TD Asset Management
TD Securities
TMX Group
Trans-Canada Capital Inc.