CANADIAN FIXED INCOME FORUM

November 2022

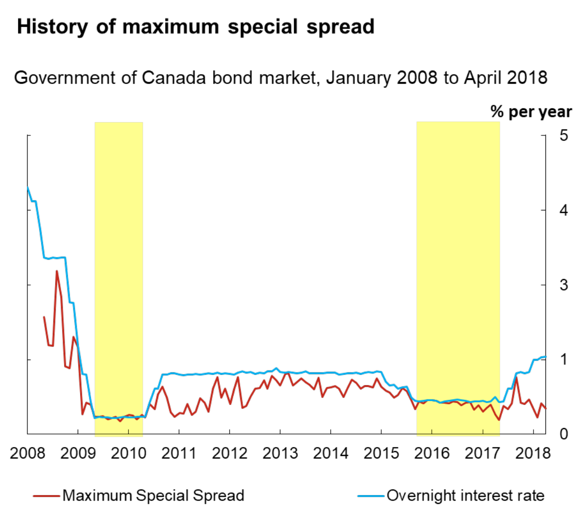
Companion FAQ: Consultation on the potential implementation of a fee for failing to settle Government of Canada bond and T-bill trades

1. Background

Q1: Why recommend the introduction of a fail fee in the GoC market? Is there a problem with fails?

- The main purpose of the fail fee is to act as an insurance policy. It preserves an economic incentive to deliver securities in a zero/negative interest rate environment, when the incentive normally provided by the overnight rate vanishes.
- Bank of Canada's research showed that the overnight rate has capped the specials spread in Canada[1]. Chart A.1 demonstrates that the overnight rate can:
    - Act as a price cap in the securities financing market
        - The maximum specials spread is below the overnight rate in chart
    - Compress the range over which the specials spread can adjust
        - The cap is more binding the lower the overnight rate is (yellow shading)
        - When the overnight rate is zero the cap is also zero

Chart A.1



[1] See Berger-Soucy, Fontaine and Walton (2019), Price Caps in Canadian Bond Borrowing Markets for the complete analysis. https://www.bankofcanada.ca/2019/01/staff-analytical-note-2019-2/

- The GoC market is not currently experiencing large and persistent fails. The calibration of the fail fee takes this into account by having only a de-minimis amount in effect, unless fail rates rise persistently and trigger the dynamic component.

Q2: Is the goal of the fail fee to eliminate fails?

- The fail fee is intended to preserve an economic incentive to deliver securities around the effective lower bound, not to eliminate fails.
- While a fail fee would help to encourage efficient settlement practices, separate work by the Complementary Policies Working Group has identified potential operational frictions in the GoC market and proposed ways to address them.

Q3: Will a fail fee create incentives to "extract" the fee from counterparties?

- A fail fee in and of itself does not encourage hoarding of securities, but restores the opportunity cost of failing. The fee facilitates special repos trading below the current soft floor of 0%.
- Hoarding can also happen in the absence of a fail fee as the overnight interest rate acts as the de-facto fail fee, e.g., when interest rates are high and hoarders could attempt to extract a sizeable special spread.
- Existing rules (such as IIROC DMR 2800: Trading in Wholesale Domestic Debt Markets) already prohibit manipulative practices, such as "artificially increase or decrease trading prices", or "abusing market procedures or conventions to obtain an unfair advantage". The IIROC rule applies directly to dealers and indirect auction participants and is also intended as a code of conduct for other market participants.

2. Blueprint of the GoC Market Functioning Framework

Q4: Were any other features considered in the development of the Framework?

- The table below lists other features that were considered for the fail fee component, but were not proposed for adoption:

Feature	Description	Assessment
EU-style static fee	• De-minimis static floor	• Does not provide much "insurance" in a stressed environment
Multi-level static fee	• A baseline static fee that gets ratcheted up or down with changing market conditions	• Requires substantial up-front governance on the ratchet mechanism • Frequent adjustments operationally cumbersome
US-style dynamic fee	• Fee adjusts with overnight rate, providing a 3% minimum total incentive to settle	• 3% may not be the right amount in Canadian context; dynamic nature necessitates more frequent updates
Grace period	• Fail fee could be applied only after a transaction fails to settle for multiple days • Avoids taxing operational fails	• In cash market, fails beyond one day are more common, so exempting 1-day fails provides only limited relief • Complicates the calculations for a limited benefit
"Name-and-shame"	• Governance Group monitors fails and provides a list of "failing entities"	• Raises confidentiality concerns for both the monitoring of entities and the dissemination of a list

3. Fail fee calibration

Q5: Why should a fail fee be introduced now when there is no problem? And why would the fail fee not be turned off completely in times when the market is functioning well?

- The timeframe for implementing a fail fee in a structured way could take more than two years, including its design, building the appropriate billing processes and controls, as well as establishing its governance and making any necessary rule changes. Therefore, it would be difficult to implement in quickly, in a structured way, if a fails issue arose.
- In addition, to ensure market participants' operational readiness, it would be preferable to begin the practice during calm times and address any potential issues then. The introduction of the TMPG fails charge in the US has been generally well-received by market participants, but it took many months to iron out initial glitches.
- Relatedly, turning the fail fee on and off would introduce "toggle risk": Stopping and restarting the practice would risk the loss of participants' "muscle memory", and would introduce uncertainty in the marketplace. As a result of this the US recently changed their fail structure to include a permanent fee irrespective of the level of US overnight interest rates.

Q6: What would happen when the warning threshold for the dynamic component is breached?

- The Framework's Governance Group would be informed and a 4-week monitoring cycle would start
- On behalf of the Group, the BoC would alert market participants that activation of the dynamic component could be imminent
- Market infrastructures (at minimum CDS) would also be informed

Q7: What if the trigger threshold for the dynamic component is subsequently breached?

- Similar to the activation of the warning, the BoC, on behalf of the Governance Group, would inform market participants of the activation of the dynamic component (incl. its effective date)

Q8: What if fail levels drop below the warning level without triggering the dynamic component?

- The BoC would notify market participants of the cancellation of the warning at the end of the 4-week cycle

Q9: What if fail levels do not drop and the trigger threshold for the dynamic component is not breached? Could the 50bp floor be changed?

- The BoC would renew the warning after 4 weeks, and issue would be further considered by the Governance Group
- 50bps was deemed an appropriate level for the floor. However, the calibration of the framework could not take into account all possible eventualities. Should there be issues with market functioning, the

framework's Governance Group could change the level of the fail fee with the approval of the Canadian Fixed Income Forum (CFIF).

4. Trial period for the framework

Q10: In the trial period, why would the dynamic component be turned off?

- The dynamic component would be inactive during the trial period to keep the environment predictable, to be able to iron out glitches, and to not complicate fail fee exchange. The trial period could also be used to gather further data on the appropriateness of the triggers for the dynamic component.

Q11: What are the governance considerations during the trial phase?

- At the outset, the Governance Group for the Framework would need to meet frequently (possible monthly) to review the working of the fail fee. Meetings could be quarterly once it is up and running
- During the trial phase, the Governance Group could solicit feedback from market participants, provide regular updates to CFIF and ultimately make a recommendation of whether to keep fail fee exchange active. The Governance Group could holistically monitor the following criteria:
    - Operational issues, either transitory or persistent
    - Appropriate transmission of the fee beyond direct participants in CDS
    - Effects on market functioning, participation and liquidity
    - Effect on fails rates and specialness
- And if fail fee exchange is continued beyond the trial phase, the Governance Group could:
    - Conduct periodic reviews of the framework; shortened review intervals whenever material changes take place (e.g., activation of dynamic fail fee component, persistent rise in fails without reaching activation trigger)
    - Also conduct ad-hoc reviews and recommend changes, e.g., if necessitated by market developments, including major changes to settlement process/infrastructure
    - Ensure that the fail fee parameters remain appropriate

5. Governance considerations for the Framework

Q12: Where does responsibility for governance of the GoC Market Functioning Framework and its components (including the "best practices") rest?

- While overall responsibility would rest with CFIF, a separate Governance Group would be formed

Q13: What is the Governance Group's relationship with CFIF? Does it have delegated authority from CFIF to monitor and make changes, if necessary?

- The fail fee framework would be "given teeth" by being part of CDS's rules, which would require approval by CDS's supervisors (i.e., respective members of the Canadian Securities Administrators and the BoC)

- The Governance Group would make recommendations to CFIF for approval. If any recommendations require rulebook changes, regulatory approval may be necessary. The triggering of the dynamic component is expected to be 'hard-coded' into the rulebook and any changes to the levels of the fail fee, if necessary, are not expected to require regulatory approval.
- Significant changes/decisions may also benefit from industry consultations

Q14: What are the Governance Group's responsibilities?

- Monitor fails, holistically review the framework's effectiveness and recommend any changes
    - This would be especially important during the trial phase
- Formulate a recommendation of when to enable fail fee exchange and whether to keep it active
- Maintain associated best practices and documentation
- Provide regular updates to CFIF, including through the publication of meeting minutes

Q15: Who would chair the Governance Group, how would members be appointed, and what would be the composition of Governance Group membership?

- CFIF would appoint Governance Group co-chairs for 2-year terms
    - BoC could co-chair during the first term along with a market participant
    - CFIF would endorse composition of the Governance Group, appointments at co-chairs' discretion
    - BoC and CDS would be permanent members
- Additional members and observers would include a broad range of stakeholders, including sell-side, levered and non-levered buy-side, custodians/agent lenders, prime broker, legal representation, CSA representative, industry associations
- Around 10 members, possibly more during the trial period, fewer in steady state
- Mix of expertise (e.g., traders, settlement experts)

Q16: What would be the process for decision-making within the Group? Who provides the secretariat function?

- To be determined later as part of the Terms of Reference (ToR), in consultation with CFIF and Governance Group co-chairs