CANADIAN FIXED-INCOME FORUM

SUMMARY OF THE DISCUSSION

Ottawa, June 19, 2023, 4:00 p.m. to 6:00 p.m.

1. Introduction

The co-chairs welcomed Bronwyn Ward, Managing Director, Head of Trading, CPPIB, and Vinayak Seshasayee, Executive VP and Portfolio Manager, PIMCO, as new members of CFIF. Grahame Johnson, Advisor to the Governor, will begin his secondment to Department of Finance as Assistant Deputy Minister, Financial Sector Policy Branch, in July and will be joining CFIF in his new role.

2. Recent bond market developments

Jason Williams, VP, Interest Rate Research (Citi Group), discussed his insights and outlook for the US money market with CFIF members. He began by noting that he expects the US Treasury to rebuild the Treasury General Account (TGA) balance to at least $400 billion by the end of June and to $600 billion by the end of August, mostly by increasing Treasury bill supply. The increase in the TGA will need to come from a reduction in either the Federal Reserve's reverse repurchase agreement (RRP) operations or bank reserves. The speaker thinks RRP usage may stay elevated in the short-term, as money market funds may choose to keep funds in the RRP program amidst monetary policy uncertainty. Consequently, bank reserves overall are expected to decline further. He noted that the reduction in bank reserves may not be equally distributed across all banks. Foreign and large US domestic banks are expected to remain flush with reserves while small US banks continue to see outflows in the short term. However, he expects the size of total bank reserves to eventually normalize later this year as the pressure due to quantitative easing and TGA rebuild will start to ease and money market funds begin to extend the weighted average maturity of their portfolios by reducing their use of the RRP.

Grahame Johnson provided a historical perspective on the Bank of Canada's (Bank) balance sheet and the quantitative tightening (QT) program in Canada. The monetary policy actions taken by the Bank during the pandemic boosted its total assets to over $570 billion, with Government of Canada (GoC) bond holdings peaking at roughly $440 billion. As a result of QT, the Bank's GoC bond holding has declined by approximately $135 billion since last year. The Bank's GoC holdings will decline as the bonds mature. He noted that the Bank's GoC holdings are available on the Bank's website and that the monthly maturity profile remain uneven, with maturities concentrated in several key maturity dates. He also noted that once the amount of settlement balances, or bank reserves, needed to operate in a floor system in Canada is reached, the Bank would start buying assets again as part of its regular balance sheet management process. This is expected to occur around the end of 2024 or the first half of 2025, given the current best estimated of the system's steady state demand for reserves of roughly $20-$60 billion.

3. Mortgage funding

Chris Thomas, Managing Director, Desk Head Mortgage Aggregation and ABS Trading (Scotia Capital) presented his thoughts on the Residential Mortgage-Backed Security (RMBS) market to CFIF. The presenter noted that from 2017 to 2022, residential mortgages in Canada increased from $1.2 trillion to $1.7 trillion. He pointed out that Canadian mortgages are predominantly funded on bank balance sheets and as a result the major Canadian banks are more reliant on wholesale funding than their international peers. He believes that a more developed RMBS market in Canada could create alternative funding source for banks and reduce reliance on wholesale unsecured bank funding. It could also improve funding market access for smaller lenders. The speaker advocated for leadership from the industry to improve pricing and liquidity for the product and for work on reviewing bond index eligibility requirements for RMBS.

A participant noted that Canadian banks' success in raising cost effective wholesale funding has hampered their incentives to issue securitized product, including RMBS. At the same time, investors are hesitant to invest in RMBS due to insufficient data on the underlying mortgage pool and the already tight RMBS spreads compared to other jurisdictions.

A member pointed out that extension risk in RMBS also cause investor hesitancy in the product. Investors are concerned that the weighted average life (WAL) of a RMBS can be significantly extended if the underlying mortgages cannot be refinanced at contractual maturity. The reliance on sponsors remains high in the current RMBS structure in Canada and any potential weakness of the issuing sponsor may trigger repricing of the bonds. Given the average amortization period of mortgages is long, at around 25 years, any changes in the WAL can potentially lead to a material loss in the value of the RMBS.

CFIF members generally agreed that a developed RMBS market could help banks to diversify their funding sources. Members suggested that a national mortgage database to support analysis of RMBS underlying mortgage assets and potential work on bond index eligibility requirements along the lines discussed in the presentation would be important first steps to develop a more viable RMBS market.

4. BA Transition Virtual Network update

The co-chairs of the BA Transition Virtual Network (Network) updated CFIF on the progress on the group's work.

To facilitate an orderly transition away from BAs, the Network has advanced work in several areas. Earlier in the year, the Network worked with CFIF and CARR to conduct a survey to better understand the type of short-term funding instruments banks and dealers may used to replace BAs, which will cease to be issued after CDOR disappears on June 28, 2024. Leveraging the survey results, Network members reviewed the list of potential alternative products to BAs and took actions towards educating, promoting, or removing barriers for market participants, where appropriate. In particular, the Network is developing a case for treasury bill issuance in the 1-month tenor and is engaging Department of Finance in discussions. The Network has also met with TMX regarding the launch of the Canadian Collateral Management Services to introduce a triparty repo solution in Canada and CDCC on their Secured General Collateral (SGC) note initiative to provide a secured repo security. There were also discussions on developing a bilateral collateralized commercial paper program.

In addition, the group has engaged the Investment Funds Institute of Canada (IFIC) to look at potential exemptive relief from certain provisions in NI 81-102 and other provisions of applicable securities legislation to help expand the investment universe for constrained participants. Looking ahead, the group will also work with bank treasuries to minimize the possibility of a sudden and disorderly drop in BA issuance (cliff effect) around the CDOR cessation date.

The working group will continue its work to support a smooth transition from the impending cessation of BA issuance.

5. CARR update

[Secretary note: At the suggestion of the CFIF co-chair, the order for item 5 and 6 has been switched to allow for better flow of the discussions. CARR update was discussed first, followed by discussions on collateral infrastructure and market practices]

CARR's co-chairs provided an update on the group's work since the last CFIF meeting in May, noting that the CDOR transition is progressing well. Most market participants have already transitioned their derivative activities from CDOR to CORRA as required by the end of the first stage (June 30) of CARR's timeline to the transition from CDOR. The second stage relates to transitioning the loan market away from CDOR. The co-chairs noted that CanDeal and TMX datalinx are progressing well to launch a beta version of Term CORRA in early July, with an official launch in early September, which will support the transition of the loan market. They also mentioned that to facilitate the loan transition, CARR will be publishing their recommendations for remediating loan agreements by the end of July. The recommendations will include the introduction of a "no new CDOR or BA loan" date milestone. The co-chairs also noted that CARR will soon be publishing their recommendations for tough legacy securities, including for Canadian mortgage-backed securities (MBS), as well as a set of FAQs.

CARR will continue its work to facilitate a smooth transition away from CDOR, and to ensure Canada's benchmark regime is robust, reliable, and effective.

6. Collateral infrastructure and market practices

A revised proposal to form the Collateral Infrastructure and Market Practices Advisory Group (CIMPA) was presented to members, following the discussion at the May CFIF meeting.

The key objective of CIMPA is to promote operational efficiency in the Canadian securities financing and collateral markets through industry coordination. The group aims to support market functioning through promotion of best practices for settlement and risk management. It will also work to facilitate broad participation in tri-party repo in Canada. As part of the proposal, the presenters suggested integrating the remaining work of the Government of Canada Market Functioning steering group (GMF) into CIMPA to better incorporate this work into the wider objective to improve market functioning. The GMF was formed in 2020, with the goal to support GoC market functioning through the design of a financial mechanism to incentivize timely settlement for GoC bonds and bills. Its goal aligns well with CIMPA as both groups aim to improve settlement efficiency and enhance robust market structure over time. The integration of the work by GMF to CIMPA will be similar to the evolution of the Treasury Market Practices Group (TMPG) in the US. TMPG was first formed to look at introducing financial charges on settlement fails. The group's mandate was broadened to including discussing and promoting best practices related to trading, settlement, and risk management.

CFIF approved the proposal to create CIMPA. It was agreed that the next step is to consider the group structure, including potential co-chairs, as well as develop CIMPA's Terms of Reference.

7. Initiatives to enhance GoC Market Functioning

The GoC Market Functioning Steering Group (GMF) co-chair shared an update of the group's work since the last CFIF meeting.

The co-chairs of the GMF expressed support for incorporating the remaining work for GMF into CIMPA. They noted that until CIMPA is formed, the GMF will continue its work on finalizing the framework and following up on comments received from the public consultation. A summary of the consultation results along with the proposed responses will be circulated to CFIF members for approval and publication later in the fall.

Meeting participants:

CFIF members:
Jim Byrd, RBC Capital Markets, Co-Chair
Brian D'Costa, Algonquin Capital
Nick Chan, BMO Capital Markets
TJ Sutter, Connor, Clark & Lunn
Karl Wildi, CIBC World Markets
Bronwyn Ward, CPP Investments
Philippe Ouellette, Fiera Capital
Vinayak Seshasayee, PIMCO
Jason Lewis, Ministry of Finance, Province of British Columbia
Paul Scurfield, Scotiabank
Elaine Lindhorst, TD Asset Management
Eugene Lundrigan, SLC Management

External participants:
<u>Item 2</u>
Jason Williams, VP, Interest Rate Research, Citi Group

<u>Item 3</u>
Chris Thomas, Managing Director, Desk Head Mortgage Aggregation and ABS Trading, Scotia Capital

<u>Item 4</u>
Charles Lesaux, Managing Director, Fixed Income Repo

Bank of Canada:
Toni Gravelle, Co-Chair
Wendy Chan, Secretariat
Harri Vikstedt
Sheryl King
Mark Hardisty
Maksym Padalko
Zahir Antia