CIBC CAPITAL MARKETS

CORRA: Implementation Frictions or Policy Interference?

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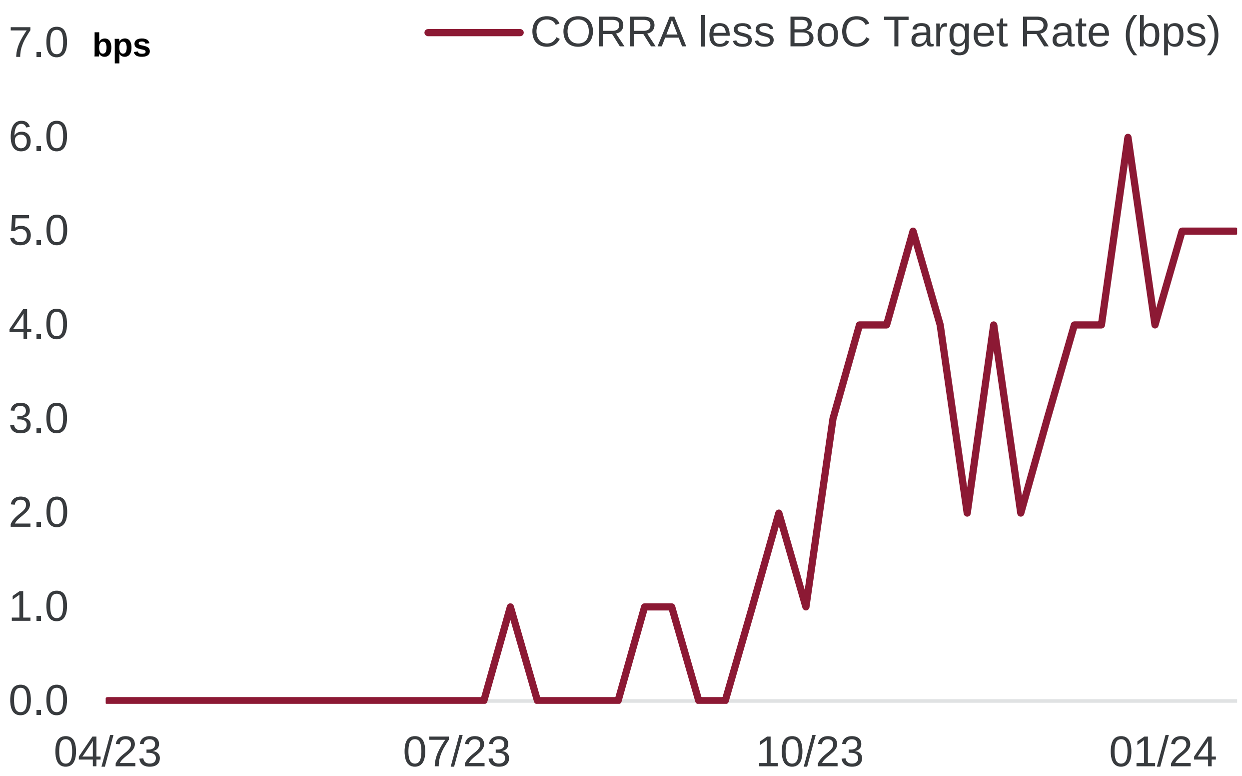
What’s the issue?

CORRA has shown persistent deviations from the target rate



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Source: Bloomberg, CIBC Capital Markets

- CORRA has deviated from the target overnight rate for 20 consecutive weeks (beginning in earnest in September 2023)
- During this period, excess settlement balances have declined ~C$45.0bn…
- …however, in the preceding six months (Jan23-Sep23) excess settlement balances fell by only a slightly smaller amount
- Ahead of an easing cycle, it is critical to ensure the 'plumbing' of the system is clean. This will promote the smooth transmission of monetary policy objectives
- We believe CORRA is exhibiting slippage not stress. That said, a more permanent solution must be implemented to ensure funding markets remain stable. We need to identify an anchoring path for QT that prescribes the 'right' level of reserves in the steady-state
- **The persistent deviation of CORRA from target is a signal that the room for shrinkage without a pre-committed liquidity point is limited**

Most Oft-Cited Market Reasons for the Slippage in CORRA

1. Settlement Balances have fallen below the ample level required to maintain participant liquidity preferences

2. Institution specific funds transfer pricing (FTP) dynamics are forcing dealers to self-fund more than usual

3. Regulatory innovations, like Fundamental Review of the Trading Book (FRTB) makes leverage, incrementally, more expensive. Balance sheet just generally more expensive

4. ‘Hangover’ from year-end dynamics

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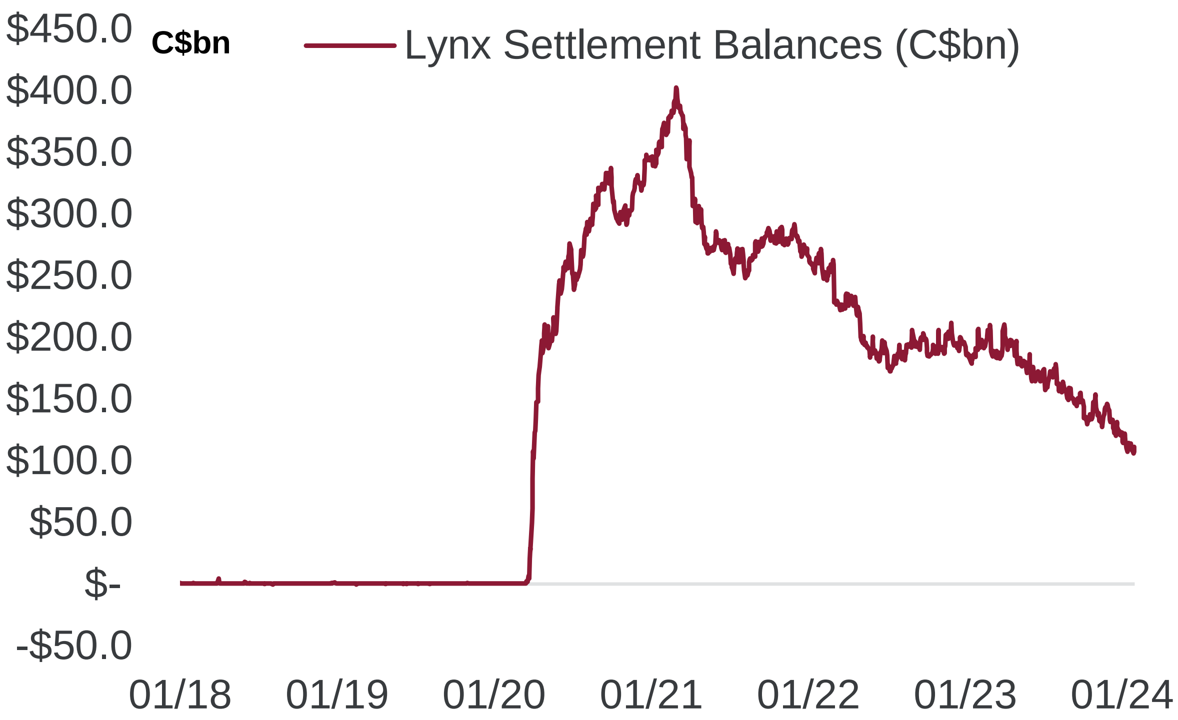
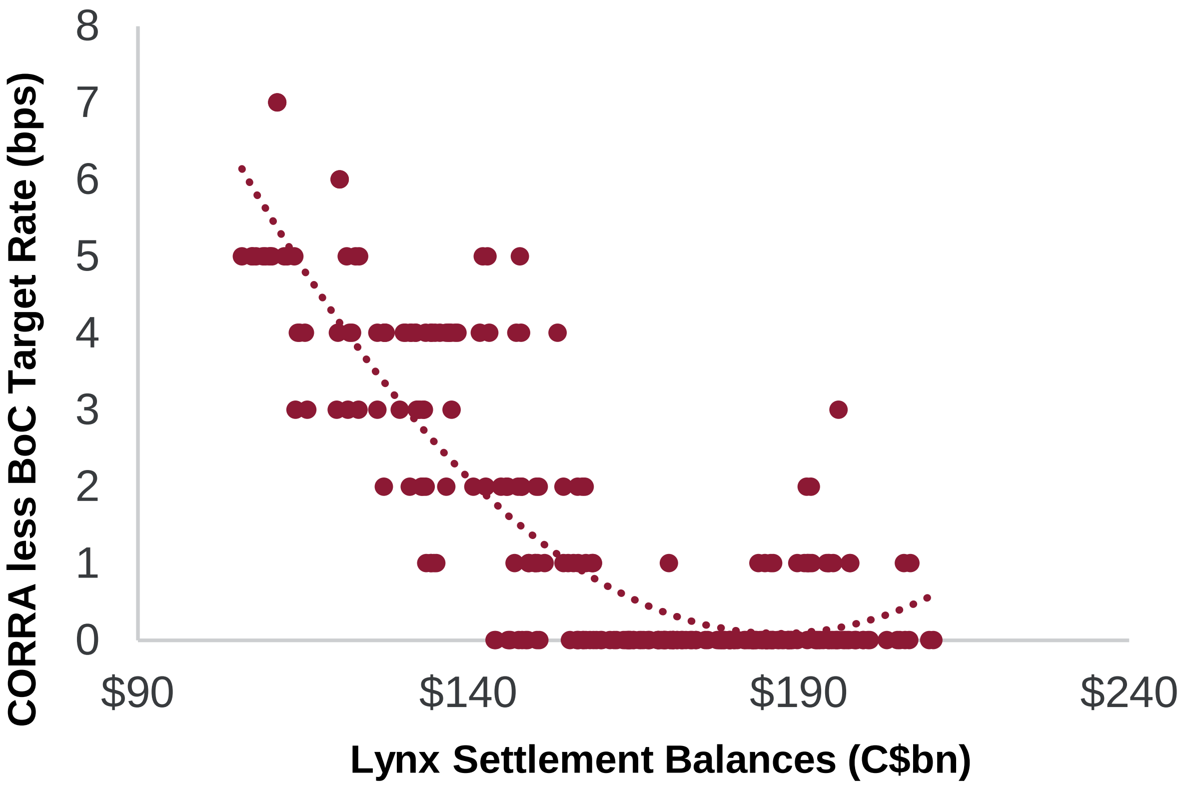
Where’s the Smoking Gun?

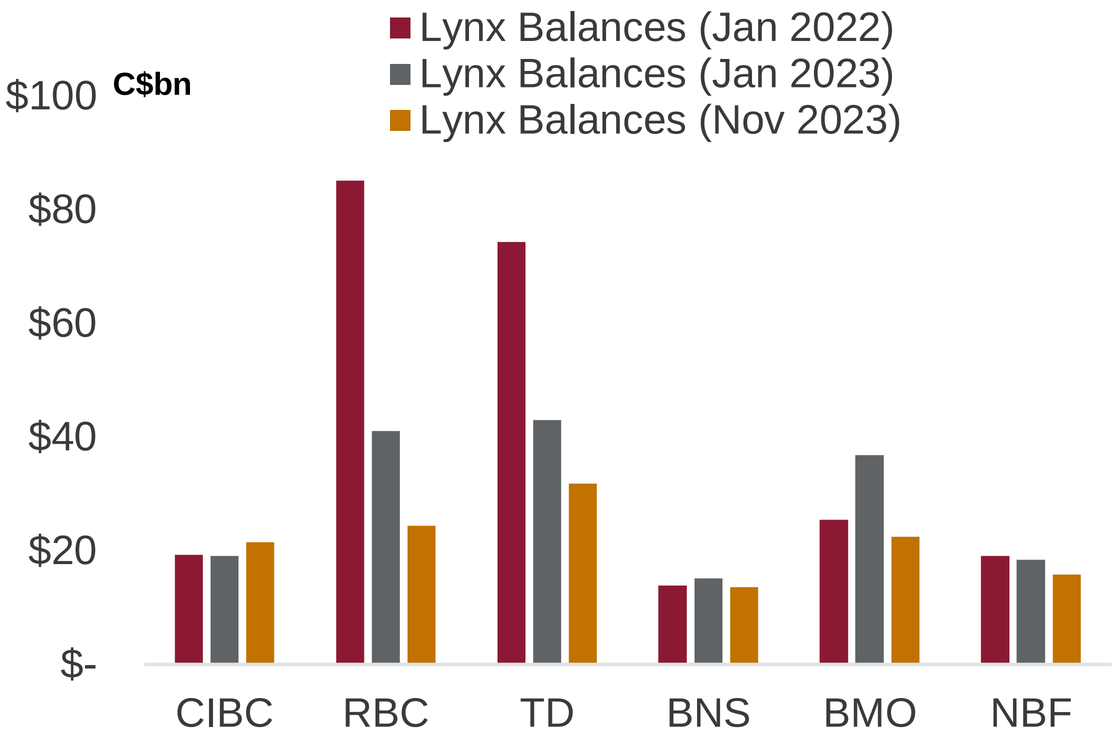
Scarce liquidity creates transmission instability – but is the system ‘really’ struggling with ~C$100.0bn of reserves?

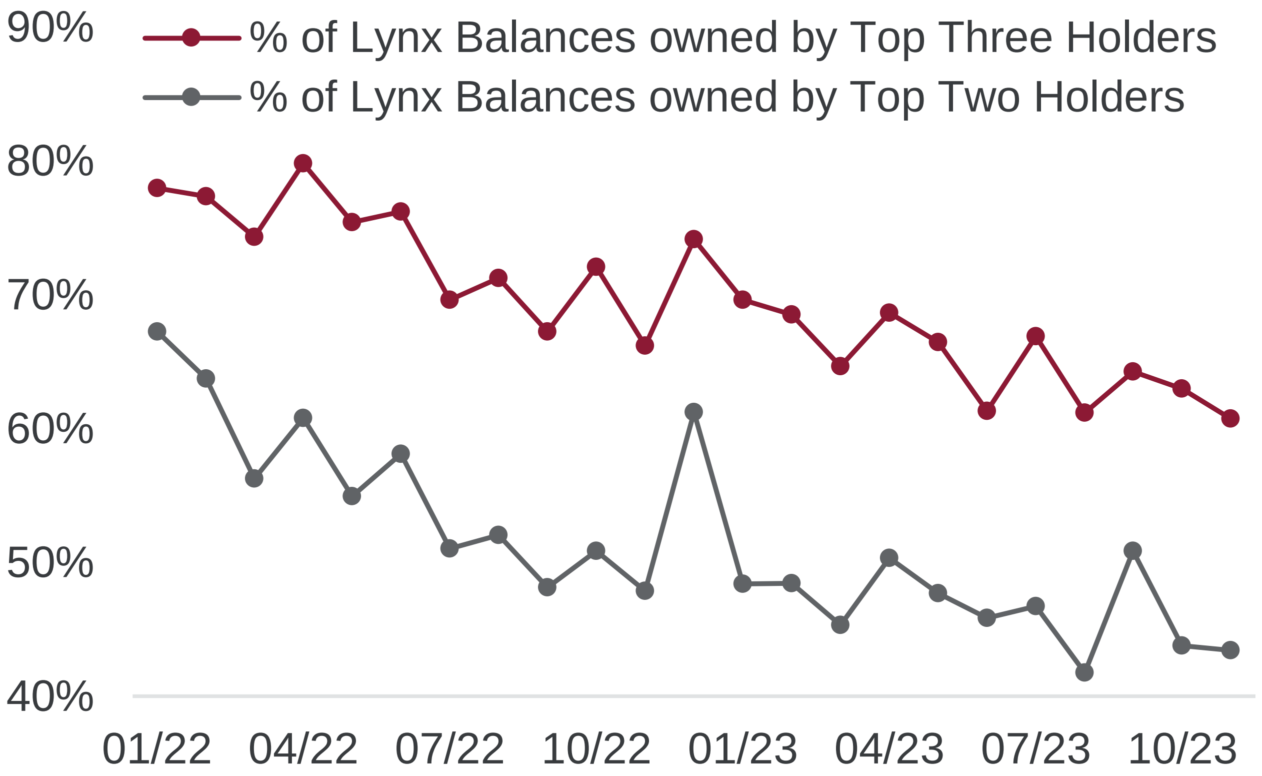




Source: Bloomberg, Bank of Canada, CIBC Capital Markets

The Concentration of Reserve Ownership is Important

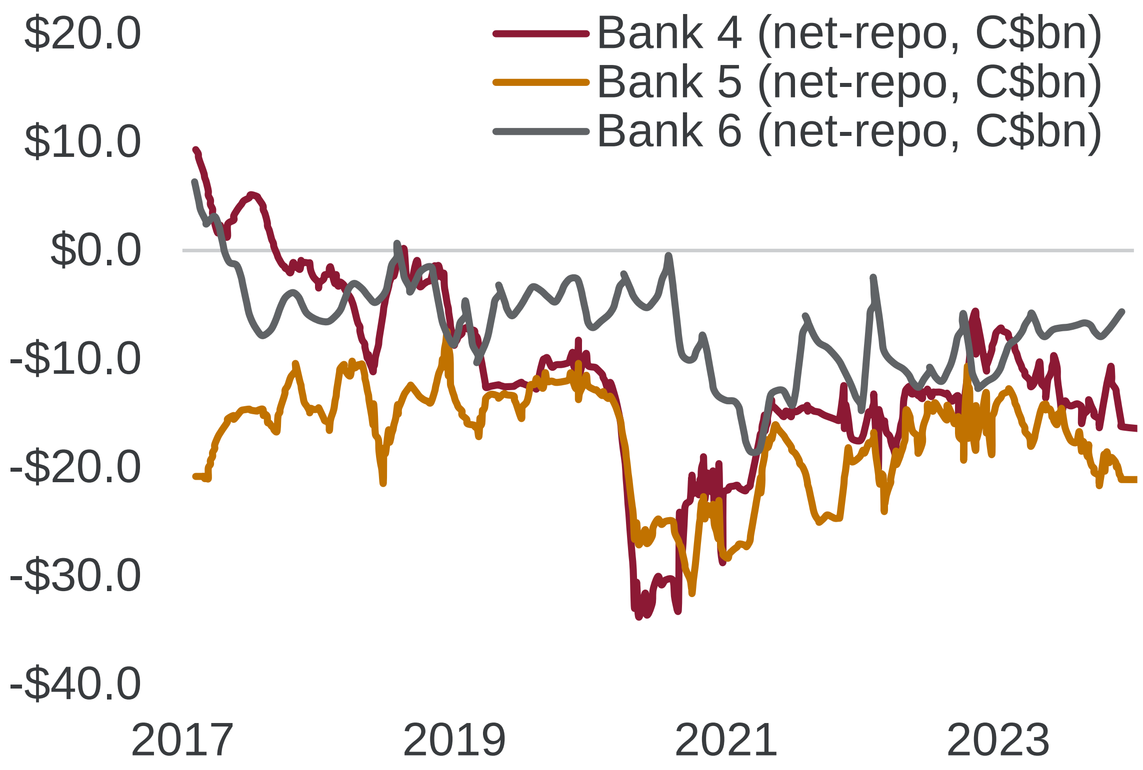


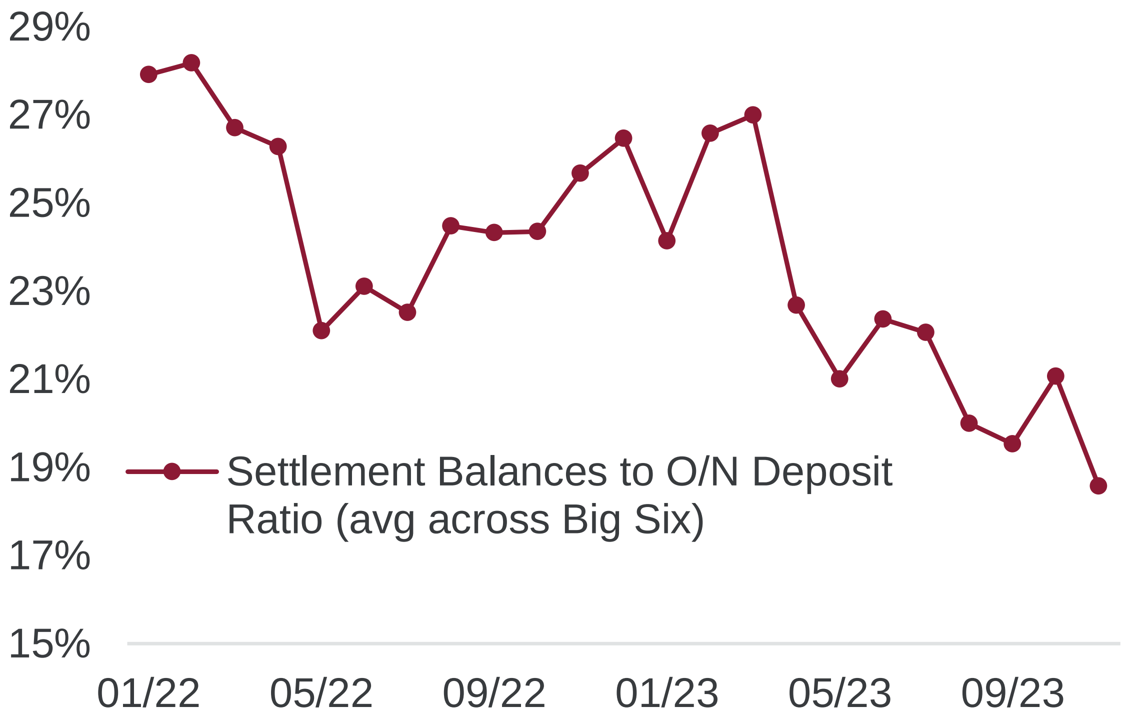


1. There is evidence suggesting more bifurcated reserve ownership differentials to start 2024
2. The difference between 1st and 6th largest holders of reserves now sits above prior 6m average

Source: OSFI, Haver Analytics, Company Earnings Reports, CIBC Capital Markets

Net-repo is inconclusive without knowing collateral (L), Avg ratio of Lynx balances to O/N deposits is now below most volatile banks (R)

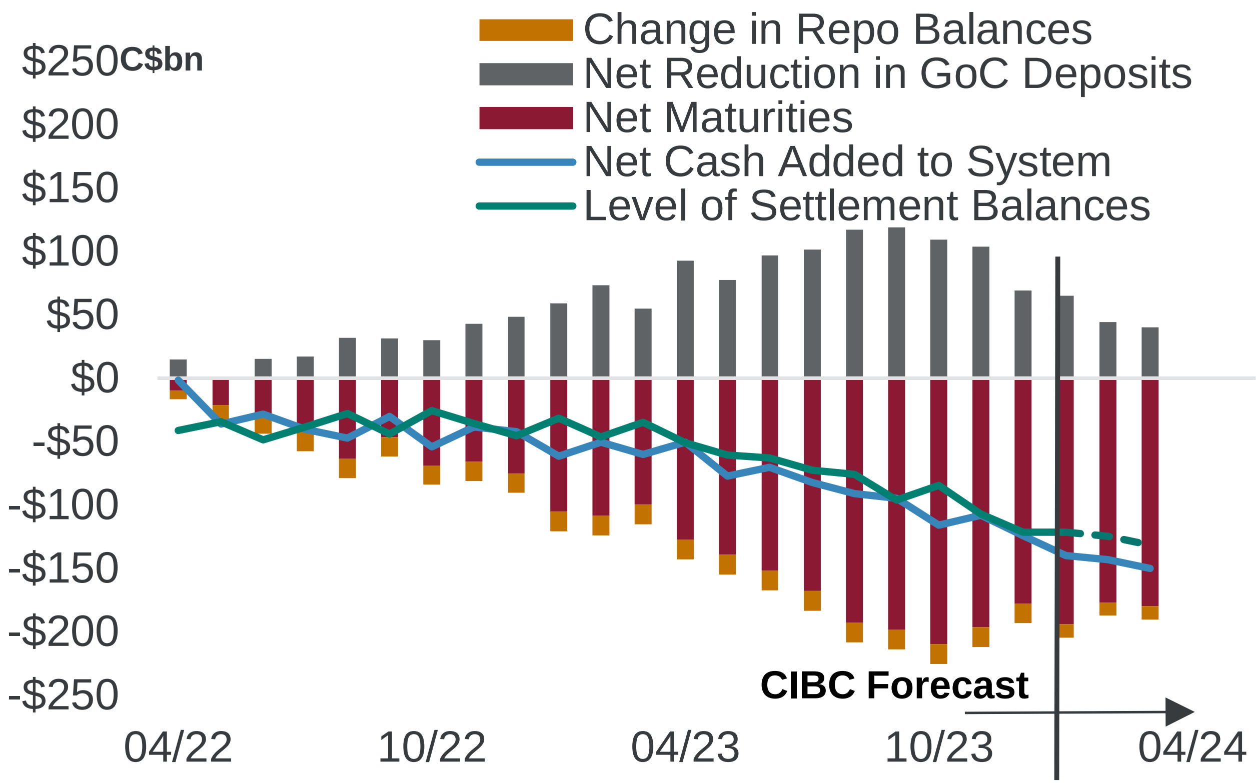




Source: OSFI, Haver Analytics, CIBC Capital Markets

Let’s talk about QT and the implied path of Reserves

Money-in vs Money-out: Implied path of Settlement Balances



- In the steady-state, Lynx balances are forecasted to fall to C$94.0bn by the end of FY23/24 in March 2024
- CIBC anticipates the bank to officially announce QT cessation at the April meeting
- Note: this analysis assumes ongoing OR operations until end of FY23/24

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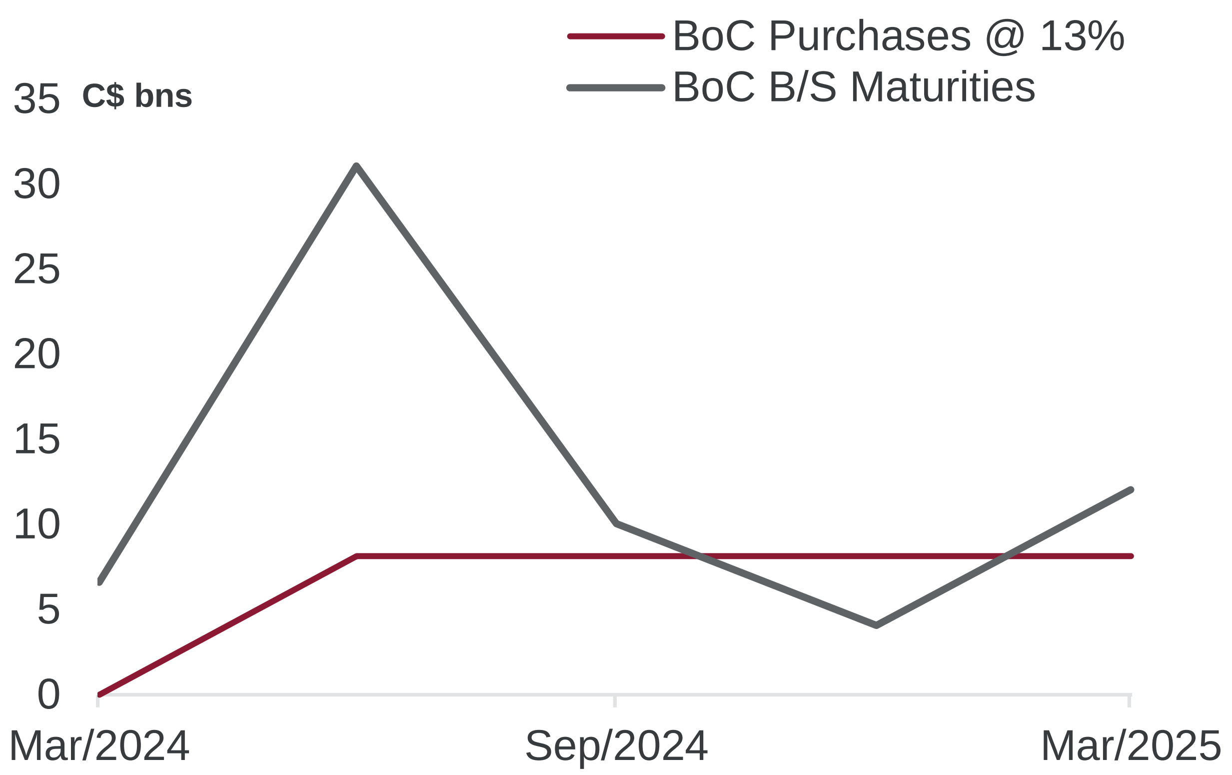
Source: Bank of Canada, Bloomberg, CIBC Capital Markets

Ending QT also poses another problem for Lynx Balances & CORRA



- A key issue around QT cessation relates to the outlined sequencing of what the BoC will do. For example, BoC communication suggests post QT, primary purchases are back on the table
- For FY24/25, CIBC estimates ~C$240.0bn of issuance. Despite a small improvement in the budgetary balance, elevated maturities and non-budgetary items (read: CMB funding requirements) keep issuance very high
- The Bank would need to purchase ~20.0% of all primary issuance in order to offset maturities. **Failure to do so would mean QT cessation actually turns into 'QT Lite'**

Source: Bank of Canada, Department of Finance, CIBC Capital Markets

Market Implications

Trading Implications of CORRA distortions persisting

- **Cross-currency basis can't widen –** As long as CORRA distortions continue, it remains difficult for short-end cross-currency to widen. This also helps put a bid into front-end collateral at a time when BA rolloff starts to matter

- **Cash to remain cheap to swaps –** Failure of CORRA to trade back towards target makes cash product cheaper given elevated financing costs. This is currently being offset by mortgage production in the 2yr/3yr sectors. This should maintain downward pressure on belly spreads

- **Front-meetings stay cheaper –** Preference to be paid the rolldown means front OIS meetings stay cheap. But this also pressure the next-to-be front meeting, absent a more material pivot from BoC

X-Ccy Basis	2/01/24	2/02/24	2/03/24
O/N	-11.25	-12.5	-11.5
1m	-10.48	-12.57	-11.5
2m	-12.59	-11.87	-12
3m	-12.25	-11.04	-12

Recommendations to stabilize CORRA

Bottom Line: Be Patient but be Mindful

Here are solutions to consider going forward:

1. **Be Patient –** BA runoff, particularly from March-to-April, should push CORRA back towards 5.02% level. Do not over-react to near-term fluctuations
2. **Re-think the Repo Facility** (size it up, broaden it out, change pricing). Note: BoE has facility weekly, ECB discussing having facility slightly above Deposit Rate; Fed has the SRF at IOR + 10.0bps, RBA has OMO at OIS + 10.0bps, the BoJ (seriously, do I have to mention BoJ?!)
3. **Begin tiering Lynx balances alongside OR's**, as it allows a maintenance of the floor system
4. **Make OR operations permanent,** but larger and communicate persistence

Bottom Line: Considerations

1. It is not clear that ending QT will **exert downward pressure** on CORRA. Rather, it is likely to **limit further upward** pressure only
2. Current cadence/communication of OR operations cause uncertainty and actually biases GC/CORRA higher
3. Whatever tool the BoC chooses to use, consider something which not only maximizes the liquidity distribution BUT allows you to **learn** the most about participant behaviour. <u>Anchoring reserves requires knowledge</u>
4. The BoC should avoid reverting back to the corridor system at all costs, particularly as RTR and other payment innovations are introduced

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