IIAC LETTER

Short-term Credit Market Functioning and Projected Policy Changes

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INTRODUCTION

Short-term credit market functioning in Canada was at significant risk as a credit crunch took hold in the early stages of the Covid-19 Pandemic. It was initially feared that there was a real possibility that the credit crunch could grow to be a system-wide contagion, or at the very least, adversely affect a significant portion of capital market participants. The situation began to worsen quickly, and the markets began to unravel in early March 2020 as many institutions rushed to access credit and funding lines at the same time. This threat was swiftly addressed, through liquidity injections and other monetary policy measures. Material financial damage was prevented through this aggressive intervention undertaken by the Bank of Canada (BOC) and the Office of the Superintendent of Financial Institutions (OSFI). This intervention was both significant in magnitude and very timely in its implementation. Ultimately, the Bank of Canada, and other central banks in developed markets actively interceded and credit spreads improved rapidly and dramatically in their respective short-term markets.

INDUSTRY PROPOSALS AND ACTION BY BANK OF CANADA AND REGULATORS

As a measure of short-term credit risks, at their peaks in late March 2020, the 3month CP/OIS spread and the 3month CDOR/OIS spread widened dramatically, reflecting a material tightening of credit conditions early in the pandemic. Widening spreads not only risked material cost increases to short term credit borrowers, but there was also concern that credit in general would become hard to readily access, or worse, unavailable.

The Bank of Canada (BOC) supported the short-term credit markets through the Bankers' Acceptance Purchase Facility (BAPF) and the Commercial Paper Purchase Program (CPPP). The BOC announced amendments to the Provincial Money Market Purchase (PMMP) program in addition to changes to the amount of Government of Canada treasury bills acquired at auction. It also announced amendments to the Standing Term Liquidity Facility (STLF) and assertively y cut interest rates. As can be seen in Figure 1, the CDOR/OIS spread has remained fairly well behaved since the initial spike in March despite some hiccups in economic activity, surges in domestic COVID-19 cases and related progress in vaccines and vaccine distribution.

FIGURE 1

Source: Bloomberg

WINDING DOWN OF EMERGENCY MEASURES

As the short-term credit market has returned to near normal operation and liquidity in recent months, several emergency credit facilities have been ended, or will be ended, in the by the third quarter of 2021. Some of these programs have had modest usage or declining usage since an initial flurry of activity early into the pandemic. Their declining need reflects an improving and stabilized short term credit market and decrease in general risk aversion since the pandemic eased in May 2020. Not withstanding a few brief spikes in program usage, at this time, most of the programs are no longer necessary. Of note, however, is that there has been clear communication that programs can be re-introduced quickly if needed if conditions deteriorate again. The current status of cancelled and on-going programs is shown below:

Programs that have been discontinued as of the time of writing include:

BOC PROGRAMS

Provincial Bond Purchase Program; Corporate Bond Purchase Program (CBPP); Commercial Paper Purchase Program (CPPP); The Canada Mortgage Bond Purchase Program (CMBP); The Bankers Acceptance Purchase Facility (BAPF); and The Provincial Money Market Purchase Program (PMMP)

FEDERAL PROGRAMS

Insured Mortgage Purchase Program (IMPP)

See Appendix 1 for more detail on these programs.

OSFI LEVERAGE RATIO EXCLUSIONS

On August 12, 2021 "OSFI confirmed that the exclusion of sovereign-issued securities from the leverage ratio exposure measure for deposit-taking institutions (DTIs), introduced at the outset of the COVID-19 pandemic, will not be extended past December 31, 2021. Central bank reserves will continue to be excluded from the leverage ratio exposure measure for DTIs".

Several BOC programs been extended beyond May 26th, 2021. These include:

- Government of Canada quantitative easing (QE) bond purchase program; and
- Standing Term Liquidity Facility (STLF)

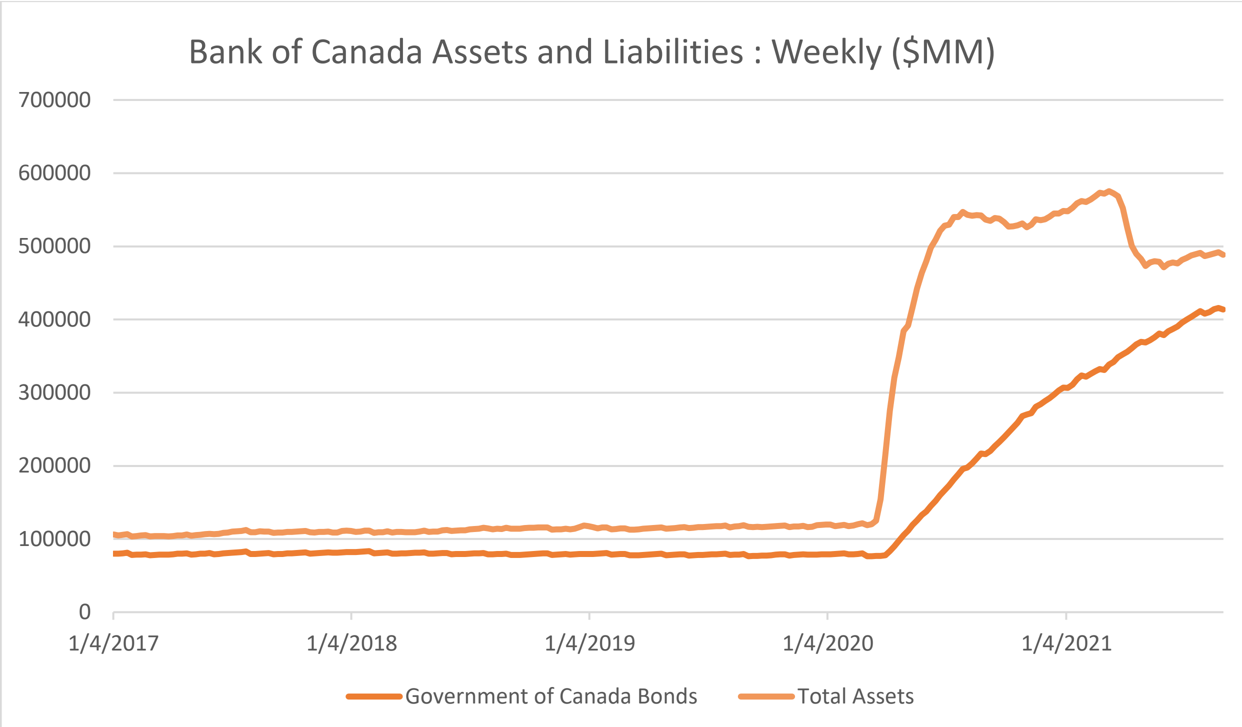
The BOC has tapered bond purchases to $2Bn as of the time of writing, but the timing of further tapering is still uncertain due to the market effect implications, the robustness of the overall economy and any resurgence of COVID-19 due to more highly transmissible and deadly COVID-19 variants. The taper of QE in Canada to $2Bn from an initial level of 5Bn, is significant, especially considering that the Federal Reserve in the United States has yet to initiate tapering of its own QE program.

Regardless, the BOC is expected to remain vigilant and continue to support the smooth functioning of the short-term funding and credit markets, as necessary. Federal and provincial governments and regulators will likely pull back or provide additional support only as required. There may be an opportunity for the BOC to taper off its QE program in a measured way again later in 2021, but recent public statements from Ottawa have reinforced that the tapering of QE will be very well telegraphed.

There have been unforeseen consequences of aggressive policy action. These include a historically high level of excess settlement balances that have kept downward pressure on repo and other short-term rates. As well, QE purchases of Government of Canada bonds have resulted in a very large percentage (approx. 40%) of outstanding Government of Canada bonds residing on the Bank's balance sheet. The Bank's balance sheet is shown in Figure 2 below:

Thankfully, there have been efforts to mitigate these effects with some success, including a larger availability Government of Canada bonds held by the BOC that are made available through the use of Securities Repo Operations (SRO). The SRO makes up to $2Bn in bonds held by the BOC available to each primary dealer.

FIGURE 2



Source: Bank of Canada

INFLATION

Inflation has risen in developed economies after being incredibly subdued in the early stages of the pandemic. To date there is general consensus that this rise in inflation is due to supply chain frictions, is related to a surge in demand for commodities that had production slashed in 2020 and will be transitory in nature.

There remains the firm belief that inflation has not been a result of central bank monetary policies, particularly QE in Canada and other jurisdictions, because money supply created in QE execution never left central banks balance sheets. Additionally, future inflation expectations are a key driver, and these expectations remain largely in check for now. That being said, the transitory nature of a recent surge in inflation is being questioned by some. The real issue that remains is when will QE tapering occur and how far and how long after inflation moves above the 2% target will central banks wait before they begin to raise o/n administered rates.

While there has been co-ordination between the BOC, federal and provincial governments, and regulators, let there be no mistake that independence of these bodies is fully intact. If future inflation trends sustainably above 2 per cent beyond a period that more than compensates for the prior sub 2 per cent period of inflation early in the pandemic, the BOC and other central banks will surely act as mandated and raise their target interest rates.

CURRENT AND FUTURE CONSIDERATIONS

A look back at Canada's response to the market events of the spring of 2020, and the months that followed, reveals several important outcomes and lessons. The robust return of liquidity in short-term and overall credit market that occurred after a significant credit event in April 2020, is testament to the effectiveness of actions undertaken by the BOC, federal and provincial governments, and regulators. While there has been an accumulation of a significant amount of debt by governments and a large expansion of the BOCs balance sheet, these programs and liquidity measures could be reintroduced quickly if required.

Certain sectors of the economy have benefitted from the help of low administered rates, liquidity provisions and stimulus, particularly the surging real estate and equity markets, but there is a limit to how far these sectors can run without an improvement in underlying economic fundamentals.

There has been a recent steepening bond yield curve that has occurred despite the maintenance of material QE activities and statements by the BOC that, while QE may be tapered further in the near and medium terms, it will likely be in place for up to several years. This steepening of the yield curve may be evidence of concern in the capital markets that there is the risk of growing non-transitory inflation pressures in the future.

Part of the steepening of the yield curve is likely driven by government and credit market fixed income supply. Presumably part of this is due to aforementioned future inflation expectations. But it's worth emphasising that there is no clear evidence that QE leads ultimately to higher inflation. While Canada has not used QE in prior crises, central banks in the United States, Europe and Asia have successfully done so without stoking inflation. In these markets, there have been multiple rounds of QE without inflation pushing past target levels.

APPENDIX 1: PROGRAMS THAT HAVE BEEN DISCONTINUED

BOC PROGRAMS

Provincial Bond Purchase Program

This program has been used fairly regularly since it was introduced but has been operating at well below its $50 Bn cap. By purchasing provincial securities, which has helped to tighten spreads, the program supports liquidity and functioning in these markets. As this market is functioning quite well, the BOC announced on March 23, 2021, this program would expire in May 2021 but could quickly reverse this action if market conditions deteriorate.

Corporate Bond Purchase Program (CBPP)

This program has only been infrequently used and has been operating far below its $10 Bn limit. This program acts as a backstop and supports the operation of the corporate debt marketplace. The BOC announced on March 23, 2021, that program would be discontinued in May 2021.

Commercial Paper Purchase Program (CPPP)

This program has not had recent usage but was used at inception for a total of $3 Bn (these purchases have all since matured). The program was phased out in April 2021.

The Canada Mortgage Bond Purchase Program (CMBP)

This program was discontinued in October 2020 and was used for a total of $8 Bn. Financial institutions use Canada Mortgage Bonds (CMBs) to fund mortgage lending. CMB purchases support mortgage renewal and overall credit lending.

The Bankers Acceptance Purchase Facility (BAPF)

This program was discontinued in October 2020 and was not used after the sixth week following its introduction. It had total program usage of $47 Bn. The program supported BA markets which is an important source of funding for small and medium sized corporations.

The Provincial Money Market Purchase Program (PMMP)

This program was discontinued in November 2020. The program reached a total usage of $12.4 Bn, with usage tapering significantly prior to its closure. The purchase facility supported short-term provincial borrowing.

FEDERAL PROGRAMS

Insured Mortgage Purchase Program (IMPP)

This program was used little after April 2020. The CMHC announced in October it would end the program in December 2020. Total purchases were under $8 Bn out of a total cap of $150 Bn.