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IIAC LETTER

Canadian Short-Term Credit Markets During the COVID-19 Crisis

INTRODUCTION

While the market impact of the COVID-19 pandemic has abated in recent months the size and length of its impact remain highly uncertain. Overall markets and short-term credit markets, which are examined here, remain on high alert. In short-term credit markets this is both because, in addition to higher costs, financial institutions, may again face obstacles in securing their own funding in addition to a renewed reluctance to lend to certain borrowers who may find themselves unable to readily repay their obligations. The short-term credit markets underpin financial system globally and in Canada and do not get the attention they deserve. As past and current financial crisis have taught us, when financial and non-financial organizations find themselves in liquidity distress rates on short-term borrowing virtually always spike significantly higher.

To be sure, however, conventional, and unconventional policies enacted by the Bank of Canada and measures brought into place by various levels of government have had great effect to date and restored the near normal functioning of short-term credit markets. It should be noted, however, that while the Bank of Canada implemented these measures in a timely manner, they relied a great deal on the Canadian dealer community for assistance in the full, complete, and competent execution of these policies. Additionally, dealers quickly adjusted to remote operations and were heavily tested by executing and settling record trading volumes and issuance during the period.

IMPORTANCE OF SHORT-TERM CREDIT MARKETS

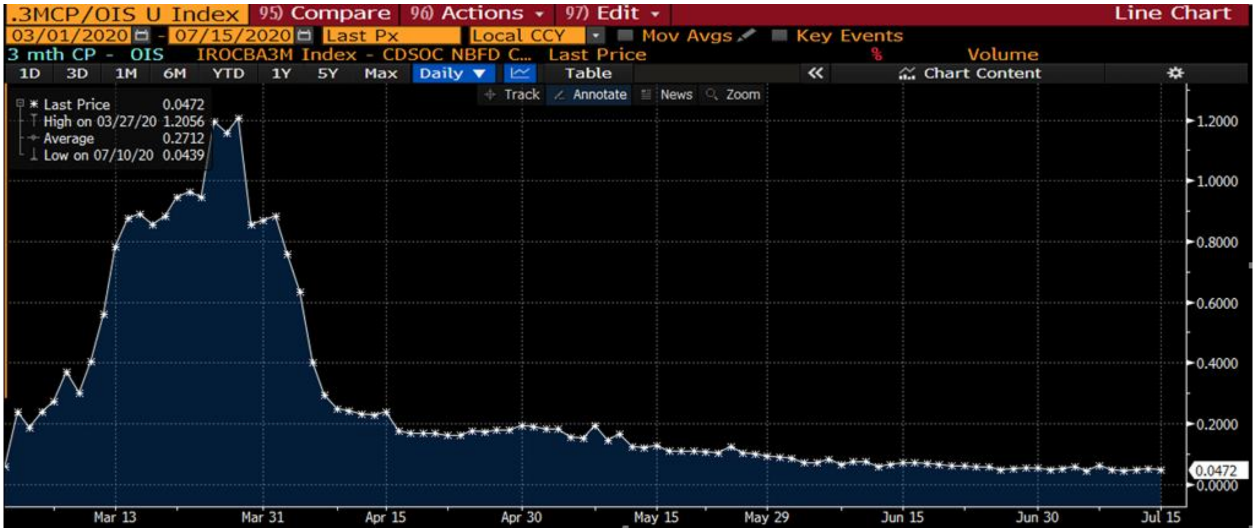
The short-term credit market is a critical market for borrowing by all businesses, and if access to this market is compromised and companies cannot easily access their short-term borrowing requirements at a reasonable cost or at all, they will be unable to make timely payments to creditors or employees. Short-term funding issues can be system-wide or affect specific organizations and if there is rush to access funding lines, and to sell off holdings to raise emergency funding these activities can easily overloaded the system.

As figure 1 and 2 indicate short term funding spreads as measured by 3 month commercial paper (CP) vs 3 month overnight index swap (OIS) Spreads and 3 month Canadian dollar offer rate (CDOR) vs 3 month overnight index swap spread (OIS) spiked dramatically wider in the last 2 weeks of March as the potential effects of the COVID-19 pandemic began to be understood and overall financial conditions worsened.

In terms of the short-term credit markets, at their peaks in late March the 3month CP/OIS spread gapped to 121bp and the 3month CDOR/OIS spread widened to 130bp (these spreads were

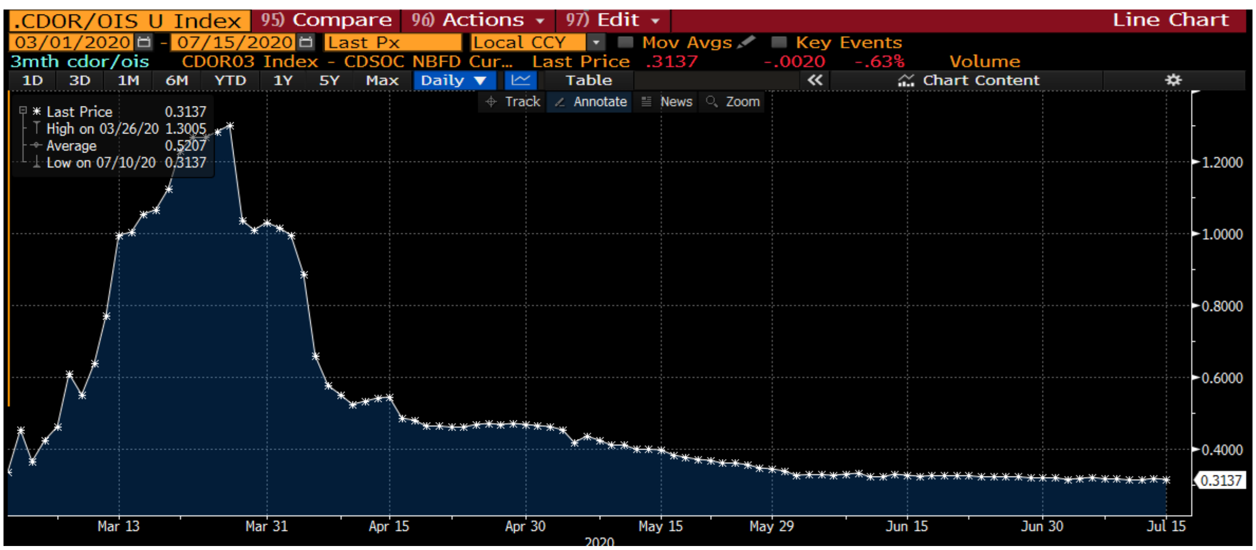
44bp and 31bp, respectively on July 10, 2020). As can be seen when the Bank of Canada intervened in these markets in mid to late March the spreads improved dramatically.

Figure 1: 3 Mos Commercial Paper (CP) vs 3 Mos Overnight Index Swap Spread (OIS)



Source: Bloomberg

Figure 2: 3 Mos Canadian Dollar Offer Rate (CDOR) vs 3 Mos Overnight Index Swap Spread (OIS)



Source: Bloomberg

BANK OF CANADA (BOC) PROGRAMS SUPPORTING CANADIAN SHORT-TERM CREDIT MARKETS

As indicated, the BOC initiated a number of programs to support the short-term credit markets. These include the Bankers' Acceptance Purchase Facility (BAPF) which undertook the purchase of bankers' acceptances (BAs) and the Commercial Paper Purchase Program (CPPP) which supports the commercial paper markets that have experienced severe strain and virtually locked up in mid to late March.

Other facilities introduced by the central bank to improve liquidity in the front end include the Contingent Term Repo Facility (CTRF) which is a bilateral liquidity facility that provides funding secured by securities issued or guaranteed by the Government of Canada or a provincial government; the Standing Term Liquidity Facility (STLF) where financial institutions can use broader set of collateral that includes mortgages to help provide business and personal loans; and the Enhanced term repo operations and Standing Liquidity Facility (SLF) that provides access to funding for an expanded list of eligible institutions with access to a longer term and allows a broader range of collateral.

REMAINING CHALLENGES IN UNCERTAINTIES IN THE MARKET

As indicated, early in the crisis the commercial paper market that many companies use to meet short-term cash requirements, was effectively frozen. Although liquidity in the front-end credit markets has improved significantly since the initial lock up of liquidity, this liquidity can get more expensive or dry up without notice. The challenge to react swiftly to increase existing programs if necessary or enacting additional ones if needed.

Another issue is that in disrupted markets there is a heightened demand for safer assets and as a result some financial institutions and counterparties may again experience problems accessing capital in the event being downgraded or prolonged slump in business.

CONCLUSIONS

As indicated, there are a number of tools at the BOCs deposal to improve commercial and financial market firm's ability to access financing in the short-term credit markets and the central bank has been quick to utilize many of them in the recent crisis. There is justified confidence that the BOC will continue to be vigilant and provide funding and enact additional measures such as purchasing lower quality assets, to support liquidity in order to support the continued functioning of the short-term funding and credit markets, if required, and that the Canadian dealer community will rise to the occasion and competently help execute these policies if called upon.

It appears likely that the measures enacted to contain the economic fallout from the pandemic will be unwound slowly, which may point to correspondingly gradual return of economic activity, which points to a U-shaped recovery as opposed to a V-shaped one.

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