IIACACCVM

INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

LETTER FROM THE PRESIDENT

Vol. 128

Current challenges in global debt markets with implications for Canada: Observations from the 51st Annual General Meeting of the International Capital Market Association

HIGHLIGHTS:

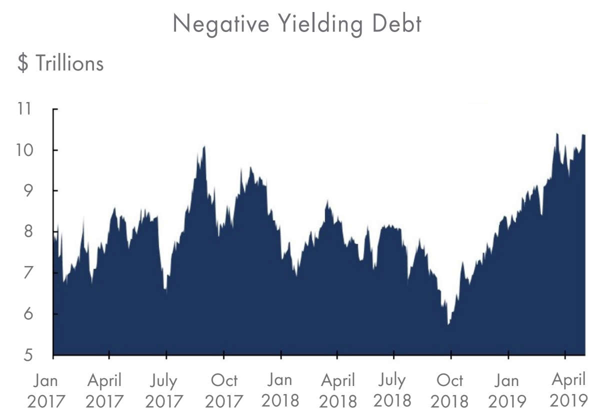
The disruption in trade flows from the U.S.-China dispute and prospect for Brexit have weakened global growth prospects and pushed interest rates to lower bounds, or to negative levels in Europe, with related complications for monetary policy.

Poor liquidity of European repo markets, compared to Canadian and U.S. repo markets, reflects in part the absence of a robust underlying sovereign bond market in Europe.

Canada is not unlike Europe and the U.S., struggling to define common standards and definitions to strengthen liquidity of the green bond market and sustainable ESG bond market.

The International Capital Market Association (ICMA) Annual General Meeting and Conference on May 15-17 looked at the state of the capital markets as it responds to geopolitical events, changing economic policy, and continued regulatory reform. Geopolitical risks, ongoing liquidity concerns, as well as continued regulatory reform, notably the remaking of financial benchmarks, continue to impact international debt markets. On the risk front, escalating trade tensions between the U.S. and China could put a dent into the global economy and reverberate through bond and equity markets. So too could rising uncertainty in the Middle East and potential oil price volatility. At the same time, the prolonged Brexit negotiations raise the spectre of market fragmentation and related inefficiencies, and increased market uncertainty. To many in the largely European audience at the ICMA meetings, the withdrawal of the UK, with the largest economy and capital markets in Europe, would marginalize the influence of the UK in Europe and the global economy and put increased stress on the Eurozone countries still heavily indebted and without deep capital markets to recapitalize the banks and fund investment spending.

Sluggish global growth, muted inflation and dovish central banks have seen bond yields fall sharply around the world. Roughly 30 per cent of global government debt has a negative yield, some US$10 trillion worth, much of it concentrated in the eurozone and Japan. However, negative yields are not just constrained to government bonds. More than US$700 billion of corporate debt also trades with a sub-zero yield, mostly in the Eurozone. Negative interest rates make it more difficult for central banks to cut rates further to fight the next recession, and fiscal policy hamstrung by large deficits and debt burdens also limits scope to respond to any sizeable downturn.



Source: Bloomberg Barclays Global Aggregate Negative-Yielding Debt Index

Despite the extensive G20 reform efforts in the ten years since the financial crisis, and success strengthening the resilience of the global banking system, concerns remain about the sustainability of market liquidity in response to stressed conditions, especially in thinly traded credit markets. The European repo markets have demonstrated a thin layer of liquidity as quality collateral has become increasingly scarce. Indeed, the repo markets have evolved to function more as a transmission mechanism to attract scarce and increasingly expensive collateral to support bank capital requirements and central counterparty clearing (CCP) margin requirements than a funding vehicle for the markets. Before the financial crisis, repo was often used by banks and investors to borrow heavily to invest in financial securities.

Market participants have argued the need for more highly rated and liquid short-term securities to boost collateral in the marketplace and improve the functioning of repo markets. The availability of EU-backed securities, however, is not possible as long as

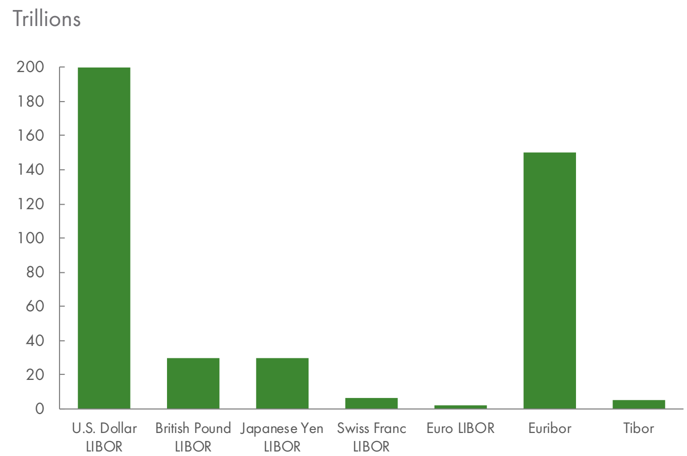
EU member countries have discretion to manage fiscal policy and issue their own sovereign debt against borrowings. In this context, some market participants have advocated the creation of a synthetic Euro security resulting from the securitization of euro area sovereign debt, where a third-party intermediary would purchase, directly or in the marketplace, sovereign bonds from the highest credit-rated EU member countries (GDP weighted). The purchasing entity, preferably a public organization with preferred credit status, would issue 'E-bonds' backed by the pool of sovereign credits, and in this way augment the available pool of top-rated collateral. These discussions have not led to any practical outcome.

The collateral shortage has been much less pronounced in Canadian short-term markets where there are large government bond benchmarks, particularly out to the 5-year issue. The repo market has proven more liquid and deeper, with strong demand for overnight funding from both dealers and buy-side institutions to increase leverage and boost returns in traded markets with narrow bid-offer spreads and attractive funding levels. It should be noted, however, that there is not a meaningful term repo market in Canada. The constraint on borrowing is the high-hurdle rates for portfolio positioning, given the significant cost of capital for some. Market intermediaries and buy-side institutions in Europe and North America will face another round of reforms that will put further pressure on liquidity and borrowing from new Basel proposals related to the Net Stable Funding Ratio (NSFR) and the Fundamental Review of the Trading Book (FRTB).

Another priority for the regulators is to build a robust liquid market in green bonds and sustainable ESG (environmental, social and governance) bonds to fund social and environmentally sustainable projects through the capital markets. Europe will need significant green project investment in coming years to meet its commitments under the Paris Agreement within the United Nations Framework Convention on Climate Change. A liquid and efficient green bond market depends on a defined taxonomy that establishes green bond criteria definitions (What is a green bond?); environment, social and governance (ESG) scores and disclosures; and standards for prospectus disclosure and "use of proceeds" disclosure and climate-related disclosures. Canada has small but growing green bond and ESG bond markets and is in the midst of designing common standards to promote corporate issuance. As in Europe, Canada has significant potential green project investment to meet climate considerations and promote economic growth.

Perhaps the highest regulatory priority in global debt markets is the transition to risk-free interest rate benchmarks to replace the ubiquitous LIBOR benchmark (the gross notional value of all financial products tied to US Dollar LIBOR is around $200 trillion, roughly 10 times U.S. GDP). The transition is a cooperative and harmonized effort across the major jurisdictions in the developed economies to develop robust, risk-free or nearly risk-free reference rates. The transition effort is rooted in a campaign to make investors, issuers and other market participants aware of the need to move away from the LIBOR benchmark as panel banks will not have the obligation to submit LIBOR quotes after 2021. Market participants are encouraged to shift new borrowings to the designated new financial benchmark rates – i.e. US SOFR (Secured Overnight Financing Rate), UK SONIA (Sterling Overnight Index Average), €STR (Euro short-term rate), Swiss SARON (Swiss Average Rate Overnight) and Japan TONA (Tokyo Overnight Average Rate). The next steps are to sort out the regulatory, legal, tax and operational/system issues.

Value of Financial Products Tied to LIBOR and Other Similar Benchmarks



Source: International Swaps and Derivatives Association, Inc.

Canada is an integral participant in this multi-jurisdictional effort to develop new benchmark risk-free rates in accordance with IOSCO standards. The Bank of Canada's Canadian Alternative Reference Rate (CARR) Working Group was created to identify and seek to develop a new term risk-free Canadian dollar interest rate benchmark to be used alongside the existing Canadian Dollar Offered Rate (CDOR). It has proposed enhancements to the Canadian Overnight Repo Rate Average (CORRA) as well as to assess the need for and potentially develop a Canadian dollar term overnight risk-free rate benchmark. CARR formed the Alternative Rates subgroup specifically to evaluate options for enhancing CORRA. Raising awareness of the global benchmark reforms is very much a part of their work.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
June 2019