Plumbing and Spreads:
COVID-19 Drives Liquidity Measures

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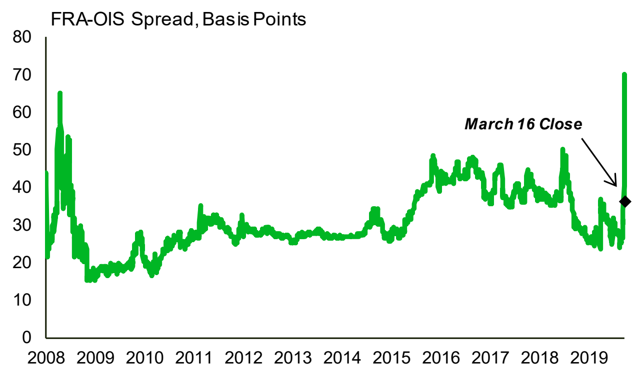
Highlights

- Fiscal packages and interest rate cuts make headlines, but other measures recently put in place to ensure that Canada's financial plumbing remains in good working order should not go unnoticed.
- Over the last several days the Bank of Canada has introduced a Bankers' Acceptance Purchase Facility, and a revamped U.S. dollar swap facility, adjusted its Large Value Transfer System, broadened the eligible collateral for its term repo facilities, and announced additional purchases of Canada Mortgage Bonds.
- At the same time, the Canada Mortgage Housing Corporation (CMHC) has brought back its crisis-era Insured Mortgage Purchase Program, intending to purchase up to $50 billion of insured mortgage pools.
- These measures are not economic stimulus per se – rather, they are intended to reinforce the transmission of monetary policy by addressing near-term funding and liquidity challenges, keeping Canada's financial system in good working order. Given dislocations that had begun to emerge, these programs are a needed and welcome development.

With every day bringing an onslaught of COVID-19 related headlines, all but the largest announcements can quickly blur together. While travel restrictions, fiscal packages, and interest rate cuts may be memorable, just as important is ensuring that the financial plumbing continues to operate smoothly. In the current high volatility environment, elevated uncertainty risks turning into a breakdown of trust and a 'dash for cash' that blows out credit spreads and seizes up funding markets even further. This risk was already becoming evident by last week as the FRA-OIS spread, a measure of perceived credit risk in the important Bankers' Acceptance market, rose rapidly (Chart 1).

Fortunately, policymakers have been quick to respond. The Bank of Canada has introduced a slew of liquidity measures, and CMHC has brought back a crisis-era mortgage purchase program. It seems a safe bet that there will be further challenges (and further responses) before the COVID-19 outbreak is in the rear-view mirror, but we can take some solace in these timely efforts to keep Canada's financial plumbing functioning as it should.

Chart 1: Credit Spread Blow out Appears to Have Been Short Lived



Source: Bloomberg, TD Economics

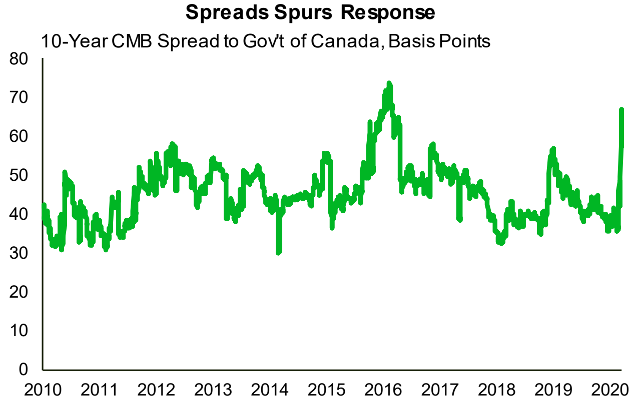
Bank of Canada Not Holding Back

The staff of the Bank of Canada have been busy of late. Friday's 50 basis point inter-meeting cut, coordinated with Finance Minister Morneau and OSFI Superintendent Rudin was a big event, but there has been much more going on, with the Bank of Canada putting its balance sheet to work supporting funding markets.

The following highlights the array of newly-announced measures:

- Also announced Friday was a new Bankers' Acceptance Purchase Program. Operational parameters are forthcoming, but this appears intended to mitigate the kinds of spread blow-outs seen in Chart 1.
- Even before Friday, the Bank announced an expansion of its bond buyback program, as well as new temporary 6- and 12-month repurchases operations, joining its regular 1- and 3-month operations. These expanded operations should help ensure liquidity in short-term funding markets.
    - Related to this, the Bank yesterday expanded the list of eligible collateral for those operations to anything that is eligible for use at its Standing Liquidity Facility – similarly aimed at making it easier for firms to access liquidity if/as needed.
- Over the weekend, the BoC, alongside a number of advanced economy central banks, announced the return of a U.S. dollar swap line with the Federal Reserve, priced at an attractive 25 basis point spread to the market overnight rate. This should help hold down U.S. dollar funding costs for Canadian banks, helping support important economic functions such as trade finance, which BIS research suggests occurs by and large in U.S. currency.
    - Notably, for Canada, the swap lines may function more as a confidence booster by their presence, rather than their usage. Even during the depths of the financial crisis, the Bank's swap line was never tapped.

Chart 2: Sharp Widening of Mortgage Bond Spreads Spurs Response



Source: Bloomberg, TD Economics

- In a similar vein, the BoC has made tweaks to Large Value Transfer System rules to allow participants to assign more of their non-mortgage loan portfolio as collateral. Like the prior change, this will give core financial institutions more flexibility in managing their balance sheets, reducing the likelihood of significant stresses in the system. It is important to note that BoC lending under these facilities remains fully collateralized.
- Last week's $500 million purchase of Canada Mortgage Bonds proved to be the start of something bigger. The Bank announced yesterday that it will make twice weekly purchases of these securities, targeting $500 million per week for "as long as market conditions warrant". As Chart 2 shows, this market has been experiencing widening spreads, potentially interfering with the transmission of monetary policy into mortgage rates.
    - This action is interesting as it will both be first time that the Bank of Canada has purchased CMBs in the secondary market, and the first time they've bought them with the goal of promoting market functioning. Typically, the Bank purchases CMBs at auction for balance sheet management, similar to how they currently approach government bills and bonds.

CMHC Reaches Back Into Its Crisis-Toolkit

Notable by its absence from Friday's coordinated policy response was CMHC, whose mandate is stated as 'help[ing] Canadians achieve their housing needs'. It was only a few days later that this agency announced its own boost of support for the Canadian economy. CMHC will make up to $50bn in purchases of insured mortgage pools via its Insured Mortgage Purchase Program (IMPP), a facility last used during the global financial crisis. These pools are, in simple terms, collections of individual insured mortgages made by financial institutions that are packaged together. These packages are then sold directly to investors or turned into Canada Mortgage Bonds via the CHMC's Canada Housing Trust, which uses swaps and other tools to further reduce the risk profile. By purchasing these pools, CMHC provides lenders with an additional source of liquidity. Like the Bank of Canada's purchases of CMBs, this liquidity should help rein in credit spreads, improving the transmission of interest rates to mortgage borrowers, and thus supporting the important residential investment market.

Bottom Line

There are bound to be debates over whether these new measures, particularly the BoC's, qualify as quantitative easing or not. Regardless of what you want to call them, these balance sheet operations are a welcome addition to the list of economic responses to COVID-19. With the economic impact of the pandemic serious enough, the last thing that Canada needs is a freezing up of the financial system. The Bank of Canada and CHMC are moving swiftly to mitigate this risk, and given recent communications, are set to do more if warranted.