

Debt markets in need of reform

An expert working group is looking at ways to promote stability by making structural changes

ONE OF THE POIGNANT LESSONS the Canadian securities industry has taken from the current financial crisis is that improvements are needed to the trading and clearing/settlement infrastructure of Canadian debt-capital markets for these markets to function effectively in crisis situations. In addition, we need to provide the needed efficiencies for competitiveness; meet the risk-management concerns of market participants; and enable the efficient transmission of monetary policy.

The Investment Industry Association of Canada has put together a working group of senior executives from our member firms active in domestic debt markets to provide leadership on a series of initiatives designed to improve the functioning of our debt markets. The dislocations in secondary credit markets during the recent crisis, and the prospect of the fixed-income business becoming more capital-intensive — reflecting the new Basel II rules and possible revisions to dealer-capital rules to meet “through the cycle” requirements — have tightened industry focus on efficient transaction flows.

The repo markets, or markets for collateralized short-term borrowing, are at the fulcrum of well-functioning government- and corporate-debt markets. The inability to fund transactions through the repo market during the recent crisis period caused trading activity to seize up right across the yield curve. The IIAC has issued requests for proposals to several domestic and foreign clearing houses to design and implement technology for the real-

GUEST COLUMN
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time netting of similarly structured repo transactions. The simultaneous netting of repo trades will provide more efficient use of capital and higher ROEs, and, in turn, encourage greater investor participation in the marketplace — particularly in stressed markets.

The financial crisis has forced a rethinking of risk-management standards for market participants. One dimension of risk is the need for full disclosure of traded instruments — particularly complex derivative structures — and the transparency of bid-offered and traded market prices for over-the-counter securities. The IIAC has responded to the **Canadian Securities Administrators’** proposals for greater disclosure of asset-backed securities, recommending much higher standards than at present. The IIAC anticipates the CSA will reissue these proposals for comment in the near future, and we will respond at that time.

The IIAC working group has spearheaded a partnership between the CanPX transparency system, which provides real-time pricing for government- and corporate-debt securities, and the CanDeal trading platform to build more effective dissemination of market data to investors. The partnership brings together two competing debt transparency systems, to achieve more comprehensive government- and corporate-debt information — in terms of both in-

dicative and actual bid-offered prices. We have also worked closely with the regulators and CanPX and succeeded in obtaining for CanPX the Information Processor designation for corporate-debt markets.

Another dimension of risk is the containment of counterparty risk. The IIAC working group is considering a proposal to build a clearinghouse for OTC derivative securities. The clearinghouse could embrace certain derivative securities, such as interest rate and cross-currency swap transactions. The framework will promote increased trading activity in OTC securities by transferring counterparty risk to the clearinghouse and encouraging greater standardization of OTC securities as these securities meet common standards for eligibility to the clearinghouse.

A clearinghouse for certain OTC securities, combined with a well-functioning repo market, will promote continued trading in debt securities — notably, complex structured securities — in times of financial crisis, making dislocations in trading activity experienced in the recent crisis less likely. Better-functioning credit markets will reduce the need for extraordinary central bank interventions.

The IIAC will continue to be a strong advocate of a single securities regulator. With the establishment of the federal Transition Office, the prospects for regulatory structural change are better than ever. The replacement of the multi-jurisdictional system with a single regulator will achieve cost efficiencies in the regulatory process. Moreover, the single

regulator will facilitate better co-ordination among banking and securities regulators. A close relationship between banking and securities regulators is essential for comprehensive and efficient regulation — particularly, for derivative securities — given the integration between banking and capital markets in product development, and the trading and distribution of these securities.

The existing system has demonstrated a frustrating inability to deliver new rules and regulations on a timely basis in response to changing market conditions. Regulators need to develop a more streamlined regulatory framework to accommodate globally traded issues of large foreign issuers, avoiding the categorization of these securities as conventional private placements — in this way, limiting distribution, trading and excessive issuance fees, which are disincentives to Canadian market offerings. There are many other examples of needed regulatory reform.

The past four months have seen a dramatic improvement in credit markets: credit spreads have narrowed significantly; more liquid markets have emerged across the curve; and new issuance has returned to pre-crisis levels. The concern is that these improving conditions will deflect concentration on needed reform as disastrous events from the recent crisis become a faded memory. We must stay the course with reform; to fail to do so is at our peril. **IE**

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