Funding market 101

An overview of how the funding market works to help explain why interest rates have yet to go down despite the COVID-19 pandemic.

Overview

- The funding market is one part of the financial market, mainly composed of financial products that have a maturity of one year or less.
- The main participants include financial institutions, corporations, the government and the Bank of Canada and each participant uses the market a bit differently.

How does the funding market work?

Governments issue Treasury Bills (short-term debt obligations sold at a discount) to help fund public initiatives.

Corporations manage their treasury by lending and borrowing liquidity.

Investors manage the "cash" portion of their portfolio by buying and selling short-term papers.

Funding markets

The Bank of Canada (BoC) is the referee, setting the policy rate to anchor liquidity and intervening to buy and sell as needed.

Financial institutions manage their liquidity by lending and borrowing.

What happens during a crisis?

As with all markets, supply and demand of funds dictates the price. Increased demand for liquidity pushes up the cost, leading to rising interest rates and increased supply pushes the cost down, leading to declining interest rates. Due to the COVID-19 economic crisis:

- Corporations and businesses forced to close or limit operations require additional credit from financial institutions.
- Many laid off or sick workers also require additional credit.
- Financial institutions must generate additional liquidity to meet the demand.
- With everyone buying liquidity and no one selling, costs - and therefore interest rates - remain high (or even increase).
- To preserve lending margins and limit risk, financial institutions must keep interest rates on lending high.

What is being done to help?

Government has increased spending on programs to support people and businesses impacted by COVID-19, including new funding programs, grants, loans and more.

The BoC has significantly cut its policy rate and is working to flood the market with liquidity among other measures.

Financial institutions are offering various support programs including mortgage and loan payment deferrals, new loans and reduced interest rates on certain products in an effort to help people in need of financial support.

Despite these efforts, it will take several weeks for those programs to fully impact the market. In the meantime, lending rates (e.g. mortgage rates) may remain high. **If you need immediate help, contact your credit union today to see what they can do for you.**

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