Canadian interest rate benchmark reform

Global financial markets are undergoing a major transformation

LIBOR, a set of key global interest rate benchmarks, is set to disappear because the underlying market it represents is no longer robust, and panel banks no longer want to contribute rates. LIBOR will disappear for four currencies (CHF, EUR, GBP, JPY) after end-2021, with the key USD LIBOR rates disappearing after June 2023. This will affect trillions of dollars of loans, bonds and swaps. Global authorities are working with the private sector to prepare markets to transition from LIBOR to risk-free rates. Similar work is underway in non-LIBOR jurisdictions, including Canada.

- In Canada, benchmark reform efforts are being led by the Canadian Alternative Reference Rate Committee (CARR), a group of financial sector firms and public sector institutions. CARR's mandate includes promoting the use of the Canadian Overnight Repo Rate Average (CORRA) as a key risk-free interest rate benchmark in Canada.
- CORRA is a robust, transaction-based benchmark that reflects billions of dollars in daily overnight repo transactions. It meets global benchmark standards and is similar to other global risk-free rates (RFRs).
- While the Canadian Dollar Offered Rate (CDOR), Canada's other main interest benchmark, is currently not anticipated to go away, we expect its relevance to decline, like other credit-based benchmarks, as markets globally move to RFRs. CARR is reviewing the efficacy of CDOR as a benchmark and, as a voluntary and survey-based measure, CDOR may ultimately be discontinued.

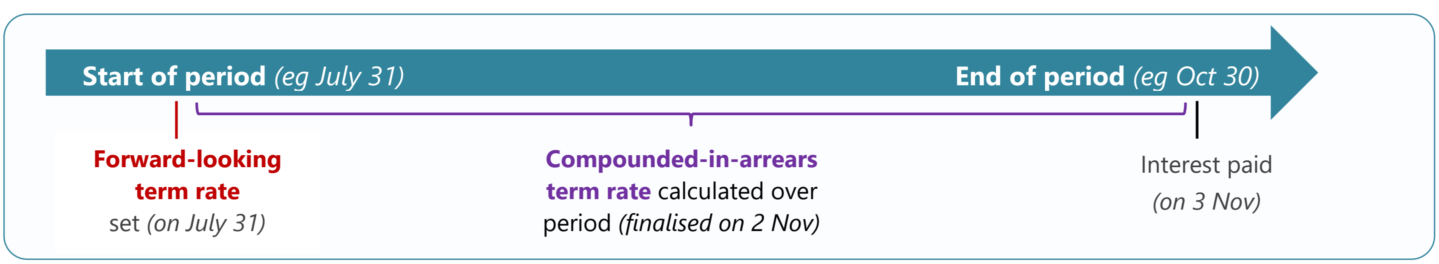
Canadian Dollar Offered Rate (CDOR)

- Credit based rate that incorporates both term and bank credit risk premium
- Measures the rate that Canadian banks are willing to lend to clients with existing credit agreements via banker's acceptances
- Survey-based, intended to reflect Bankers Acceptance transaction rates
- Submitted rates lack transparency
- Term rate (1, 2, and 3-month)
- **Forward-looking term rate** (payment is known in advance)
- Administrator: Refinitiv

Canadian Overnight Repo Rate Average (CORRA)

- Risk-free rate that reflects the overnight risk-free rate
- Closely tracks the Bank of Canada's policy rate
- Measures the cost of overnight lending via general collateral repo transactions secured by Government of Canada debt
- Transparent, transaction-based (i.e. reflects actual market transactions)
- Overnight rate
- Needs to be **compounded in arrears** to calculate a term rate and payment
- Administrator: Bank of Canada
- No publication delay for free usage

- A **forward-looking term rate** is set at the start of the period over which you calculate interest, while a **compounded-in-arrears term rate** is based on a daily interest rate compounded over the calculation period. In other words, you know how much interest you will have to pay on a loan referencing a **forward-looking rate** at the start of the loan. For an **in-arrears rate**, you will not know the exact amount to be paid until the end of the period, although with each day you gain increased certainty.



- Since **in-arrears** rates are compounded daily over a period of time, they are less likely to be impacted by short-term spikes (as these will be averaged down by all the other observations over the calculation period).
- The CORRA in-arrears rate is relatively stable if there is no change to the Bank of Canada's policy rate. However, it will immediately reflect the new rate if there is a change to the policy rate. In times of financial stress, the spread between CDOR and CORRA will normally widen.
- Derivatives (such as overnight index swaps) can be used to lock in a fixed rate for any length of time, so that payment amounts are known in advance.
- Systems and processes developed for using **forward-looking rates** (e.g. financial software) may need to be updated to handle **in-arrears rates**. It is expected that over time most systems will adapt to being able to handle both.

CARR is hard at work preparing the Canadian market for CORRA as a key risk-free interest rate benchmark.

- CARR has developed an enhanced calculation methodology for CORRA, developed a "CORRA Compounded Index" now published by the Bank of Canada to ease the calculation of interest rate payments on bonds or loans referencing CORRA, contributed to the development of Montreal Exchange's CORRA futures contract, and kept Canadian businesses informed on benchmark issues. CARR has published "fallback language" for floating rate notes referencing CDOR or CORRA. It has also developed recommended market conventions for floating rate notes and loans referencing CORRA and for certain types of swaps.
- CARR is now working on:
    - ✓ Assessing and monitoring whether systems providers, such as software companies that develop systems for market participants, have incorporated CORRA and in-arrears methodologies.
    - ✓ Identifying and working with other groups on accounting, tax, regulatory and risk issues that might arise from the transition from CDOR to CORRA, as well as from the LIBOR transition happening globally.
    - ✓ Assessing the current status of CDOR and the Bankers Acceptance market and how effective CDOR is as a financial benchmark for the future.

Work to prepare derivative and swaps markets for benchmark transition is being coordinated globally by the International Swap and Derivatives Association (ISDA).

- ISDA has developed robust **fallback language,** including for CDOR, for swaps and derivatives that are not cleared by central counterparties (CCPs). This fallback language has also been adopted by the CCPs.
- ISDA has also developed a "protocol" to integrate these new fallbacks into any legacy contracts.

Recommended next steps

- Make sure you understand the reform efforts going on in the benchmarks that you have exposure in.
- Make sure you have robust CDOR fallback language in place so that you are ready if CDOR is stopped being published. In May 2021 Refinitiv stopped publishing the 6- and 12-month CDOR tenors.
- Make sure your internal/external systems can incorporate these new benchmarks.
- Benchmark reform is a complex issue, so discuss with your bank, dealer or trusted financial counterparty how benchmark reform may impact you and how you can start using these more robust benchmarks going forward.

Stay informed!
Visit these national working groups.

CARR | ARRC | RFRWG | EUR WG | JPY WG | CH NWG