Canadian Alternative Reference Rate
Working Group

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Credit Sensitive *Benchmarks* – A way forward for Canada

Global financial markets are moving from survey-based inter-bank offered rates (IBORs) to transaction-based overnight risk-free rates (RFRs). This move will intensify after LIBOR ceases to be published, currently expected to be the end-of 2021. These new or existing RFRs are appropriate reference rates for many asset classes, including derivatives, securitizations, and floating rate notes. However, they may not be optimal for certain types of loan products, especially committed revolving loan facilities due to adverse incentives that may arise during periods of financial stress.[1] Benchmarks that flex with changes in bank credit spreads mitigate these procyclical flows in a stress period and would be preferable to an RFR for some loan products. Such a benchmark could either be a credit sensitive 'spread' that would be added on to an RFR, or a credit based 'all in rate'. Work on the merits and alternatives for new credit sensitive benchmarks is currently underway in a number of jurisdictions.

In Canada, the Canadian Dollar Offered Rate (CDOR) has been the prevailing credit benchmark rate for the past 30 years. While CDOR is structurally different than LIBOR and did not suffer from the same frailties as LIBOR, it is also a survey-based rate. Using expert judgement, the six CDOR panel banks provide daily submissions to Refinitiv, CDOR's administrator, that reflect the rate at which they are willing to offer credit to companies against banker's acceptances (BAs) across various tenors.

Recent reforms to CDOR have focused on the submission process rather than the underlying structure, including the BA market. The CDOR submission process has been subject to enhanced oversight, including a code of conduct initially published by IIROC in 2013 and new supervisory guidelines from OSFI in 2014. Nonetheless, a fulsome analysis on the architectural underpinnings of CDOR, including funding through BAs, has yet to be undertaken, even though post-crisis reforms to banking regulation has adversely impacted the effectiveness of BAs as a short-term funding instrument for banks. It is proposed that Canada embark on such an analysis to ensure Canada's financial benchmarks are robust, relevant and effective.

The Canadian Alternative Reference Rate working group (CARR) was constituted to focus on financial benchmark reform in Canada. CARR's mandate has been directed towards the development of a robust Canadian RFR (i.e. the Canadian Overnight Repo Rate Average or CORRA) and the efforts to help transition products to the RFR. The group includes members representing a broad-cross section of the Canadian financial system, and therefore makes it the best-suited Canadian body for analysing the Canadian credit benchmark landscape.

CARR could expand its mandate to include an analysis of the current state of CDOR and the underlying BA market, as well as make recommendations based on that analysis. CARR's membership would be adjusted to reflect its new mandate. CARR would be re-structured to have two primary subgroups: 1) an RFR transition subgroup responsible for supporting the transition to and adoption of CORRA as a key financial benchmark in Canadian derivatives and securities; and 2) a credit benchmark subgroup responsible for analyzing the current status of CDOR, its underlying architecture as well as its function as a credit sensitive benchmark. The subgroup would also be responsible for making recommendations based on the analysis.

Bringing both of Canada's interest rate benchmarks under the purview of CARR would leverage the broad market representation and subject matter expertise on the national working group to ensure Canada's benchmark regime is robust, relevant and effective in the years ahead.

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[1] During periods of stress, IBORs like CDOR tend to increase reflecting the increased funding cost of banks, while RFRs like CORRA tend to decrease. Were loan facilities to reference an RFR, without any new limitations on draws, borrowers would be much more likely to borrow funds during times of stress, leading to both liquidity and profitability concerns. Anticipating this behaviour, banks offering loan facilities tied to RFRs would need to increase the liquid assets they hold for these facilities, unless they add new constraints on the ability of borrowers to drawdown their committed facility, potentially increasing the cost to the end borrower.