CARR's Review of CDOR: Analysis and Recommendations[1]

Executive Summary

- The Canadian Alternative Reference Rate working group (CARR) was established in March 2018 to guide benchmark reform efforts in Canada. Its membership includes senior representatives from a variety of stakeholders in the Canadian financial system. In 2020, CARR was tasked with reviewing and analyzing the efficacy of the Canadian Dollar Offered Rate (CDOR) and making recommendations for its future based on that analysis.
- CDOR, originally developed in the 1980s as the basis for pricing Bankers' Acceptance (BA) related credit facilities, is currently the primary interest rate benchmark in Canada. It is referenced in more than $20 trillion of gross notional exposure across the Canadian wholesale financial system, including in derivatives, bonds, and loans. About 97% of this exposure relates to derivatives, while only about 1% relates to loans. CDOR is currently administered and published by Refinitiv Benchmark Services (UK) Limited (RBSL).
- While CDOR has served the Canadian dollar market well for many years, there are certain aspects of CDOR's architecture that pose risks to its future robustness. CARR's objective has been to analyze these issues in the context of the new, higher standards expected of critical interest rate benchmarks to ensure Canada's benchmark regime is robust and resilient in the future.
  - Key global interest-rate benchmarks, including both risk-free and credit sensitive rates, are increasingly being restructured to be primarily based on large volumes of underlying transactions rather than expert judgement. While CDOR is a committed lending rate, the determination of that rate, and therefore CDOR itself, is based predominantly on expert judgement. It cannot be directly tied to observable arms length transactions and is therefore not consistent with evolving global best-practices. All other major credit sensitive rates are defined as a borrowing rate and can therefore be more directly determined by securities transactions.
  - The BA lending model, which supports CDOR, is no longer seen as an effective way for banks to provide credit to their corporate clients. Banks' funding methodology has evolved to better match the term of their funding to the term of their loans, and this practice is now codified in Basel III regulation. Because BA loans are "term" or "committed" facilities, bank treasuries no longer fund them through the issuance of BA securities that are generated through the loan drawdown. It is likely that banks will reduce or cease issuance of BAs. Banks have already started moving in this direction by either holding more BAs on balance sheet instead of selling them into the market and by creating CDOR-based loan products that do not generate a BA. Notwithstanding the absence of a direct linkage, a decrease in BA issuance would increasingly erode the foundation upon which CDOR is built.
  - The International Organization of Securities Commissions (IOSCO) recently called for greater attention, in credit sensitive benchmarks, to (a) the size of the underlying market(s) referencing a benchmark in relation to the volume of trading in the products used to determine the benchmark, also known as "proportionality", and (b) whether there is sufficient underlying data

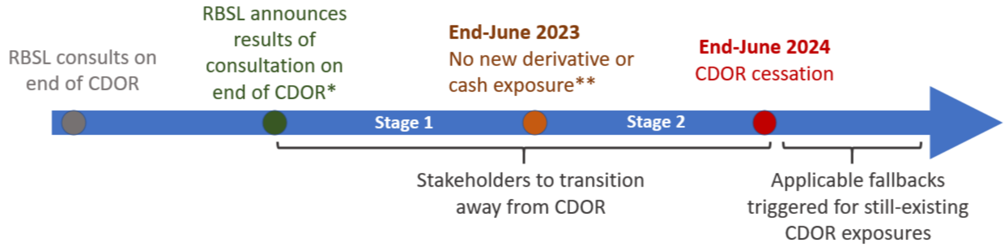
[1] Full report: https://www.bankofcanada.ca/2021/12/carr-publishes-white-paper-recommended-future-cdor/

to support the benchmark in both normal times as well as stress periods. Both of these issues are relevant to CDOR and its ongoing robustness.

- Benchmark reform is a global endeavour seeking to establish a sound foundation for financial products in the future. In Canada, this initiative is being supported by the work of CARR and by a new regulatory framework brought in by the Canadian Securities Administrators (CSA) as benchmark regulators. This framework aligns Canada with the heightened standards other jurisdictions began adopting in 2018. Securities authorities in Ontario and Quebec have designated CDOR a "critical" interest rate benchmark, increasing the obligations on both the benchmark's administrator and the benchmark's contributors.
- As was experienced with LIBOR (and other global survey-based benchmarks), contributing member banks may decide they no longer wish to continue submitting rates voluntarily given the increased obligations and costs to do so, as well as potentially from their own concerns about the future of CDOR in light of CARR's analysis of the rate. This is a key fragility given that only six contributing banks remain on the CDOR panel.

- CARR examined the feasibility of reforming or enhancing CDOR, as was done with the Canadian Overnight Repo Rate Average (CORRA), Canada's overnight risk-free rate, and other global credit sensitive benchmarks. This was not seen as a tenable option due to CDOR's definition and the inherent inability to tie it directly into arm's-length securities transactions. Changing either would almost certainly result in a benchmark that was both legally and economically different from what CDOR is today.
- **CARR recommends that RBSL should cease the calculation and publication of CDOR after June 30, 2024. CARR proposes a two-staged approach to the transition from CDOR (see Figure 0). The first stage would run until June 30, 2023, and the second and final stage would end on June 30, 2024. By the end of stage one we would expect all new derivative contracts and securities to have transitioned to using CORRA, with no new CDOR exposure after that date except with limited exceptions. Those exceptions include derivatives that hedge or reduce CDOR exposures of derivatives or securities transacted before June 30, 2023 or in loan agreements transacted before June 30, 2024.**
- The second stage to June 30, 2024 would provide firms with additional time to transition their loan agreements and deal with potential issues related to the redocumentation of "legacy" securities. The longer time window would also allow for more existing CDOR-based securities exposures to mature. Approximately $95 billion in floating rate notes and securitized products referencing CDOR would remain outstanding after the end-date of June 30, 2024.
- These recommendations for the future of CDOR have been unanimously endorsed by CARR and Canadian Fixed Income Forum (CFIF) members.
- **The decision to ultimately cease CDOR lies solely with RBSL and CARR's recommendation does not constitute a public statement or publication of information that CDOR has ceased or will cease permanently or indefinitely. As outlined in Section 12.2, for RBSL to cease publication of CDOR, it will first need to determine that it is necessary to cease the provision of the benchmark, including whether cessation is the appropriate course of corrective action. RBSL is required to consult on any proposed end-date and later publish a notice of an end-date ahead of any actual cessation date. It is this notice that would trigger the credit spread adjustment calculation under ISDA's derivative CDOR fallbacks, as well as CARR's recommended CDOR floating rate note fallbacks. The actual fallbacks would only apply once CDOR is no longer published. CARR expects Refinitiv to provide more clarity as to their actions in the near future.**

Figure 0 – CDOR transition conditional on RBSL's decision to cease CDOR



* A notice from RBSL announcing the cessation of CDOR would trigger the calculation of the ISDA credit spread adjustment as well as the credit spread adjustment in CARR's recommended fallback language for FRNs.

** Except where derivatives hedge or reduce CDOR exposures in derivatives or securities transacted before June 30, 2023 or in loan agreements transacted before June 30, 2024.

- The recommended timeline would provide time for stakeholders to transition CDOR exposures to other alternative benchmarks. In the case of Canadian dollar derivatives and securities, CARR expects these products will transition to CORRA (calculated in-arrears) and can do so within the shorter timeframe, given the experience and lessons learned from the LIBOR transition. Loan products may also transition to CORRA in-arrears, but CARR will consider the various options for loan products and will consult by the end of Q1-2022 on the potential need for any additional new benchmarks for loan products, including a forward-looking term CORRA.[2] Any new Canadian benchmarks would be expected to be IOSCO compliant and meet new global standards for robustness.
- Should RBSL agree with CARR's analysis and recommendations and announce that they will discontinue the publication of CDOR following their public consultation, the transition from CDOR to CORRA will benefit from the resources dedicated to the ongoing LIBOR transition. It will also benefit from work already done by the International Swaps and Derivatives Association (ISDA) to facilitate the move to overnight risk-free rates. CDOR was included, along with other major global credit sensitive benchmarks, in ISDA's recently completed work to develop and incorporate more robust fallbacks to derivatives transacted under ISDA agreements.
- CARR has already laid some of the groundwork required to support a successful transition having completed its work on enhancing CORRA, provided recommended robust CDOR fallbacks and CORRA conventions for those products currently referencing CDOR. However, CARR recognizes that there is much work yet to be done should RBSL discontinue CDOR, including infrastructure changes, potential changes to governing laws or regulations, and the potential development of new benchmarks. All of these factors have been considered in the development of the two-staged recommended transition plan.
- CARR will continue to work with CDOR's stakeholders, including Canadian authorities, to develop the tools and milestones necessary to enable a smooth transition away from CDOR. To this end, and to reduce the risks to Canadian financial markets posed by an abrupt transition, CARR expects that the six CDOR contributing banks will continue to remain on the CDOR panel and will support BA issuance, to the extent possible, until CDOR's recommended cessation date of June 30, 2024.
- While CARR's recommendation is only with respect to CDOR, the end of CDOR may have implications for the issuance of BAs, with banks potentially moving away from issuing short-dated BAs in favour of other forms of funding. CFIF will work with industry to assess the potential impact of reduced BA issuance and determine what additional work, if any, is needed to support the investment community in adapting to any resulting changes.

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[2] Similar to term SOFR's initial licensing, term CORRA's use could potentially be restricted to loans and hedging of loans.