Canadian Alternative Reference Rate Working Group

January 11, 2023

Consultation on a potential new term interest rate to replace CDOR in certain financial instruments

Summary of results

Overview

The Canadian Alternative Reference Rate working group (CARR) was established in March 2018 to help guide benchmark reform efforts in Canada. On May 16, 2022, CARR launched a public consultation to seek feedback on the need for a potential forward-looking term rate (i.e. Term CORRA) to replace CDOR in certain loan and hedging agreements. CARR received 42 responses, over half of which were from non-financial companies, and the remainder from banks, non-bank financial companies, and government-owned entities. The companies that responded to the consultation included a wide variety of non-financial firms from across the Canadian economy, including energy and pipelines, manufacturing, real estate, and utilities.

CARR's response:

CARR thanks all those who provided feedback on the consultation. All comments received were carefully considered by CARR members and have helped guide CARR's decision-making process.

Question 1) Does your institution need a Term CORRA rate? If so, for what purpose and how would you use Term CORRA?

The vast majority of respondents (88%), including all non-financial companies that responded to the consultation and the majority of the major Canadian lenders, wanted a Term CORRA benchmark. Respondents generally noted cash flow predictability and operational simplicity (e.g. no expensive IT system overhauls, less burden on staff) as benefits of a term rate.

- Several firms stated that accurate cash flow forecasting was particularly important for hedge accounting.
- One firm noted the risk that, should a significant change in interest rates occur towards the end of the loan, the firm may not be able to acquire adequate cash to pay interest by the due date.
- It was highlighted that the administrative burden of not having Term CORRA would weigh heaviest on smaller firms.
- Several respondents noted the importance of a term rate for inventory/receivables financing.

Those few firms that did not fully support the creation of a Term CORRA noted that the rate would result in a more-complex, multi-rate environment and expressed concerns about basis risk and its hedgeability. Some expressed concern that Canada's market may be too small to support a term rate.

In response to the overwhelming support for a Term CORRA, CARR members agree to try to develop a Term CORRA, so long as a robust and IOSCO compliant rate can be created.

Question 2) Besides bank lending and trade finance, are there other products or activities for which you would need a Term CORRA? If so, what are the key factors driving your need. Please be as explicit as possible.

Non-financial companies mentioned the following additional uses of Term CORRA:

- As a market basis for discount calculations where a present value is needed (e.g. financial reporting)
- Hedging loan facilities (e.g. for derivatives products to hedge term SOFR-denominated USD borrowings to a CAD term equivalent) and other term rate exposures
- Transfer pricing for inter-company loans
- As a reference rate when negotiating contracts with third parties (e.g. vendors, JV partners, customers) or related entities (e.g. partnership loans)
- Securitization products with floating rate tranches
- Financial leases

Financial companies noted the following additional uses of Term CORRA:

- Clients' hedging activity (i.e. firms hedging Term CORRA loans need interest rate swaps, caps and floors based on the same benchmark)
- Derivative products, including the hedging of Term CORRA derivatives in the inter-dealer market (as US banks offering Term SOFR products are facing substantial issues managing the associated risks)
- Securitizations of Term CORRA-based lending
- As a fallback rate for certain "tough legacy" CDOR-linked products where operational constraints on some of the parties to the contract limit their ability to use overnight rates

> CARR established a working group tasked with determining allowable use cases for Term CORRA. The feedback from the consultation was one of the inputs used by the working group to recommend the allowable use cases for Term CORRA.
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> The recommended use cases were published here.

Question 3) How would your institution be affected if the use of Term CORRA was restricted to use in loans and trade finance only, and not to derivatives hedging those loans (i.e. Derivatives would be restricted to overnight CORRA compounded in-arrears)? Please be as explicit as possible.

Of the non-financial companies that responded, 72% said they would be impacted if Term CORRA's use was limited to loans and trade finance, 23% said there would be no impact or a minimal impact, and one respondent was uncertain. Firms that said they would be impacted typically cited the impact on cash management and hedging (i.e. unable to swap to fixed when needed). Firms that foresaw no or minimal impact typically had little or no derivatives exposures.

Of the financial firms that responded, 85% said they would be impacted if Term CORRA's use was limited to loans and trade finance, and 15% said that they would not be meaningfully impacted. They expressed concern that, if they were unable to hedge the Term CORRA loans that they offered to their clients with Term CORRA derivatives, they would be exposed to an unhedgeable basis risk resulting in increased P&L volatility or be unable to assist clients who seek to hedge their interest rate exposures.

> The responses to this question were also reviewed by the working group mentioned in the response to Question 2. The results of this work were published here.

Question 4) CARR is considering recommending that Term CORRA be limited to only the 1- and 3- month tenors. If only one of these tenors was available, which would you need and why?

Of those firms that offered an opinion, 80% of financial and 70% of non-financial companies said they would prefer a 1-month rate over a 3-month rate if forced to choose. A majority of respondents indicated, however, that they preferred both rates be made available. Respondents generally preferred the rate that reflected their current borrowing/lending behaviour. One respondent also urged the creation of longer-term tenors.

> Based on the responses received to this question, CARR's recommendation is to pursue both 1- and 3-month Term CORRA tenors. The viability of any published Term CORRA tenor will depend on the underlying CORRA futures liquidity remaining robust enough to sustain an IOSCO-compliant benchmark over the longer term.

Question 5) If Term CORRA was not available, would your institution use overnight CORRA? If not, could you explain why and what other alternatives would you consider?

A large majority of financial firms that responded said they would primarily shift to overnight CORRA. Most non-financial firms either responded that they had not yet contemplated a replacement rate or saw Term SOFR as their alternative rate, with the US dollar proceeds being swapped back to Canadian dollars. Some additional rates such as Prime were also noted. Several non-financial firms expressed concern over the operational complexity of using overnight CORRA. Several financial and non-financial firms noted the importance of term rates for trade finance.

> This feedback was useful for determining whether or not to proceed with developing Term CORRA. All firms using Term CORRA as a benchmark will need to include robust legal fallback language in their documentation to address the possibility that Term CORRA ceases to be published at any point in the future.

Question 6) Are there any aspects of the potential design of Term CORRA that you would like to comment on?

- Several respondents expressed concerns about the liquidity of the futures markets in Canada, and whether sufficient transaction volume was available to create a robust Term CORRA benchmark.

- Transparency was sought on how Term CORRA would be designed, for example how bids/offers and extrapolations from prior transactions may be included in the rate.
- One respondent noted that only one rate should be created: multiple benchmarks with multiple administrators lead to confusion in other jurisdictions.
- Some respondents suggested that, if Term CORRA is created, its definition should include a fallback to an overnight CORRA rate or CORRA-in-advance, should transaction volume fall below a transaction threshold.

> This feedback has been incorporated into the calculation methodology for Term CORRA, which is published here, together with information with respect to Term CORRA's administration. All firms using Term CORRA as a benchmark will need to include robust legal fallback language in their documentation.

Question 7) Are there any aspects of Term CORRA not specifically asked about in this consultation that you would like to comment on?

Respondents provided a variety of additional comments. Some of the comments not already noted in previous sections of this note include:

- Concern was expressed over whether the Canadian market could sustain a term benchmark.
- Outreach efforts in Asia and Europe were requested.
- One respondent noted that if Term CORRA were offered, that it would be beneficial to have standardize language to define the rate in legal documents (e.g. loans, trade deals, derivatives).

> CARR will include a global component in its outreach efforts, including through global organizations such as ISDA. CARR will develop relevant documentation for the use of Term CORRA in the applicable instruments.