September 2023

CANADIAN FIXED-INCOME FORUM

# Update from the BA Transition Virtual Network

## 1. Introduction

On May 16, 2022, the Canadian Dollar Offered Rate's (CDOR) regulated administrator, Refinitiv Benchmark Services (UK) Limited (RBSL) announced that it would cease the publication of CDOR after June 28, 2024. With the cessation of CDOR's publication, the Bankers' Acceptance (BA) based lending model, which is responsible for creating the BAs that are sold to money market investors, will be discontinued. As a result, there will be no, or at most very limited, BA issuance taking place after June 2024. BA issuance is expected to remain relatively robust until the end of 2023, however, it is expected to progressively drop as we approach the CDOR cessation date.

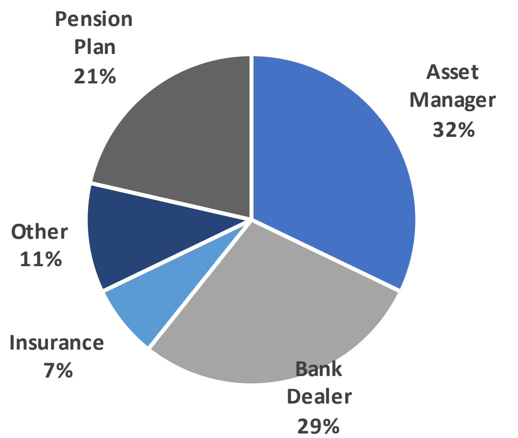
As outlined in the White Paper published by Canadian Fixed Income Forum (CFIF) in January 2023, BAs are important short-term Canadian dollar money market assets, currently comprising about 20% of the notional outstanding, or C$90 billion, in the Canadian money market. They are the second largest money market instrument after Government of Canada (GoC) treasury bills, and account for a signification portion of the investable product in the 1-month maturity bucket.

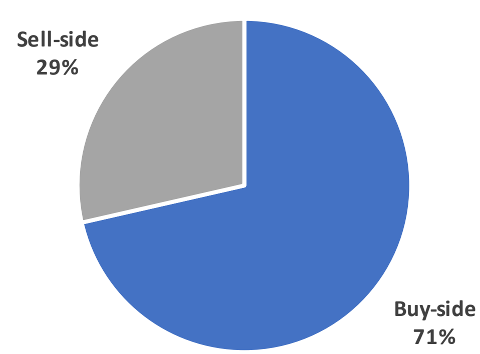
Given their importance, an orderly transition away from BAs is vital for the well functioning of the Canadian money market. To help with this effort, CFIF has formed a BA related working group, the BA Transition Virtual Network (Network), co-chaired by Elaine Lindhorst (TD Asset Management) and Charles Lesaux (RBC Capital Markets). This paper provides an update on the work carried out by the Network to date.

## 2. The BA Transition Virtual Network and its focus to date

The Network consists of members from close to 30 institutions, primarily from major buy-side investors active in BAs. Members include insurance companies, pension funds, money market funds, the major BA issuing banks and their dealers, as well as other relevant stakeholders. Member institutions account for approximately 60% of end-investor BA purchases.

Chart 1: BA Transition Virtual Network membership composition



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Network members have confirmed the key money market investment themes that were identified last year through the CFIF sponsored BA workshop series. Specifically, members confirmed that money market investors have varying needs for their money market investments regarding liquidity, yield, term, credit quality, amount, and predictability of issuance. Moreover, while money market issuers prefer to obtain longer-term funding, money market investors tend to prefer shorter-term investment instruments. Furthermore, some market participants may have internal or external constraints that further limit their investment choices. [1] Therefore, the alternative investment options to replace BAs will depend on each investor's investment needs and no single investment option is expected to fully replace current BA issuance.

To assist in an orderly transition away from BAs, the Network has advanced work in several areas. Earlier in the year, the Network worked with CFIF and the Canadian Alternative Reference Rate working group (CARR) to conduct a survey to better understand the type of short-term funding instruments banks and their dealers may potentially use to replace the funding provided by existing BA issuance. Leveraging the survey results, members reviewed the list of potential alternative products that could replace BAs and took actions towards educating, promoting, or removing barriers for market participants, where appropriate. For instance, the Network invited product specialists to discuss with members the characteristics of different alternative options, which are discussed later in the paper. Members have also discussed plans to expand industry outreach beyond the Network and reached out to infrastructure and service providers to explore ways to address operational issues.

In addition, the group has engaged the Investment Funds Institute of Canada (IFIC) to look at potential exemptive relief from certain provisions in National Instrument 81-102 (*Investment Funds* NI 81-102) and other provisions of applicable securities legislation. Lastly, the Network is working with the BA issuing banks to ensure that BA issuance declines smoothly without the possibility of a sudden and disorderly drop in BA issuance before the CDOR cessation date.

## 3. Results from BA funding replacement survey

In early April 2023, CFIF and CARR surveyed the six major BA issuing banks and their affiliated dealers to better understand how the short-term funding of these institutions may change after BAs disappear with CDOR's cessation. The focus of the survey was only on market-based Canadian dollar funding options and did not cover wholesale deposit type or foreign currency funding.

[1] For example, most asset management firms offering money market products are subject to regulatory constraints imposed by National Instrument 81-102. In addition, the industry practice of having a constant net asset value for retail money market funds can also pose additional investment constraints for portfolio managers.

Table 1: Gap between BA issuance and potential increase in repo, BDNs, and ABCP

| (Billions of Canadian dollars) | Overnight (1 day) | 1 Week (2-7 days) | 1M (8-46 days) | 3M (46 – 125 days) | 6M (126 – 210 days) | 9M (211 – 300 days) | 12M (301 – 365 days) | Total |
|---|---|---|---|---|---|---|---|---|
| **Current BAs** | - | - | **70** | **19** | **1** | **1** | **1** | **91** |
| **Market-based replacements** | **3** | **6** | **15** | **17** | **16** | **9** | **7** | **71** |
| **BDNs** | - | - | - | 3 | 13 | 8 | 7 | 31 |
| **ABCP** | - | - | 3 | 8 | 2 | - | - | 12 |
| **Repo** | 3 | 6 | 13 | 6 | 1 | - | - | 28 |
| **Difference** | **+3** | **+6** | **-54** | **-2** | **+15** | **+8** | **+7** | **-20** |

The survey sought numeric estimates of how banks would potentially replace current BA-based funding with market-based alternatives by instrument and by maturity sector. See table 1 for the aggregated results across the six BA issuing banks. The survey also asked qualitative question on the factors these banks and dealers will consider when determining their future funding structure.

The estimated overall gap in potentially investable short-term money market products issued by the banks, their affiliate dealers or securitization vehicles is about C$20 billion once BAs cease to be issued after June 2024. However, this gap is especially apparent in the 1-month and under maturity bucket at C$45 billion.

# 4. Potential Alternative products to BAs

The Network has focussed most of its time reviewing potential alternative investment products to BAs, including both existing and new alternatives. The key market-based alternatives are discussed in more detail below.[2]

## 4.1 Existing alternatives

### 4.1.1 Bearer Deposit Notes

Bearer deposit notes (BDNs) are issued from bank treasury for general funding needs instead of being the result of a corporate loan drawdown as is the case with BAs. They are the closest substitute to BAs in terms of credit quality and yield, however, due to higher regulatory costs for very short-dated bank liabilities, they are generally issued for longer maturities, primarily 6 months and longer. The desire for longer maturity BDN issuance is confirmed by the responses to the BA funding replacement survey.

As shown in Table 1, major banks could potentially replace about one third of their existing BA funding with BDN funding. The amount of BDN funding issued will depend on their relative cost to other funding

[2] Please see the CFIF January 2023 White Paper for the full list of potential alternatives.

alternatives.[3] Other factors also play an important role in determining the banks' BDN issuance, including their desire to maintain a market presence, achieve a cost-effective funding profile, matching existing maturities and diversifying funding sources across regions, products and terms. The surveyed banks see value in having a consistent issuance pattern and maturity ladder for BDNs, a feature also valued by investors. However, funding requirements are subject to change, and both market conditions and investor demand for BDNs are less predictable given their longer tenor.

Of note, BDNs are most often cited by those investors that are not constrained by their longer tenor as one of their top investment alternatives to replace BAs after they cease to be issued, subject to yield and liquidity considerations.

#### 4.1.2 Term Reverse Repo

A repo is essentially a collateralized loan. One party to a repo lends cash and earns interest on the cash lent (the cash provider is said to be doing a reverse repo). The other party borrows the cash, supplies the collateral and pays the interest (the collateral provider is said to be doing a repo). The borrower secures the loan by posting the agreed type of security as collateral (e.g., GoC bonds or treasury bills, investment grade corporate bonds etc). Repos can be structured for any term but are currently primarily transacted on an overnight or tom-next basis.[4] They can be conducted bilaterally, through a third-party agent (known as a tri-party repo), or through a central counterparty (CCP). In Canada, currently the vast majority of repo transactions take place bilaterally, although a large share of overnight GoC repos is conducted through the Canadian Derivatives Clearing Corporation's (CDCC) repo CCP.

The banks together with their dealers could potentially replace around C$30 billion of BA funding with repo funding (see Table 1). The primary drivers for determining whether banks or dealers access funding through repo versus other sources are cost, availability of other funding sources (including parent bank and cross-currency funding), liquidity profile, balance sheet or capital impact, and regulatory factors.[5] Term and collateral type are also important considerations for repo funding, with supply being driven by the availability of appropriate collateral. Dealers have a strong interest to increase the use of investment grade corporate collateral in repo given its availability and the current lack of robust corporate repo market in Canada. In the survey, bank dealers cited several constraints to developing an active term repo market in Canada. They noted that Canada has not had a true two-way repo market as there has been limited investor appetite so far to invest cash through the repo market. The reliance on primarily a bilateral repo market with no generic repo baskets due to lack of tri-party infrastructure has been a major factor in the underdevelopment of a two-way Canadian repo market. Processing bilateral repo is not very automated, especially with respect to substitutions, which are an important consideration in the case of open or term repo.

[3] Banks see BDNs and term deposits as fungible funding sources, with pricing differences driven by investor type due to Basel and OSFI regulatory requirements.
[4] A tom-next or tomorrow-next repo trade is an overnight repo trade that is executed on T+0, with the opening leg of the transaction settling on T+1 (tomorrow), and the closing leg of the transaction settling on T+2 (next).
[5] Limited collateral class eligibility in CDCC's CCP repo and limited linkages with other CCPs are also factor s that could affect market participants repo funding decisions.

*New tri-party repo service in Canada – Canadian Collateral Management Service (CCMS)*

TMX Group Limited and Clearstream Banking S.A. announced in May plans to launch the Canadian Collateral Management Service (CCMS) later this year. CCMS is the first domestic tri-party collateral platform in Canada. The European style tri-party platform aims to optimize collateral with real time substitution throughout the business day and connect various collateral pools across the market. The initiative has been welcomed by CFIF and is expected to fundamentally improve the Canadian financial ecosystem for securities financing and collateral markets by modernizing and automating repo related processes. It is expected to make repo a more easily accessible investment asset to a wider set of market participants as is the case in the US where repo is used by a wide range of market participants to invest cash, including by money market mutual funds and corporate treasuries.

CCMS has the potential to facilitate the transition away from BAs by streamlining repo operations and making repo a more attractive investment alternative. On this front, the Network has connected members with representatives from the TMX and has encouraged members to consider joining the service. The Network has also discussed various ways to better educate market participants on repo, including having educational sessions with repo market practitioners to facilitate an active dialog, which will ultimately encourage wider repo market participation.

### 4.1.3 Asset-Backed Commercial Paper

Asset-backed commercial paper (ABCP) is the fourth largest product segment in the Canadian money market and is usually issued at a slightly higher yield than BAs despite being secured by a dedicated pool of assets. Survey results indicated that banks could potentially see ABCP funding increase by up to C$12 billion in a relatively short-time span, subject to having increased investor demand. However, survey respondents cited several constraints for increased ABCP supply and demand. Even though the majority of ABCP being issued today is from major Canadian bank sponsored entities, ABCP nevertheless retains a negative stigma with some investors who are still not willing to buy the product based on the issues experienced with some non-Canadian bank based ABCP around the Great Financial Crisis. However, this issue may be mitigated through increased education on the product, and the Network has identified potential initiatives (e.g. investor roadshows, publishing an ABCP primer) that could help address this negative perception. Another option pursued by one bank has been to change the structure of their program to have a full bank guarantee, making their ABCP program fully equivalent from a credit perspective to their BAs and BDNs.

Other factors also affect the overall potential size of the ABCP market. Issuers require well-established businesses and asset origination practices to increase the amount of assets available to be funded through the various ABCP vehicles, which take time and can be costly to develop. Maturity mismatch is also an issue, as investors want shorter-dated issuance while the preference is to issue longer-dated ABCP to ensure stable funding. While there could be some short-run increase in the supply of ABCP, a substantial increase in longer-term supply depends on having both strong investor interest in the product, especially for longer tenors, and increased demand from originators, which is also dependent on the relative cost of their other funding options.

## 4.2 New alternatives

### 4.2.1 Floating rate BDNs

All Canadian asset management firms manage their retail money market mutual fund portfolios under a constant Net Asset Value (NAV) regime.[6] As a result, these asset managers need to tightly control their interest rate risk to avoid material movements in the value of their portfolios, which is achieved by managing their portfolios to a very short average term to maturity (e.g., 30 days).

Floating rate BDNs, with monthly coupons and a maturity less than 1-year, have the potential to address several needs for this subgroup of constrained BA investors.[7] Like BDNs, they are the closest substitutes to BAs in terms of credit quality and yield. However, being a floating rate instrument implies that they will typically have shorter duration compared to equivalent maturity BDNs, a desirable feature for investors with low appetite for interest rate risk. The major Canadian banks already issue these types of instruments on a frequent basis in the US and would issue them in Canada to replace BA funding, in lieu of BDNs, subject to investor demand.[8] However, the current issuance process in Canada through CDS for floating rate BDNs is operationally cumbersome, which discourages banks from issuing these types of instruments in large scale.

To help address the operational concerns, the Network is working with CDS to try to identify potential solutions that can help simplify the issuance process.

### 4.2.2 Government of Canada 1-month treasury bill

As noted in section 3, the cessation of BAs creates a C$45 billion gap in the 1-month and under tenor. The Network has spent time to explore different alternatives for BAs, however, it will take time for these new alternative products to potentially develop. Market participants will also need time to adjust their systems, processes and investment guidelines, including obtaining any regulatory relief. As a result, this gap in the 1-month tenor may be even larger in the short-term.

GoC treasury bills have the strongest credit rating, are very liquid, and are also widely accepted as collateral for margin calls, providing a major benefit over BAs. Although a 1-month treasury bill will not provide the same level of return as BAs, having regular access to a liquid money market instrument in the 1-month tenor is important for some investors, such as NI 81-102 regulated retail money market funds. This need stems both from a liquidity and interest rate risk management perspective. Until other alternatives come online, or processes and regulation are adjusted to reflect the new money market product mix, members of the Network indicated having such access is important for the well functioning of the Canadian money market and could help to ensure that the transition away from BAs goes smoothly.

The Network conducted a survey amongst its members to gain a better sense of demand for a 1-month treasury bill. The survey results show that 96% of respondents support the creation of a temporary 1-month treasury bill to ensure a successful transition from BAs. Based on the survey results, interim

[6] A money market fund that aims to maintain its asset value at a constant price per unit.

[7] The transition from CDOR to CORRA based FRNs further reduces the interest rate risk for these types of products as the coupon is calculated based on an overnight CORRA compounded over the coupon period, instead of a forward-looking CDOR rate.

[8] In the US these types of instruments are known as floating rate yankee CDs.

demand from just the Network members is estimated conservatively to be around C$17 billion per month. Note that this estimate does not include the potential additional demand from other BA investors who are not part of the Network or from international investors who would have interest in a liquid 1-month Canadian dollar asset that would be considered a level 1 high quality liquid asset under Basel regulation. Although most members deem a 1-month treasury bill as an important temporary alternative, they acknowledge that most of the current C$90 billion demand for BAs will be met by other types of money market products post the cessation of BAs.

Network members envision this 1-month treasury bill supply to come from the existing three treasury bill tenors. The issuance is expected to be temporary, and to have automatic review periods to assess uptake and efficiency, as well as the possibility of an early wind down of the program if there is insufficient uptake from domestic buy-side clients.

The Network will present their proposal for a temporary 1-month treasury bill to the Department of Finance in September, to help the market transition away from BAs. However, the decision of whether to issue a 1-month treasury bill will be with the Department of Finance.

### 4.2.3 New secured notes backed by a basket of collateral

TMX's CCMS also facilitates the potential creation of new securitized repo based money market notes. CDCC is looking at launching its secured general collateral (SGC) note in Q1-2024, which would be secured by repo transactions using collateral that is eligible for the Bank of Canada's Standing Liquidity Facility. At the same time, National Bank is potentially looking at options to create a product that would be secured by repos using residential mortgages. Both of these notes would have issuance terms ranging from one month to a year and would be offered on a discounted basis. They would have security identifiers (e.g. ISIN or CUSIP) and be tradable like other money market securities. From a return and risk standpoint, these notes are expected to provide yields and bear levels of credit risk similar to BAs. [9]

The Network has hosted multiple information sessions with the potential issuers and encouraged members to give feedback and work with the issuers to help develop these products.

## 5. Workstream on regulatory considerations

As outline in the White Paper published by CFIF in January 2023, market participants that are subject to Canadian Securities Administrators (CSA) regulation can potentially try to seek regulatory relief with respect to certain investment parameters outlined in their regulation given the impact that the disappearance of BAs will have on their investment options. To facilitate this work, the Network initially engaged the Investment Fund Institute of Canada (IFIC) to look at potential venues for regulatory relief for NI 81-102 regulated money market mutual funds.

[9] In both cases, the products are dependent on the successful launch of CCMS.

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IFIC established a Bankers' Acceptances Sub-Group (BA Sub-Group) in February 2023 to investigate this issue. Since then, certain members of the BA Sub-Group along with other asset managers have agreed to pursue exemptive relief with the CSA on a collective basis and have hired external counsel to do so.

## 6. BA cliff effect around CDOR cessation

In order to ensure an orderly transition of the BA market and to safeguard the ongoing stability of Canada's financial system, the Network will be providing feedback on the path of BA issuance between now and June 2024 to protect against a sudden large drop in BA issuance, which could severely impact market functioning. As a result, it is expected that BA issuance will start to gradually decline after CARR's recently announced "no new CDOR or BA loan" milestone date of November 1, 2023. After this date the BA lending model, which creates the BAs that could be sold into the market on any loan drawdown, will no longer be available for new loans. However, BAs will still be created from any drawdown on an existing loan facility. Having BAs available also supports the CDOR submissions made by the six panel banks, and therefore a minimum level of BA issuance is required until CDOR's cessation. Note that as BA issuance declines, the relative pricing of BAs to other money market instruments, including to equivalent term overnight index swaps and the CDOR setting, could also change.

CFIF, together with CARR, are expected to provide their guidance on the path of BA issuance by the end of September.

## 7. Conclusion: Continue to prepare for BA cessation

An orderly transition away from BAs is vital for the well functioning of the Canadian money market. A heightened level of awareness from investors, issuers, regulatory authorities, and policy makers on alternative investment options to BAs is needed to ensure a successful transition given the relatively short timelines before BAs disappear. Market participants who invest in BAs are therefore asked to start reviewing their potential alternative investment options, as well as to start making any required changes to their systems, processes and investment guidelines or policies in order to be ready when BA issuance starts to gradually decline by the end of the year.

CFIF, working with industry and through the BA Transition Virtual Network, will continue to monitor and help facilitate, where appropriate, a smooth transition away from BAs.