Alternative reference rate transition in the Canadian market

5 insights for executives

The future of Interbank Offered Rates (IBORs), the major benchmark rates for variable rate financial instruments around the world, is in doubt. Global and Canadian efforts are aiming for a smooth transition to Alternative Reference Rates (ARRs). However, there is still much work to be done.

Driven by concern of systemic risk in the generation of IBORs, decline in the liquidity in the interbank unsecured funding markets, manipulation scandals and reluctance from panel banks to submit quotes, the global regulatory community initiated IBOR reform to reinstate confidence in the reliability and robustness of benchmark rates with the goal of transitioning to ARRs by the end of 2021.

Of special interest to:

- Chief executive officers
- Chief financial officers
- Treasurers

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Over the past year, regulators and industry groups have been undertaking an intense, carefully coordinated global push for firms to recognize the pressing circumstances surrounding IBORs, hasten efforts to phase out products referencing IBORs and transition to ARRs.

The progress made to date in the development of fallback provisions, as identified in various International Swaps and Derivatives Association (ISDA) consultations, and the market efforts to build liquidity for products referencing the ARRs are strong examples of the pace in preparation of the transition.

In Canada, the Canadian Alternative Reference Rate Working Group (CARR) was established and has worked in sync with the various global IBOR transition working groups while focusing on the unique aspects of the Canadian market.

For the latest updates on the global IBOR transition, as well as its impact on market participants, please refer to EY's IBOR transition homepage: **https://www.ey.com/en_gl/banking-capital-markets/ibor-transition-services**.

1

What's happening in Canada?

In Canada, the CARR was established to identify and develop a Canadian dollar term risk-free rate benchmark. In 2018, the working group finalized its recommendation to propose **enhanced CORRA** (Canadian Overnight Repo Rate Average) as the Canadian overnight risk-free rate benchmark.

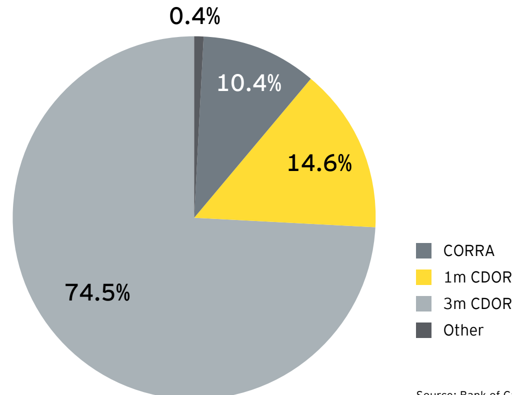
Consistent with other jurisdictions, Canada is working to develop ARRs, including both overnight and term. Canada is a multi-rate jurisdiction, and the new term ARR would act as a complementary reference rate for the Canadian market and would operate alongside the Canadian Dollar Offered Rate (CDOR).

Commonly used benchmarks in Canada

CDOR is the primary benchmark rate in Canada and represents the rate at which submitting banks would be willing to lend funds against issued bankers' acceptances to their existing clients. The most common maturities are the three-month and one-month (see chart below), but they're also available for two, six and 12 months.

CORRA, a lesser-used benchmark rate in Canada, is the weighted average of rates on overnight general collateral repo transactions conducted though designated interdealer brokers (collateralized with Government of Canada securities). CORRA is the overnight reference rate in Canada for Overnight Index Swaps (OIS) and the terms are often used interchangeably in the market.

Distribution of repricing index referenced



Source: Bank of Canada

2

What is enhanced CORRA?

In February 2019, the CARR published a consultation paper asking for feedback on its preliminary methodology for enhancing CORRA. Enhanced CORRA was meant to:

1. Be risk free
2. Derive from more volume than CORRA today
3. Represent General Collateral (GC) funding
4. Be simple and easy to explain

Comments are due by 30 April 2019 and therefore the CARR has not yet published the results of this consultation.

	Current CORRA	Enhanced CORRA	SOFR
Counterparty types	Inter-dealer brokers only	Wider market[1]	Wider market[1]
Collateral types	Federal government securities (general only)	Federal government securities (general and specific)	Various federal, agency and state securities (general and specific)
Rate calculation	Volume-weighted mean	For all eligible transactions, volume-weighted trimmed median (lower 25% removed)	Volume-weighted median (for one data source including bilateral repo transactions, the lower 25% are removed).
Daily volume of transactions	CDN$1b-$5b	CDN$10b-$20b	US$700b-$1t

[1] Unaffiliated counterparties, no government transactions.

Enhanced CORRA is similar to current CORRA in that it's an overnight rate for repo transactions secured with Government of Canada securities (which represents the vast majority of repo collateral). Enhanced CORRA will include transactions beyond just the inter-dealer market, which significantly increases the volume of transactions and makes the rate more robust.

In the expanded market, there are certain transactions, known as "specials," where a lender is trying to source a specific security and offers lending rates below typical funding rates. As these transactions are not representative of general collateral funding (criteria 3 above), the enhanced CORRA calculation methodology attempts to exclude them. The methodology to exclude these specials is similar to the approach used by the US Federal Reserve's Secured Overnight Financing Rate (SOFR), whereby it removes transactions with rates below the 25th volume-weighted percentile rate.

What you need to know

- Enhanced CORRA will have much more significant transaction volume than current CORRA.
- Enhanced CORRA is expected to be less volatile than current CORRA due to the trimmed-median approach.
- Enhanced CORRA is similar to SOFR in that it is a secured, overnight repo rate using government securities as collateral.

3

What does transition mean for the market?

The Canadian market continues to closely follow the IBOR transition developments globally, especially in the US and UK, where the markets are much further along. In those markets, the focus is on:

- Developing the required **term structure**
- Developing **liquidity** surrounding ARRs
- Developing the related **credit spread**
- Minimizing the potential **value transfer** on transition

Term structure: Though there has been no final decision on the methodology in the Canadian market as of the time of writing, there are two common methods for developing the term structure:

- Compounded setting in arrears rate:
  - Calculated as the daily compounded ARR observed over the relevant tenor period
  - Currently favoured by UK and European ARR working groups and identified in the recent global ISDA consultation as the preferred method
  - Currently being discussed as a default option in the US if there is no viable forward-looking term rate
- Forward-looking term rate:
  - Calculated as an average rate, mirroring the structure of OIS referencing the ARRs
  - Since the information used to determine the rate is not available at the start of the relevant period, it could result in actual interest rate movements not reflecting prior expectations of interest rate movements over the period.
  - Currently being discussed as an option in the US.

Both methods require a robust governance framework and transparency on its generation, a high enough volume and liquidity to promote reliability, and an ongoing ability to meet these conditions.

Liquidity: To develop the new term ARR, it is necessary that the volume of transactions referencing the enhanced CORRA is large enough to be a truly liquid market. The scope of products referencing enhanced CORRA should expand to include futures markets, derivatives, clearing house settlements, debt issuances and other cash products. This will require industry-wide collaboration to begin transacting using the new enhanced CORRA rate to build up liquidity in the market.

Credit spread: The existing IBORs have an inherent credit component (as it often represents AA-rated counterparties), while the ARRs are nearly risk free. For smooth transition from IBORs to the ARRs, it is necessary to develop and apply a credit spread adjustment to the ARR to maintain a level of consistency upon transition. The historical mean/median spread between the IBOR and the ARR over a historical lookback period is the most favoured approach in the ISDA consultation feedback. In the Canadian market, the dynamic is slightly different since there is no plan in place at this time to decommission CDOR. Therefore, there is still uncertainty as to how much focus the credit spread will receive.

Value transfer: In the event that CDOR ceases to be published, depending on which methods are employed for the term rates and credit spreads, there will inevitably be asymmetry between the fair value of the product under the existing and new rates. As a result, there will be a certain amount of value transfer upon transition to the new ARR between the counterparties. It will be important for the market to understand what is driving this value transfer, how to price the new instrument to minimize this amount, and what the tax implications for any cash payments that may arise.

4 What are the next steps?

The current focus in the Canadian market is to establish enhanced CORRA as the preferred benchmark. The CARR is delaying further consultations pending the results of the consultations on enhanced CORRA currently underway.

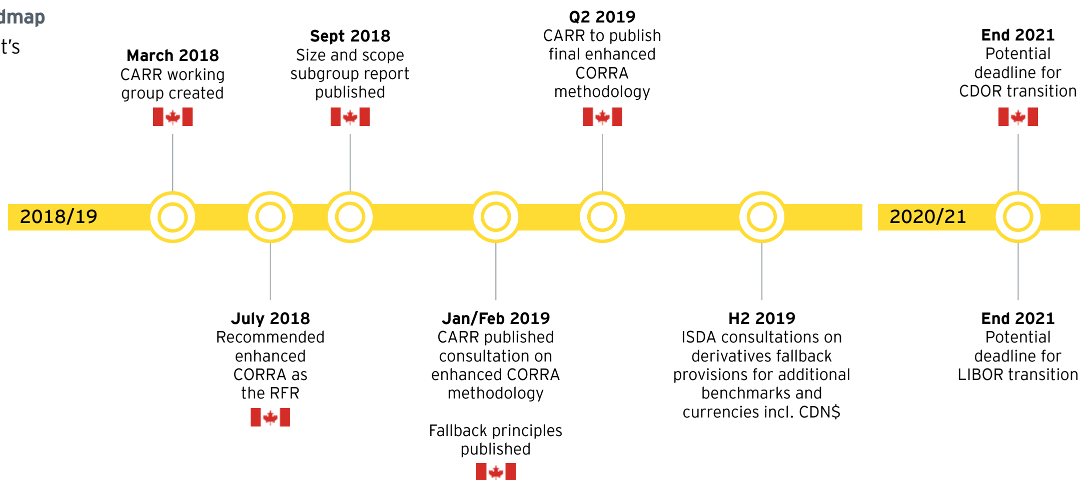
A second step for the Canadian market is the development of fallback language. In January 2019, CARR published its Principles for Enhancements to Fallback Language for cash products. These principles focused on the need for fairness and consistency across the market as well as transparency in any calculations or triggers. In addition, the principles highlighted the importance of minimizing value transfer upon any triggering events, minimizing the instances where a floating rate transitions to a fixed rate, and minimizing legal and regulatory risks, while considering the operational, tax and accounting impacts.

With respect to derivatives, ISDA, which is leading a global initiative on developing centralized fallback language for derivative contracts, recently published a supplementary consultation that included Canadian CDOR. ISDA has not yet published the results of this consultation.

A third step for the Canadian market is the development of term rates. As mentioned above, there are different possible calculation approaches, and there has been no market consensus so far in Canada. This is a key area for CARR in its 2019 work plan (see timeline below).

Canadian CDOR transition roadmap

What's happened so far and what's still to come



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What do financial institutions need to do to prepare for transition?

For the Canadian market, participants are most likely impacted by the IBOR transition areas where they currently have the largest exposures, such as USD LIBOR, GBP LIBOR and CDOR.

While CDOR's transition timeline still lacks clarity when compared with other jurisdictions, financial institutions in Canada should start developing a view of where the major IBORs are used or referenced in their organizations to understand the impact of this transition to their business.

The following are four key areas an impact assessment should include:

Products: Complete assessment of product inventory and the impact of IBOR transition on this inventory categorized by exposure type, maturity profile and product features (e.g., optionality).

Contracts: Complete assessment identifying transition impact on legal contracts to assess the potential need for base rate and fallback language amendment, re-pricing, re-papering and client outreach.

Valuation models: Assess the impact of transition on enterprise-wide valuation model inventory for both quantitative and qualitative impact – leverage existing first- and/or second-line inventories and model evaluation criteria.

Operating model: Assess the impact of transition on core business line and enterprise-level processes – leverage existing process catalogue and defined impact assessment criteria. Adapt treasury-related systems, capturing market data and financial products.

Want to learn more?

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