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Will CDOR be out the door in 2024?

By Taylor Schleich

Yesterday, the Canadian Alternative Reference Rate (CARR) working group—the group tasked by the Canadian Fixed-Income Forum (CFIF) with analyzing the future of the Canadian Dollar Offered Rate (CDOR)—published a white paper recommending Refinitiv Benchmark Services (CDOR's administrator) cease publication of CDOR after June 2024. Yesterday's announcement comes in the context of a global reference rate transition. Most notably, USD LIBOR panel submissions are due to end in June 2023 (with some settings ceasing at the end of 2021). Over the past years, we've documented the global benchmark reform transition which you can read here. In this note we focus on the CDOR-to-CORRA transition in light of the CARR's recommendation.

What is CDOR?

- CDOR is the primary wholesale interest rate benchmark in Canada, measuring the average rate at which Canadian banks are willing to lend to corporate borrowers via Bankers Acceptance credit facilities. While CDOR was originally developed in the 1980s as the basis for BA facilities, its usage has evolved over past decades. CDOR now serves as a reference rate for more than $20 trillion in gross notional exposures in Canada's financial system, including in bonds, derivatives and loans. The vast majority (97%) is linked to derivatives, while bank loans are just 1% of total notional exposures referencing CDOR. Its current published tenors are 1-month, 2-month and 3-month, with the 6-month and 12-month settings having been discontinued by Refinitiv in May 2021.

What is the problem with CDOR?

- Like LIBOR, CDOR is reliant largely on "expert judgement" and thus, not market determined or based on a large volume of observable transactions. Unlike LIBOR, CDOR is a committed rate (i.e. Banks commit to lending at this rate whereas LIBOR is an indication of what rate banks estimate they can borrow at). However, the fact that it is survey-based—there are just six submitting institutions—means its exposed to manipulation risk and not consistent with global best practices. Moreover, there have already been three institutions drop out of the panel of banks making CDOR submissions. Additional dropouts represent another potential risk even if it's unlikely given that the remaining submitters are Canada's 'Big Six' banks.

- Proportionality is also seen as a concern. In other words, $70-$100 billion in BAs sold to investors are the basis for over $20 trillion in financial products directly referencing CDOR. Moreover, while 90% of CDOR exposure is based on the 3-month term, 90% of BA trading volumes are in the 1-month tenor (since corporate clients predominantly borrow for 1-month periods). Comparatively, CORRA (Canada's other major reference rate) is calculated based on more than $15 billion in overnight repo transactions.

- Additionally, the BA Lending model is no longer seen as an ideal way for banks to lend to corporate clients in the Basel III regulatory environment. CDOR's existence depends on banks continuing to support BA-based lending but the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) make BA issuance more balance sheet intensive, effectively penalizing banks for issuing these products. Indeed, banks have already lightened up on BA issuance in recent years, with a continued deterioration representing additional risk to CDOR's integrity.

CARR's recommendation

- While the CARR working group considered recommending 'enhancing' CDOR, its inconsistency with global best practices (namely, tying rates to observable arms-length transactions) was seen as too much to overcome. Additionally, reforming CDOR to be based on BA transactions would constitute a "legally" different benchmark. Economically, the CDOR/BA basis, currently north of 20 bps, would mean an 'enhanced' CDOR would be meaningfully different from CDOR under its current definition.

- Instead, CARR recommends that the calculation and publication of CDOR cease after June 30, 2024 as part of a two-stage transition. The first stage, to be completed by June 30, 2023, would see all new derivative contracts and securities transition to using CORRA, with few 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 of the transition (June 2023 to June 2024) gives firms more time to transition, address issues related to 'legacy' securities (i.e. those in which there is no adequate 'fallback' language written into contract language) and allow more CDOR-based securities to mature. By the end of June 2024, CARR estimates that roughly $95 billion in securities referencing CDOR would still be outstanding.

- CARR expects that CDOR-linked derivatives and securities would transition to CORRA, a Canadian benchmark rate compliant with international standards. Loans might also transition to CORRA but CARR will consult next year on the potential need for other benchmarks that may be more appropriate. A forward-looking term CORRA is a potential option. We'd note that a forward-looking term SOFR was launched earlier this year.

- The recommendation was unanimously endorsed by CARR and Canadian Fixed Income Forum members, however, the decision to cease CDOR is at the discretion of Refinitiv. In other words, the white paper only represents a *recommendation*. Refintiv released a statement shortly after the publication of CARR's white paper noting that it "*will conduct its own analysis, engage with market participants and*

consider what further steps might be necessary in order to reach a conclusion regarding the future of CDOR. We anticipate providing more information in Q1 of 2022"

- Importantly, to make sure the transition from CDOR is a smooth one, CARR expects that the six banks contributing CDOR submissions will continue to do so until the recommended cessation date on June 30, 2024.

CORRA: CDOR's recommended replacement

- The Canadian Overnight Repo Rate Average, or CORRA, is a Canadian risk-free rate based on overnight repo transactions between two arms-length counterparties collateralized by Government of Canada securities. Unlike CDOR, it is a risk-free and backward-looking rate, of overnight term only. Most importantly, it is based on a large quantity of observable repo transactions and is thus compliant with global standards for an appropriate reference rate. The rate has been in existence since 1997 but was 'enhanced' in 2020 when the Bank of Canada took over as administrator.

- There has been ample work done in recent years to develop a CORRA-based environment. In June 2020, the Montreal Exchange launched three-month CORRA futures. Trading volumes here remain low but should ramp up, particularly if, as and when CDOR is officially discontinued. In April 2021, the Bank of Canada began publishing a CORRA compounded (in-arrears) index, allowing market participants to calculate payments more easily in various financial instruments. Canadian banks (in addition to some provinces and SSAs) have also begun issuing CORRA-based FRNs. Canada Housing Trust, Canada's largest FRN issuer, also announced that it will move to utilize CORRA as the reference rate for new FRNs starting in 2022.

- Already in place is robust "fallback language" for CDOR-linked derivatives that are governed by the International Swaps and Derivatives Association (ISDA). In contracts governed by ISDA's master agreement, if a reference rate ceases to be published (e.g., CDOR), the derivative's reference rate changes or 'falls back' to the jurisdiction's recommended overnight risk-free rate (e.g., CORRA). To make the rates more comparable, a credit spread adjustment—the median spread between CDOR and CORRA over a five-year lookback period—is added to CORRA to calculate the new derivative reference rate. This legal provision is incorporated into all new swaps transacted after January 25, 2021. ISDA also allows legacy contracts to reflect this new language if counterparties agree. While the majority of Canadian market participants have signed the ISDA protocol, there are remain some contracts that will need to be sorted out over the coming years. CARR has also published recommended fallback language for any CDOR-based FRNs, which have been the market norm since 2019.

- Importantly, CORRA has historically traded within a small handful of basis points of the Bank's overnight target, this stability/predictability being a desirable feature. Since the COVID-19 Bank of Canada stimulus response injected an unprecedented amount of liquidity into the financial system, that has changed. Exacerbated by a sharp decline in Government of Canada issuance, we've seen GoC securities increasingly trade 'special' in repo which has pushed CORRA well below target. As we eventually enter a period of balance sheet normalization (we expect that mid-way next year), this should somewhat abate and CORRA should drift back towards target. However, it's not clear we'll be back to pre-COVID balance sheet or LVTS settlement balance levels by June 2024 which could mean significantly sub-target CORRA prints persist. As the financial system continues to transition to CORRA, the Bank of Canada will be increasingly forced to try 'normalize' CORRA's behaviour. Its Securities Repo Operations were at least partially intended to help here but so far this tool has been insufficient.

Bottom Line:

To be sure, the writing appeared to be on the wall for CDOR as the global transition away from survey-based reference rates was already well underway and today's recommendation had been well-telegraphed. While CDOR differs non-trivially from a rate like LIBOR, it is not compliant with global best practices for reference rates in its current form. The recommendation by the CARR working group to cease publication of CDOR by the end of June 2024 was an important development in Canada's transition to the use of risk-free benchmark interest rates. However, it is worth highlighting that the CARR white paper only represents a *recommendation*. Ultimately, the decision to cease publication has to come from the current administrator of CDOR, Refinitiv Benchmark Services. Refinitiv acknowledged CARR's recommendation yesterday and will release their own conclusion regarding the future of CDOR in the first quarter of 2022. We don't expect much pushback from Refinitiv and see the transition occurring largely in line with CARR's recommendation. Fortunately for the Canadian market, the global transition (including the move from LIBOR to SOFR) is generally further along, so a road has already been paved so to speak. Moreover, the development of a robust CORRA-based market is already well underway and will continue to advance, as CORRA-based issuance ramps up and becomes more commonplace. Canadian banks have largely been leading the way on this front but a move by Canada Housing Trust (Canada's largest FRN issuer) to issue a CORRA-based FRN in 2022 represents an important milestone. While many of the steps involved in transitioning from CDOR to CORRA have already been made, there are some important issues yet to be resolved. Principally, we'll be keen to see if a term CORRA index is recommended and ultimately introduced. We tend to think this is likely and we could/should learn more after Refinitiv publishes its analysis on the fate of CDOR early next year. Again, Canada will benefit from the global experience as term SOFR rates have already been implemented, with the CME Group having started publishing these earlier this year.

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