



# Canadian interest rate benchmark reform: Cessation of CDOR

Potential accounting considerations



# Introduction

Interest rate benchmarks form the foundation of the global financial system and are extensively used by market participants to determine interest rates for a wide range of contracts.

Interest rate benchmarks are referenced in trillions of dollars of financial products globally including derivatives (hedges), loan products, variable rate notes, etc. Two types of interest rate benchmarks have generally been prominent: Interbank Offer Rates (**IBOR**) such as U.S. Dollar (USD) London Inter-Bank Offered Rate (LIBOR), British Pound Sterling LIBOR (GBP LIBOR), Euro Inter-Bank Offered Rate (Euribor), Euro LIBOR (EUR LIBOR), Euro Overnight Index Average (EONIA), Canadian Dollar Offered Rate (CDOR), Secured Overnight Funding Rate (SOFR), Secured Overnight Index Average (SONIA), Euro Short-term Rate (ESTR), Canadian Overnight Repo Rate Average (CORRA), etc.

Owing to the declining confidence in the reliability and robustness of the pricing of IBOR, public authorities and regulators in many countries undertook steps to reform the IBOR and required companies to transition existing contracts to Alternative Benchmark Rates (**ABRs**). As a result:

- GBP LIBOR, CHF LIBOR, JPY LIBOR and EUR LIBOR ceased to be published after 2021; and
- USD LIBOR will cease to be published in June 2023 for all USD LIBOR tenors (*e.g.*, overnight, one month, three month, six month and twelve month)

As the USD LIBOR's cessation nears, focus has shifted to the products referencing SOFR for liquidity. The impact is expected to be significant in Canada where USD LIBOR is not necessarily a predominant rate.

Canadian Dollar Offer Rates (**CDOR**), developed in the 1980s, have been the primary benchmark rates used by Canadian banks. CDOR are provided and administered by Refinitiv Benchmark Services (UK) Limited (**RBSL**)<sup>1</sup>. The Canadian Alternative Reference Rate Working Group (**CARR**) was established by the Bank of Canada and sponsored by the Canadian Fixed-Income Forum (**CFIF**)<sup>2</sup> in March 2018 to guide benchmark reforms in Canada to ensure that Canada continues to have a robust benchmark rate regime. CARR has recommended<sup>3</sup> retiring CDOR over two phases through 2023 and 2024, and expects that CDOR-based contracts will be transitioned to the Canadian Overnight Repo Rate Average (**CORRA**)<sup>4</sup>.

In response to CARR's recommendations, RBSL led a consultation process on January 31, 2022 and invited direct comments and feedback from CDOR users, market participants and wider CDOR stakeholders prior to making any decision regarding its future.

On May 16, 2022, RBSL published a CDOR cessation notice stating that the calculation and publication for all tenors of CDOR will cease following a final publication on Friday June 28, 2024. Further, RBSL in the cessation notice stated that the publication of the CDOR cessation notice constitutes an "Index Cessation Event" under the ISDA 2020 IBOR Fallbacks Supplement and the ISDA 2020 IBOR Fallbacks Protocol.

<sup>1</sup> RBSL was appointed by a joint committee of the Canadian Bankers Association and the Investment Industry Association of Canada to calculate, distribute and administer the CDOR.

<sup>2</sup> The Canadian Fixed-Income Forum (CFIF) is a group set up by the Bank of Canada to facilitate the sharing of information between market participants and the Bank on the Canadian fixed-income market.

<sup>3</sup> CARR's Review of CDOR: Analysis and Recommendations, Bank of Canada, December 16, 2021

<sup>4</sup> In Canada, the CORRA has been identified as the ABR.

# Accounting considerations

The transition from CDOR to an ABR such as CORRA in-arrears or Term CORRA as a key benchmark rate may have certain accounting implications that may require consideration. Those related to International Financial Reporting Standards® are covered in this document.

The International Accounting Standards Board (IASB®) provided accounting relief in 2 phases to address issues that may arise from market-wide reform of an interest rate benchmark, including IBOR reform.

- **Phase 1** addresses hedge accounting matters that arise prior to the replacement of an interest rate benchmark with ABR.
- **Phase 2** addresses accounting implications related to the measurement of financial instruments and to hedge accounting arising from the replacement of an interest rate benchmark with ABR.

## Consideration 1: Economic equivalence

Issuers and holders of the CDOR-based financial instruments that are modified to reference ABR (e.g., CORRA in-arrears or Term CORRA) would normally consider the guidance in International Financial Reporting Standards (IFRS®<sup>5</sup>), specifically in IFRS 9, *Financial Instruments*, related to the accounting for a modification of the contractual terms of a financial instrument (e.g., the so-called “10% test” for modifications of financial liabilities). However, the IASB® provided relief from

these considerations by amending IFRS 9 to include as a practical expedient the ability to use normal floating rate interest accounting involving the periodic re-estimation of the effective interest rate as the floating rate index changes<sup>6</sup>. In order to use this Phase 2 practical expedient, an entity is required to determine whether the basis for determining the new contractual cash flows is “economically equivalent” to basis preceding the change.

The key consideration is whether IBOR and ABR can be considered economically equivalent. IBOR are forward-looking term rates with an embedded credit risk component, while ABR are primarily overnight rates. This structural difference suggests that the transition from existing IBOR-based contracts to ABR based-contracts may require an adjustment to the spread.

To determine whether the practical expedient may be applied will require entities to apply judgement as to what constitutes economic equivalence. The IASB® clarified<sup>7</sup> with respect to the economically equivalent criterion that entities will not be required to conduct a quantitative analysis to demonstrate economic equivalence as long as the interest rates before and after replacement are substantially the same.

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<sup>6</sup> IFRS 9.B5.4.5 states that “for floating-rate financial assets and floating-rate financial liabilities, periodic re-estimation of cash flows to reflect the movements in the market rates of interest alters the effective interest rate. If a floating-rate financial asset or a floating-rate financial liability is recognized initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or the liability.”

<sup>7</sup> IFRS 9’s Basis of Conclusion, paragraphs IFRS 9.BC5.315 and IFRS 9.BC5.316: “the entity would not be required to analyze whether the discounted present value of the cash flows of that financial instrument are substantially similar before and after the replacement.”

IASB® has provided examples<sup>8</sup> of economically equivalent:

- a. the replacement of an existing interest rate benchmark with an alternative benchmark rate with the addition of a fixed spread necessary to compensate for the basis difference between the two.
- b. changes to the reset period, reset dates or the number of days between coupon payment dates in order to implement the reform of an interest rate benchmark.
- c. the addition of a fallback provision<sup>9</sup> to the contractual terms of a financial instrument to enable any change described in (a), or (b) above to be implemented.

It is important to note that any other changes to the contractual cash flows of a financial instrument other than those solely required by the benchmark rate reform are to be assessed under normal IFRS 9 modification / derecognition accounting guidance. These changes could include adding floors/caps, extending maturity dates, repricing margins due to change in creditworthiness.

An important step upon transition to ABR to meet the economically equivalent criterion is to identify legacy contracts without an appropriate fallback language and to redraft the contracts to include language that would be considered an economic equivalent change by, for example, referring to an acceptable basis difference pricing methodology that would be used to calculate the actual basis adjustment, if any, at the time of transition. It is important to ensure that the pricing methodology minimizes transfer of value between counterparties.

## Consideration 2: Is CORRA an Eligible Risk Component in the context of non-contractually specified hedged risk?

The IASB®'s hedging standards allow an entity to hedge benchmark interest rate risk even when that benchmark interest rate is not contractually specified in the hedged item (e.g., hedging the CDOR risk in a fixed rate debt). To be eligible to do so, that benchmark interest rate needs to be separately identifiable (at the inception of the hedge) and reliably measurable. In this context,

separately identifiable is assessed within the context of the particular market structure to which it relates.

The Phase 2 amendments provide relief when ABR is designated as a non-contractually specified risk but is not separately identifiable at the inception of the hedge. The relief allows entities to assume that the separately identifiable requirement is met, provided the entity reasonably expects the risk component to become separately identifiable within 24 months from the date the entity designates the ABR risk component for the first time. As this relief is available for both fair value hedges and cash flow hedges where the hedged risk is not contractually specified (e.g., hedging the CORRA component of a prime rate instrument).

The following are a few factors which may potentially support CORRA's eligibility as an eligible risk component:

### a) Liquidity

Published in 1997, CORRA is a measure of the cost of Canadian dollar overnight general collateral funding in the repurchase agreement (**repo**) market. It is a risk-free overnight rate based on repo transactions collateralized by Government of Canada (**GoC**) Securities.

In an effort to enhance CORRA's liquidity, CARR has made certain recommendations and has developed a set of recommended market conventions/methodologies for using CORRA in certain securities or loan products, including floating rate notes and multi- and single-currency loan facilities. CARR has worked with others, including the Alternate Reference Rate Committee, to develop global inter-bank conventions for cross-currency basis swaps, including a CORRA convention for the Canadian dollar leg.

As a result of the CARR's recommendations, the transaction volumes of enhanced CORRA are expected to be more significant than those of legacy CORRA. While for the time being CORRA indexed instruments are limited in volume, with the majority being in the derivatives market, the scope of products referencing enhanced CORRA is expected to include debt issuances and other cash products, especially now that there has been an announcement of CDOR cessation. Industry-wide collaboration is required to build up liquidity in the enhanced CORRA market.

<sup>8</sup> IFRS 9.5.4.6

<sup>9</sup> For example refer: *ISDA 2020 IBOR Fallbacks Protocol*, International Swaps and Derivatives Association, October 2020



### Separately identifiable criterion

The separately identifiable criterion is to be assessed in the context of a particular market structure. The relief from applying the separately identifiable criterion is only available when the entity expects it will be met within 24 months. An entity will need to exercise judgement in assessing whether CORRA meets or will meet the separately identifiable criterion on a timely basis. A potential way is to consider the speed of the growth of the volume of enhanced CORRA used market wide and whether the expected volume will approximate the historical average use of CDOR within the 24 months from the date of the inception of the hedge.

### b) Reliably measurable criterion

The IASB® did not provide relief from the criterion that the designated risk component be reliably measurable. Hence, if a CORRA risk component cannot be reliably measured when it is designated and thereafter, then CORRA cannot be designated as a risk component in a hedging relationship. Although not specifically defined in IFRS 9, the importance of unobservable inputs to measure the risk is an indicator of whether it is reliably measurable: if all the inputs used in the measurement of the risk are observable or the unobservable inputs are insignificant to its measurement, then the risk is reliably measurable.

The following are examples of potential inputs to consider in assessing the reliably measurable criterion:

- a. trade volumes,
- b. bid/offer spread,
- c. availability of data from public sources (e.g., published enhanced CORRA rates)
- d. liquidity of the CORRA futures market
- e. pricing of debt issuances indexed to CORRA

## Consideration 3: Is CORRA a component of prime rate?

### Prime Rate in Canada

The prime rate, which is also referred to as the prime lending rate, is the interest rate that Canada's major financial institutions utilize to set interest rates for certain variable rate products (e.g., loans, lines of credit, mortgages). The prime rate is influenced by the policy

interest rates established by the BoC which represent the BoC's target for the overnight rate.

Should RBSL cease publishing CDOR rates in line with CARR's recommendation or should the market transition to CORRA and away from CDOR, issuers may find themselves hedging prime rate-based instruments with derivative instruments indexed to CORRA. In order to designate CORRA as the hedged risk in a prime-rate instrument, an entity needs to demonstrate that CORRA is an eligible risk component of that prime rate. An entity should consider whether CORRA is an identifiable component in the building block of the current pricing model for prime rate and if / how the banking industry will change its pricing model as it moves from CDOR to CORRA.

## Consideration 4: Fair value hierarchy

IFRS<sup>10</sup> defines fair value as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date in the current prevailing market conditions. Accordingly, fair value is viewed as an "exit" price rather than an "entry" price. The fair value hierarchy ranks the transparency of inputs used in the valuation of an asset or liability. It prioritizes the inputs used in valuation techniques, ranking inputs from Level 1 to Level 3, in descending order of transparency.

- **Level 1:** Quoted price in an active market.
- **Level 2:** Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly
- **Level 3:** Level 3 inputs are unobservable inputs for the asset or liability

An important consideration on the transition from CDOR to CORRA is the impact on the financial instrument's fair value hierarchy level. The latter may or may not necessarily be liquid in the in early stages. As such, an important question arises regarding the fair value hierarchy of instruments indexed to CORRA should be disclosed as being at Level 2 or Level 3? A few key considerations that are being widely discussed by stakeholders are:

- How would the valuation curves be determined for ABR? Are the underlying data points that support the construction of these curves observable or are they required to be built based on unobservable Level 3 inputs?

<sup>10</sup> Paragraph 9 of IFRS 13, *Fair value measurement*

- Do the unobservable inputs (Level 3 inputs) used in determining the fair value of a CORRA-indexed financial instrument have a significant bearing on the fair value of the instruments?
- What would be detail of disclosures that may be required? For instance, entities may have to disclose why unobservable inputs form a significant component of the valuation of the instrument. Additionally, entities may be required to disclose the inputs and valuation techniques in great detail, including providing a sensitivity analysis to demonstrate how the valuations would change given reasonably possible alternative assumptions.

The BoC has stated that ABR such as the Term SOFR, Term CORRA, etc., may be based on the Overnight Indexed Swap (OIS) curve plus a spread, with tenors of 0 to 30 years. As volumes for longer tenors may be limited, stratifying by tenor becomes essential from a fair value hierarchy perspective. It is therefore important to consider the significance of the spread that is adjusted over the OIS curve.

With respect to derivative instruments, the determination of fair value hierarchy becomes all the more important (especially for option positions with unobservable volatility inputs due to illiquid ABR options) as the classification of the instrument as Level 2 or Level 3 has an impact on financial and regulatory ratios. For example, a Level 3 classification of the instrument may lead to a product being treated as illiquid thereby resulting in an increase in the margin period of risk<sup>11</sup> and a higher exposure at default which is an input used in measuring counterparty credit risk and the ultimate risk weighted asset measure.

## Consideration 5: CARR recommendations – Impact on financial statement disclosures

CARR<sup>12</sup> recommends that RBSL ceases the calculation and publication of CDOR after June 30, 2024. Further,

CARR proposed a two-staged approach for the transition from CDOR:

- By the end of stage 1 (June 30, 2023), the expectation is that all new derivative contracts and securities would have transitioned to the ABR (overnight CORRA in-arrears) with no new CDOR exposures.
- By the end of stage 2 (June 30, 2024), the expectation is that entities have had sufficient time to resolve any issues relating to the documentation of “old” securities. Additionally, the extended time period would also allow for CDOR based security exposures to mature. Furthermore, market participants would have the ability to choose to transition their loan facilities to reference CORRA in-arrears, Term CORRA or any other alternative rate that is available at any point during the transition period.

The transition of existing CDOR exposures to new ABR represents a financial performance risk to entities. As the reform progresses, investors and others may need information to understand the impact of the reform on their investments. Such information<sup>13</sup> should be considered for disclosure in financial statements (and in other disclosure documents (e.g., Management Discussion and Analysis). Financial statement preparers should also consider the specific disclosure requirements added by the IASB® to address interest rate benchmark reform, including: the nature and extent of risk exposures; how those risks and transition are managed; and the entity’s progress in completing the transition to ABR.

In particular, financial statement preparers with reporting periods after May 16 (the announcement date for cessation of CDOR) may need to provide additional disclosures. Annual financial statements disclosures may be subject to IFRS 7 requirements.

<sup>11</sup> Margin period of risk is the time period from the last exchange of collateral covering a netting set of transactions with a defaulting counterparty until that counterparty is closed out and the resulting market risk is re-hedged

<sup>12</sup> Carr White Paper

<sup>13</sup> Determining the extent and the nature of disclosures to be provided in financial statements may require consideration of various reporting standards, including IFRS 7, *Financial instrument: disclosures* (particularly paragraphs IFRS 7.24I-24J), IAS 1, *Presentation of financial statements*, and IAS 34, *Interim financial reporting*.

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