Canadian Interest Rate Benchmark Reform: Cessation of CDOR

Extract, IFRS® Discussion Group Report on the Meeting – December 5, 2022

On May 26, 2022, Refinitiv Benchmark Services (UK) Limited, the regulated administrator of Canadian Dollar Offered Rate (CDOR) announced that CDOR would cease publication after June 28, 2024. This announcement set in motion the transition timeline set by the Canadian Alternative Reference Rate Working Group[2] (CARR) to replace CDOR with the Canadian Overnight Repo Rate Average (CORRA) as a key risk-free interest rate benchmark in Canada.

On October 7, 2022, CARR published a notice setting out an intention to begin a process for developing a Term CORRA benchmark. In this notice, CARR noted that the Term CORRA benchmark will likely only be available for loans and associated products. Accordingly, it is possible that borrowers will have loans or credit facilities that reference Term CORRA while the derivatives used to hedge the interest rate risk will refer to the overnight CORRA. This can have implications for borrowers who apply hedge accounting requirements in IFRS 9 *Financial Instruments* when transitioning the CDOR-based hedging relationships to CORRA.

The Group considered the following fact pattern and discussed the implications that transitioning from CDOR to CORRA may have on qualifying hedging relationships.

Fact Pattern

- After the discontinuation of CDOR, Entity A originated a five-year term loan with quarterly interest payments based on three-month CORRA.
- Entity A wishes to reduce cash flow interest rate risk arising from this loan. Therefore, it purchased a five-year interest rate swap with quarterly settlements to pay a fixed interest rate at 2 per cent and receive a floating interest rate based on an overnight CORRA.
- Entity A would like to designate the interest rate swap as a hedging instrument under IFRS 9.

Issue 1: What factors should Entity A consider in establishing whether the overnight CORRA derivative qualifies as an eligible hedging instrument to hedge cash flow interest rate risk in the Term CORRA loan?

Analysis

To apply hedge accounting, Entity A will first need to formally designate the interest rate swap as a hedging instrument, including all necessary documentation.

[2] The Canadian Alternative Reference Rate Working Group consists of financial sector firms and public sector institutions in Canada to coordinate Canadian interest rate benchmark reform.

Entity A would also need to consider other qualifying criteria for hedge accounting, including the following:

- effects of credit risk;
- hedge ratio; and
- whether there is an economic relationship between the hedged item (CORRA term loan) and the hedging instrument (interest rate swap).

As the interest rate swap is based on an overnight CORRA, which does not match the three-month CORRA Term loan, Entity A may need to use a quantitative assessment to demonstrate a forecasted economic relationship exists between the three-month CORRA and overnight CORRA throughout the term of the hedging relationship.

The Group's Discussion

The Group agreed that Entity A may need to use a quantitative assessment to demonstrate a forecasted economic relationship between the hedged item (Term CORRA loan) and hedging item (overnight CORRA derivative).

Issue 2: Will Entity A achieve perfect effectiveness in such a hedging relationship?

Analysis

The mismatch between the overnight CORRA and the three-month CORRA may create ineffectiveness in the hedging relationship that needs to be recognized in profit or loss. Entity A should follow paragraph 6.5.11 of IFRS 9 to calculate and account for the effective and ineffective portion of this hedging relationship.

Entity A may use a hypothetical derivative that perfectly matches the hedged risk and references Term CORRA to measure effectiveness despite such derivatives not existing. Accordingly, Entity A would need to establish the pricing of such a hypothetical derivative, which may be complex. The extent that the cumulative change in value of the actual derivative exceeds the change in value of the hypothetical derivative will create ineffectiveness that should be recorded in earnings.

The Group's Discussion

The Group agreed with the analysis. One Group member commented that the CORRA derivative market is still developing and encouraged entities to monitor these developments and consider their impact on hedging relationships. This member also highlighted that IFRS 9 provides accounting relief when an entity is transitioning to alternative benchmark rates, including for hedge accounting.

Issue 3: As an alternative, could Entity A identify that the overnight CORRA is a qualifying risk component of the loan's cash flows?

Analysis

Paragraph B6.3.8 of IFRS 9 states that a "risk component" can be an eligible hedged item if it is a separately identifiable component of the financial item and the changes in the cash flows or the fair value of the item attributable to changes in that risk component must be reliably measurable.

It is unlikely that Term CORRA will be computed using a formula that explicitly references overnight CORRA. Therefore, an entity also needs to consider the requirement in paragraph B6.3.9 of IFRS 9 associated with whether the risk component is identifiable within the context of the particular market structure to which the risk or risks relate. It is currently unknown whether the Term CORRA market structure will identify overnight CORRA as a risk component. However, it is not common in practice to identify overnight rates as a risk component of other term rates.

The Group's Discussion

The Group agreed that it is unlikely that Term CORRA will be computed using a formula that explicitly references overnight CORRA. One Group member commented that this issue is not unique to the hedging relationship in the fact pattern and that it may be relevant to other loan arrangements when the benchmark rate used differs for the hedged item and hedging item.

The objective of this discussion was to raise awareness of recent developments in Canada's Interest Rate Benchmark reform and its potential impact on hedge accounting relationships. Stakeholders are encouraged to stay informed of ongoing developments in this market. No further action was recommended to the AcSB.