Intelligence MEMOS

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To: Canadian Business Borrowers and Lenders

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Re: **THE COMING END OF LIBOR: ADAPTATION REQUIRED**

The widely-used global interest rate benchmark, Libor, is coming to an end, to be replaced by a more decentralized system of reference rates for various currencies that more accurately reflect the interest rate on a risk-free transaction in those currencies.

How can we ensure Canadian businesses are prepared for the transition to these alternative reference interest rates?

Libor is the acronym for the London Interbank Offered Rate, which was originally intended to provide the "risk-free" interest rate at which banks could borrow funds from other banks in the wholesale market. It provides a daily reference point for contracts and business transactions globally and underpins trillions in loans. It has been based on a daily panel survey of about 20 banks, managed by an arms-length regulator. The Libor system currently covers seven term lengths (overnight or spot, one week, one month, two months, three months, six months and 12 months) across five currencies – the US dollar, euro, UK pound, Japanese yen, and Swiss franc.

But financial markets have changed, and Libor could not keep pace. After the 2008-09 financial crisis and reflecting risk concerns, banks gradually stopped accessing funds from the interbank market where Libor set the interest rate. Today, Libor is no longer measuring anything that resembles real transactions. As a result, it has come to be used in specialized financial market segments, such as for derivatives in the eurocurrency market. In addition, the Libor bank panel and regulatory system was limited and quirky, making it more vulnerable to market-distorting or illegal activity, as has occurred on occasion.

After much discussion, the US-based administrator of Libor confirmed in March that the panels for the euro, sterling, Swiss franc and Japanese yen would cease operating at the end of 2021, as well as the panels for one-week and two-month US dollar Libor. The remaining US dollar Libor panels will operate until the end of June 2023. Working groups were created in the United States, the EU, United Kingdom, Japan, and Switzerland to develop alternatives to Libor, and those alternatives have now been established. They are broadly similar, but have subtle differences.

The new reference rates are: the Secured Overnight Financing Rate (SOFR) for the US dollar; the Euro short-term rate (ESTR); the UK Sterling Overnight Index Average (SONIA); the Swiss (franc) Average Rate Overnight (SARON), and the Tokyo Overnight Average Rate (TONAR) for the Japanese yen.

Similarly, the Bank of Canada has recognized the Canadian Overnight Repo Rate Average (CORRA) as the main risk-free overnight reference rate for Canadian dollar transactions, currently used primarily in derivatives markets. The Bank expects CORRA to become the dominant Canadian interest rate benchmark across a wide range of financial products.

The national authorities for these currencies, and other financial institutions, are taking steps to develop an active market, including data publication, futures trading, and bond issues based on the new reference rates. You should expect these acronyms to gradually appear more frequently in the financial media. The transition away from Libor is happening and there will be no turning back.

At this stage, it is imperative that all affected Canadian firms, financial institutions and governments take action as required to eliminate any dependencies on Libor as a reference interest rate. The smoothest pathway for this transition is to move away from Libor in all new contracts, instead selecting one or more of the alternative reference rates. SOFR and CORRA are likely to be the most relevant new reference interest rates for Canadian businesses; most international business by Canadian firms is conducted in US dollars, including exports sales, imports, and mobilizing capital and debt financing.

A shift to the new benchmarks is also necessary for legacy contracts, i.e. those still in force at end-2021 that reference Libor. Amending legacy contracts would be the most desirable approach. An end-to-end inventory of firms' Libor exposure would be ideal, covering contracts with clients, counterparties, creditors, employees, suppliers and others, for the full range of financial processes and systems, including pricing, valuation, risk management and financial accounting.

The use of Libor as an interest rate benchmark will be largely wound down by the end of 2021. The impetus is thus on firms, financial institutions, and governments to take action to transition to the alternative interest rate benchmarks. The smoothest transition pathway is to select one or more of the new reference rates for all new contracts, and to transition existing contracts to these new reference rates.

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