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SFA Research Corner

Mind the Gap: Cessation of CDOR Presents an Opportunity for Canadian ABCP

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On June 28, 2024, the calculation and publication of all tenors of the Canadian Dollar Offered Rate (CDOR) will cease. This cessation of CDOR will also mark the end of the Bankers' Acceptance (BAs) lending model, which benchmarks off CDOR. This shift will result in a C$80 billion gap in money market investment options for insurance companies, pension funds, money market mutual funds, corporations, bank treasuries, government agencies, and asset managers seeking high-rated, liquid, non-government short-term assets. In response to this void, attention has turned to Canadian Asset-Backed Commercial Paper (ABCP), valued at around C$48 billion and representing the 4th largest segment in the Canadian money market, offering higher yields than BAs, as a potential substitute. The implications of CDOR cessation for the Canadian ABCP market will be discussed at SFCanada in Toronto on May 22. Below, we explore the details of this market.

Investment Options to Replace Bankers' Acceptance

Options	Term	Predictability/ Consistency of Issuance	Secondary Market Liquidity (Equal or Stronger than BA)	Credit Quality (Equal or Stronger than BA)*	Yield (vs. BA for a given tenor)	Single Security with Identifier (CUSP / ISIN)
Existing Instruments* *						
BDN	Mostly 3M	Varies by issuer	Tenor dependent	Yes	Similar+	Yes
Regular GoC treasury bills	23M	Yes	Yes	Yes	Lower	Yes
Provincial Bills	Mostly 3M	Varies by issuer	Yes	Yes (in general)	Lower	Yes
ABCP	Varies	No	No	Yes	Higher	Yes
Commercial paper	Varies	No	Issuer dependent	No (in general)	Issuer dependent	Yes
Term Deposits	Flexible	No	No	Yes	Varies	No
Bilateral Reverse Repo	Flexible	No	No	Yes	Lower	No
Tri-Party Reverse Repo	Flexible	No	No	Yes	Lower	No
Potential New Instruments						
Regular 1M GoC treasury bills	1M	Yes	Yes	Yes	Lower	Yes
CDCC GC Basket Units	1M to 3M	TBD	TBD	Yes	Lower	Yes
Structured Deposits	Flexible	No	No	Yes	Varies	No
Floating Rate BDN	> 3M	TBD	TBD	Yes	Varies	Yes
Structured BDN	Flexible	TBD	TBD	Yes	Varies	Yes

** Assume from the same issuer for applicable products issued by commercial banks. ** Table only includes CAD denominated instruments. See section 4.2 for potential foreign currency option. + Normally within 5bps. Source: Canadian Fixed-Income Forum (CFIF) January 2023*

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Market Dimensions

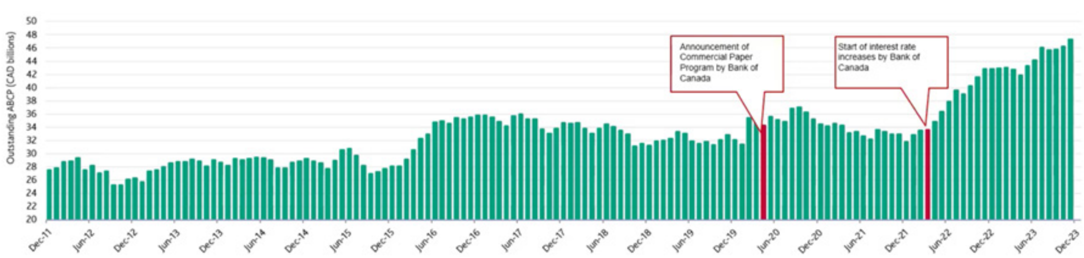
Many Canadian investors have traditionally seen ABCP as a reliable source of short-term funding. However, the market underwent significant restructuring following the 2008 liquidity crisis. This crisis stemmed from investor confidence issues related to the exposure to U.S. sub-prime mortgages in non-bank-sponsored ABCP. Consequently, the non-bank-sponsored ABCP model collapsed, leading to the inability to roll over C$32 billion of ABCP. Following the crisis, Canadian regulators introduced reforms aimed to enhance transparency, standardize practices, strengthen regulatory oversight, and safeguard investor interests. While the bank-sponsored Canadian ABCP continued to function, volumes initially fell. However, thanks to these efforts, the ABCP market in Canada has successfully rebounded. It is crucial to highlight that during the crisis, the market's performance was hampered by liquidity challenges rather than a decline in the credit quality of underlying assets.

According to Morningstar DBRS research, Canadian ABCP outstanding stands near C$48 billion, as of February 2024. This is less than half of the C$108 billion volume high in 2006, but almost twice as much as the C$27 billion low reached in 2011. Today's ABCP programs are administered and sponsored by Canada's top tier banks-- TD Securities (with 31.6% marketshare), CIBC World Markets (22.3%), Scotia Capital Inc. (14.3%), RBC Capital Markets Inc. (11.55%), BMO Capital Markets (10.7%), National Bank Financial Inc. (9.6%), and Canadian Tire Bank (0.6%), according to the rating agency.

Thirty-six percent of the assets held by today's ABCP conduits are prime quality residential mortgage loans and 38.9% are auto-related financings. Equipment financings made up the third largest asset type in 2023, at 7.8%. While auto and mortgages have historically made up the bulk of ABCP collateral, ABCP backed by equipment has been growing since 2020. In 2023, issuance reached $28.7 billion, a 12% decrease from 2022, but a 28% increase from 2021.

Since the Bank of Canada began raising interest rates in 2022, causing heightened market uncertainty, investors have increasingly favored short-term, high-quality paper such as ABCP. This trend has led to a surge in issuance activity, surpassing historical levels. In 2023, activity intensified as the discontinuation of CDOR approached, prompting the market to seek alternatives to Bankers' Acceptances (BAs).

Outstanding ABCP Issued by Canadian Programs



Source: Moody's Ratings, Structured Finance Canada: 2024 Outlook

The discontinuation of CDOR could have a favorable impact on the Canadian ABCP market, which is integral to Canada's evolving money market landscape. ABCP, revitalized and restructured post-2008 crisis as bank-sponsored, highly-rated short-term investments, provides a diversified and secured option to address a portion of the C$80 billion gap resulting from the end of the CDOR-based Bankers' Acceptance product.

A Review of ABCP

ABCP are short-term notes with maturities typically between 30 and 90 days, backed by longer-dated assets and issued by conduits, a bankruptcy-remote special purpose entity. Unlike corporate commercial paper, which represents an unsecured promissory note from a borrower to investors, ABCP is backed by a pool of financial assets such as auto, credit card, or mortgage loans. The conduit is established to purchases assets from the corporate borrower through a true sale without recourse, isolating the ABCP investor from a corporate borrower's bankruptcy. A conduit program may issue different series of securities.

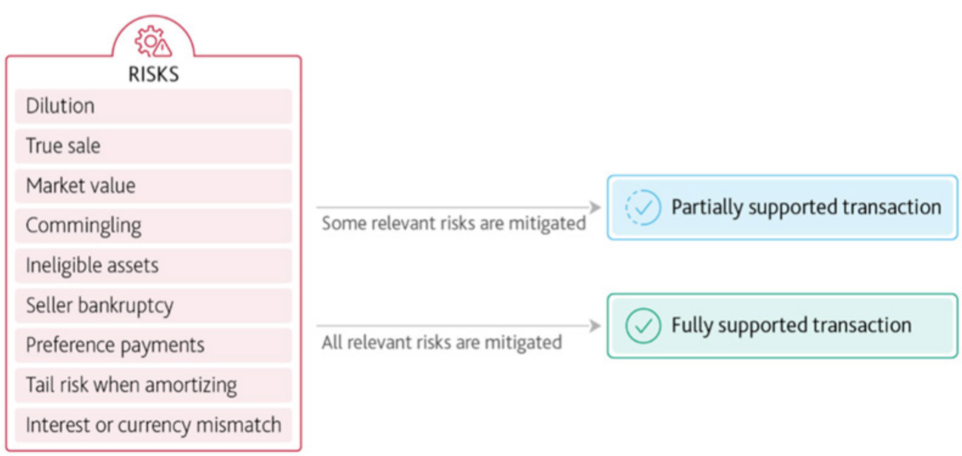
Canadian ABCP are predominately issued as multi-seller programs comprised of a diverse pool of sellers (borrowers) and asset types, mitigating credit risk associated with any one borrower. Structured to withstand high levels of asset deterioration, ABCPs contain internal mechanisms to address credit risk such as overcollateralization, excess spread, reserve funds, and subordination. Credit risk may also be addressed externally through third-party guarantors or letter of credit providers. Credit enhancements may be structured to support a specific series or an entire ABCP program.

Addressing Liquidity Risk

In Canada, ABCP are issued at a discount and at maturity the face amount is typically repaid through the issuance of new ABCP. Since ABCP are short-term liabilities that fund a variety of assets of varying maturity, there is an inherent timing mismatch between investors in the maturity of the underlying assets and that of the ABCP liabilities. To counter this, banks commonly establish liquidity facilities to bolster ABCP programs, serving as a backup funding source if new ABCP issuance stalls.

If new ABCP cannot be placed in the market, the ABCP program would draw on the liquidity facility first. In the event the bank can't perform under the liquidity facility, and in a significant departure from the corporate CP structure, the underlying assets are available to repay the investor, providing an additional layer of protection to investors, dampening the risks associated with the ABCP. A program may enter into more than one liquidity agreement.

Types of Risks that ABCP Liquidity Facilitates can Mitigate



Source: Moody's Ratings