Cassels

Interest Rates Watch: What Will the Transition From CDOR to CORRA Mean For Borrowers and Lenders? New Spread Adjustments, Compounded CORRA In-Arrears Contingency Planning and More

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Welcome back to our *Interest Rates Watch* series, developed to provide timely updates and practical advice on developments related to interest rates and benchmarks on a regular basis. As always, we are here to help.

With publication of the Canadian Dollar Offered Rate (CDOR) set to end in less than 18 months, and with over $20 trillion of notional exposure across the Canadian financial system referencing CDOR,[1] the transition from CDOR to a new reference rate will have wide-ranging implications.

The Canadian Alternative Reference Rates working group (CARR) has recommended that market participants shift from CDOR to the Canadian Overnight Repo Rate Average (CORRA), or a term rate based on CORRA (Term CORRA), the development of which is underway (please see our commentary on the development of Term CORRA here). Below, we discuss some of the key differences between CDOR and CORRA, and how those differences will impact credit facilities.

CDOR vs. CORRA – Key Differences

CDOR is Credit Sensitive, CORRA is Risk Free

CDOR was originally developed in the 1980s as the basis for pricing bankers' acceptance (BA) related credit facilities. CDOR is the rate at which the six banks on the CDOR panel[2] are willing to lend to corporate borrowers with committed BA facilities. Because CDOR is a bank lending rate, it incorporates a bank credit spread or credit risk premium and is based on expert judgment (instead of actual transactions). As such, CDOR is considered a credit sensitive rate.

CORRA, on the other hand, is not a bank lending rate but rather is the cost of overnight general collateral funding using Government of Canada (GOC) treasury bills and bonds as collateral for repurchase transactions (repos).[3] Because the underlying transactions are collateralized by high-quality assets, CORRA

includes little or no credit risk component and is thus referred to as a risk-free rate. CORRA is based on actual observed market transactions and is fully transparent.

CDOR is a Forward-Looking Term Rate, CORRA is an Overnight Rate

CDOR is a forward-looking term rate, currently available in tenors of 1-month, 2-months and 3-months.[4] For CDOR-based loans, the applicable interest rate and payment amount is known in advance.

CORRA is an overnight rate. The use of CORRA in a loan transaction would require parties to calculate a rate over a particular term at the end of that term by compounding each overnight rate in such term. This compounded CORRA in-arrears rate is the second step in a waterfall of recommended CDOR fallback rates (more on this below).

Notwithstanding that the exact rate and payment amount for a CORRA-based loan may not be known at the start of a term, overnight index swaps (OIS) can provide guidance on what the market expects the overnight rate to average over a given period.

CDOR / CORRA Spread

Because CORRA is a risk-free rate, CORRA (either compounded in-arrears or the CORRA OIS) in any particular term will generally be lower than CDOR for the same term. By way of example, on May 16, 2022 (being the date that the administrator of CDOR announced the future cessation of all remaining CDOR tenors), the International Swaps and Derivatives Association calculated the five-year median between CDOR for each relevant tenor and CORRA (compounded over each corresponding period) as follows:

CDOR Tenor	ISDA Credit Spread Adjustment
1-month	29.547 bps
2-months	30.190 bps
3-months	32.138 bps

Over the relevant five-year period, on average, 1-month CDOR was almost 30 basis points greater than the corresponding CORRA compounded in-arrears rate.

Impact on Credit Facilities

Fallback Language is Imperative

As discussed in our previous commentary, loan agreements (both existing and new) should include fallback

language to ensure that there is an effective replacement reference rate on the date that publication of CDOR ceases. Parties should strongly consider using the CARR-recommended fallback language with any modifications that may be negotiated/appropriate for a particular deal (for example, modifications for bilateral facilities), as the CARR-recommended language is the commonly-adopted fallback language in the market. However, parties should be aware that for loan agreements where the only form of borrowing is under a BA facility, the CARR-recommended fallback language will not be sufficient to address CDOR cessation since such facilities likely would not have a mechanism to borrow via a CDOR/CORRA loan. As a result, a CORRA loan mechanism should be added to such loan agreements prior to the CDOR cessation date.

Understanding the Methodology for Compounded CORRA in Arrears

While CARR has announced that efforts are underway to develop a forward-looking term rate based on CORRA (Term CORRA), there is no guarantee that Term CORRA will be available ahead of the CDOR cessation date. In that case, assuming the CARR-recommended fallback language is adopted, the replacement rate pursuant thereto would be CORRA compounded in-arrears.

Parties should ensure that they understand the CORRA compounded in-arrears methodology and have the operational capacity to transact in this fallback rate should Term CORRA not be available.

Economic Impact and Credit Spread Adjustments

Recognizing that CORRA-based rates will generally be lower than CDOR is key to managing the economic impact of the transition from CDOR to CORRA.

To account for the economic difference between CDOR and CORRA, the CARR-recommended fallback language for loans includes the CDOR-CORRA credit spread adjustments noted above. Applying these CSAs, a pre-transition loan bearing interest at 1-month CDOR plus 100 bps would bear interest at the 1-month CORRA-based replacement rate plus approximately 130 bps (being the original 100 bps plus the recommended CSA for the 1-month tenor of almost 30 bps), and this would generally be expected to yield close to an economic equivalent over an extended period of time.

However, notwithstanding that the CSAs in the CARR-recommended fallback language are expected to result in economic equivalent replacement rates over a longer term, CARR has noted that these CSAs are not meant to be prescriptive, but rather are meant to be a starting point for parties. Periods of low or high interest rates and other market factors may impact CDOR-CORRA spreads over a shorter term, with the result that the market may adopt CSAs different than the CSAs included in the CARR-recommended fallback language to account for market conditions. Parties should monitor the market to ensure that the CSAs in a given transaction reflect market conditions and practice.

What's Next

On January 9, 2023, CARR kicked off the first stage of its "CORRA First" initiatives, aimed at generating increased CORRA-based liquidity, with inter-dealer linear derivatives (i.e., Canadian dollar interest rate swaps) moving from CDOR to CORRA. The second stage of CARR's "CORRA First" initiatives will commence on March 27, 2023, with inter-dealer non-linear derivatives (i.e. Canadian dollar swaptions) and inter-dealer cross-currency swaps moving from CDOR to CORRA.

The beta version of Term CORRA is expected to be published in late Q2 / early Q3 of 2023, with publication of Term CORRA expected to commence in the second half of 2023 Q3.

The publication of all remaining tenors of CDOR will cease following a final publication on June 28, 2024. In the interim period, parties should ensure that documentation referencing CDOR adequately addresses issues relating to the end of CDOR (including ensuring appropriate fallback language is included in relevant contracts). Parties should also monitor developments in this space (including market practice relating to credit spread adjustments) as market convention and standards continue to evolve.

We will be monitoring developments and issuing further articles relating to interest rates. Find other articles in our Interest Rates Watch Series here.

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[1] https://www.bankofcanada.ca/wp-content/uploads/2021/12/CARR-Review-CDOR-Analysis-Recommendations.pdf

[2] The six-bank CDOR submission panel, which decreased from nine banks in 2012, is comprised of Bank of Montreal, The Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada, Royal Bank of Canada and The Toronto-Dominion Bank.

[3] A repo is structured as a sale of collateral, with a requirement that the seller repurchase the collateral on the termination date. From an economic standpoint, repos are similar to collateralized loans (i.e. a seller (borrower) sells collateral to a purchaser (lender) for cash (the loan), and agrees to repurchase the same collateral later (loan repayment) at a higher price, with the difference between the initial sale price and the repurchase price being the interest on the loan).

[4] After public consultation, CDOR's administrator, Refinitiv Benchmark Services (UK) Limited, discontinued CDOR's 6-month and 12-month tenors in May 2021 due to a lack of underlying BAs issued in those tenors.

This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.