Interest Rates Watch: CARR Releases Recommended CORRA Loan Agreement Mechanics

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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.

One of the biggest question marks relating to the end of the Canadian Dollar Offered Rate (CDOR) is how market participants will adjust credit facilities that currently have CDOR or bankers' acceptance (BA) loan mechanics. CDOR will no longer be published following a final publication on June 28, 2024 and BAs will not be available after CDOR publication ceases. As such, CDOR and BA mechanics in existing credit agreements will need to be replaced no later than June 28, 2024.

The Canadian Alternative Reference Rates Working Group (CARR) has published recommended provisions (the CARR Loan Mechanics)[1] to facilitate the switch from existing CDOR or BA loan facilities to a credit facility referable to the Canadian Overnight Repo Rate Average (CORRA). While the CARR Loan Mechanics may change as market practices evolve, they are a good starting point for market participants with existing CDOR or BA loan facilities. Some of the more noteworthy points of the CARR Loan Mechanics are discussed below.

CARR Confirms Expectation that BA Issuance will Cease

With the cessation of CDOR, the related BA-based lending model will be discontinued and therefore BA issuance will cease after June 2024. As a result, there will be no or very limited BA issuance taking place after June 2024. Canada is the last major jurisdiction to retain this type of lending structure, with many having modernized their lending structures decades ago away from BAs.

Rate Flip Mechanism: Term CORRA and Daily Compounded CORRA

While daily compounded CORRA can be calculated and used as a replacement rate today, a forward-looking CORRA term rate (Term CORRA) will not be published until September 5, 2023.[2] Once Term CORRA is available, however, it is expected that many borrowers will prefer Term CORRA as it is less operationally complex than daily compounded CORRA and will provide cash flow certainty for borrowers.

Despite the expectation that most borrowers will prefer Term CORRA, the CARR Loan Mechanics include both Term CORRA and daily compounded CORRA options (in addition to a Canadian prime rate option), although CARR has recommended that only one of the CORRA options should be available for borrowing at any given time for operational simplicity. To facilitate the potential use of either CORRA option, CARR has included a “rate flip” concept which allows borrowers to elect to change the CORRA rate option during the life of the loan without reopening the credit agreement.

The rate flip is in response to an emerging trend in the US market that has seen certain borrowers amend their credit agreement to replace the forward-looking Secured Overnight Financing Rate (SOFR) term rate with daily compounded SOFR (Daily SOFR) as a result of lower hedging costs for Daily SOFR. In Canada, borrowers sensitive to hedging costs may look to switch to daily compounded CORRA if hedging Term CORRA becomes more expensive on a relative basis.

Additional Benchmark Replacement Mechanics

In the event that publication of CORRA ceases or CORRA becomes non-representative, the CARR Loan Mechanics include fallback language whereby parties would choose a successor rate giving consideration to prevailing market convention.

Recommendations for Market Participants

Review Existing Contracts and Be Mindful of the November 1, 2023 “No New CDOR” Date

While it is expected that CDOR will continue to be published until the end of June 2024, market participants should review existing contracts that reference CDOR or BAs now to ensure that they include robust fallback language and develop remediation plans. CARR has set a milestone date of November 1, 2023, after which all new Canadian dollar loan contracts must reference CORRA, Term CORRA, the Canadian prime rate or another alternative reference rate in place of CDOR. Borrowers and lenders should consider transitioning to an alternative rate in advance of the CDOR cessation date, and the CARR Loan Mechanics should be used as a guideline in remediation plans.

Fallback Language is an Intermediate Step

While CARR has provided fallback language as an intermediate step, recommended practice is to amend agreements referencing CDOR and/or BAs to incorporate a new reference rate prior to the CDOR cessation date. Of particular concern are facilities where the only form of borrowing is under a BA facility. BA loan agreements include language that addresses unique BA mechanics, including references to a stamping fee, the discount rate, the form of drafts and the BA instrument, which differ from non-BA funding mechanics. As a result, when CDOR ceases and BA lending is halted, if the only form of borrowing in the loan agreement is under a BA facility, there will be no mechanism to borrow using a CORRA-based as replacement rate.

Monitor Replacement Rates and Learn Methodology

Borrowers and lenders should familiarize themselves with the various available replacement rates, including daily compounded CORRA, Term CORRA (once published) and the Canadian prime rate, as well as the calculation methodology for each. This will allow parties to make an informed decision when selecting a replacement rate.

Monitor Market Practices

Market participants should also monitor market practices, as conventions may change as market practices evolve. In particular, as was seen on many transactions in the transition away from LIBOR, credit spread adjustments (CSAs) which are meant to account for the economic difference between a risk-free CORRA-based replacement rate and CDOR may deviate from CSAs included in the CARR recommended fallback language, depending on the specifics of a particular transaction and prevailing market interest rates.

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

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[1] Recommended CORRA loan agreement definitions and loan mechanics (bankofcanada.ca)

[2] Term CORRA to be launched on September 5, 2023 - Bank of Canada

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