Cassels

Interest Rates Watch: CDOR Transition Frequently Asked Questions

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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.

The Canadian Alternative Reference Rate Working Group (CARR) has published a set of frequently asked questions[1] relating to various aspects of the cessation of the Canadian Dollar Offered Rate (CDOR), the publication of which will cease following a final publication on June 28, 2024. In addition to providing a summary of the rationale behind CDOR's cessation, the FAQs include commentary and guidance relating to the following:

Timeline

CARR expects that it will take longer for loans to transition from CDOR than other products because loans may need to transition to a forward-looking term rate while other products will mostly transition to the Canadian Overnight Repo Rate Average (CORRA) calculated in-arrears. As such, CDOR's cessation will take place in two stages.

Stage 1 (Derivatives and Securities)

Market participants were expected to transition all new derivative and securities transactions to CORRA by June 30, 2023, with no new CDOR exposure being booked after that date, subject to limited exceptions (including derivative transactions that hedge CDOR-related loans or securities – more on this below). This is consistent with the supervisory expectations for federally-regulated financial institutions and federally-regulated private pension plans published by the Office of the Superintended of Financial Institutions (OSFI)[2]. OSFI-regulated entities are the primary providers of liquidity in the Canadian financial market and, accordingly, their transition away from CDOR is expected to result in a broader market shift to CORRA.

Market participants that have loan facilities referencing CDOR can hedge their CDOR exposure using CDOR-based derivatives after June 30, 2023 until June 28, 2024, but may consider moving to CORRA-based loan facilities earlier as liquidity in CDOR-based derivatives may decline following the end of Stage 1 of the two-staged CDOR transition.

Stage 2 (Loans and All Other CDOR Exposure)

Market participants are expected to replace CDOR in all other transactions (including loan facilities), including bankers' acceptance (BA) borrowing mechanics, by June 28, 2024. It is expected that BAs will no longer be issued after CDOR is no longer published. This second stage of the transition plan provides additional time for the creation of a CORRA term rate (Term CORRA) for the loan market, which will be published (officially) beginning September 5, 2023[3].

Loan Facilities

No New CDOR or BA Exposures After November 1, 2023

While it is expected that CDOR's publication will continue through June 28, 2024, market participants should not enter into new loans referencing CDOR or BAs after November 1, 2023. This November 1, 2023 milestone will not impact the ability to draw on existing CDOR or BA loan facilities that have not yet matured. After November 1, 2023, lenders will still be expected to comply with contractual obligations in existing credit agreements referencing CDOR or BAs and to meet contractual requirements of these agreements including but not limited to drawdowns, extensions (if at the Borrower's option) or pre-documented increases (e.g. construction facilities that become available after meeting any preconditions). Permitted activities include:

- rollovers of existing BA draws, interest term renewals or new draws under an existing loan (term or revolver);
- draws on committed and uncommitted facilities entered into prior to November 1, 2023;
- new loan agreements and extensions of existing loan agreements that were underwritten or committed to prior to, but close after, November 1, 2023;
- use of accordion features in the normal course of business, not paired with extension of term; and
- purchase of existing CDOR loans in the secondary market.

Bankers Acceptance Issuance Expected to Cease After CDOR Cessation

With the cessation of CDOR's publication, the 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. While BA issuance is expected to remain relatively robust until the end of 2023, BA issuance is expected to progressively drop as the CDOR cessation date approaches.

Alternative Replacement Rates

The primary alternatives to replace CDOR as a benchmark rate for loans or BAs include Term CORRA,

CORRA compounded-in-arrears and the Canadian prime rate.

CORRA Credit Spread Adjustments

Similar to the fallback mechanics recommended by the Alternative Reference Rates Committee in connection with the transition from the USD London Interbank Offered Rate (LIBOR) to the forward looking term rate based on the Secured Overnight Financing Rate (SOFR), the CARR-recommended fallback language includes credit spread adjustments (CSAs) which are meant to account for the economic difference between the CORRA-based replacement rate and CDOR. Since CORRA reflects an overnight risk-free rate and does not include a bank funding/credit spread, CORRA is historically much lower than CDOR (similar to the risk-free SOFR vs. LIBOR). These CSAs reflect the historic economic difference between CORRA and CDOR as of the date of the announcement by Refinitiv Benchmark Services (UK) Limited that it would cease publication of CDOR.

Recommendations for Market Participants

Market participants should review all contracts that reference CDOR or BAs to ensure that they include robust fallback language. Please see our previous article on CARR's recommend fallback language. Where there is no robust fallback language, agreements should be amended to incorporate CARR's recommended fallback language. Credit agreements that include a BA borrowing option will also require robust CDOR or BA rate fallback language and remediation plans prior to the CDOR cessation date.

As a second step, and even where contracts contain robust fallback language, lenders and borrowers should consider developing a remediation plan and transitioning to an alternative rate as early as possible, and prior to the CDOR cessation date. CARR notes that fallback language is intended to be an intermediate step and applicable in the event a loan cannot be transitioned in time, but relying on CARR's fallback provisions is not best practice and should be avoided.

It will also be important for both borrowers and lenders to become familiar with the CORRA compounded in-arrears methodology as borrowers may elect to transact in this rate depending on hedging costs[4] or may be required to transact in this rate should Term CORRA not be available at any point in the future.

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, CSAs 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] CDOR Transition FAQs (bankofcanada.ca)

[2] OSFI's expectations for CDOR Transition (osfi-bsif.gc.ca)

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

[4] Please see our previous article *Interest Rates Watch: CARR Releases Recommended CORRA Loan Agreement Mechanics* for additional information