Transitioning Loans from CDOR to CORRA – Best Practices

1. Introduction

The administrator of the Canadian Dollar Offered Rate (CDOR), Refinitiv Benchmark Services (UK) Limited (RBSL), announced on May 16, 2022 that it would cease the calculation and publication of all tenors of CDOR following its final publication on June 28, 2024 (CDOR Cessation Date). This decision will have a major impact on the structure and functioning of Canada's financial markets, including on loans currently offered by the larger banks that result in the creation of a Bankers' Acceptance (BA). With the cessation of CDOR, BA-based loan facilities, whether referencing CDOR or specific BA rates, will no longer be offered to borrowers.[1] Banks will supplant the use of CDOR or a BA rate in favour of risk-free rates (overnight or term) or the bank's prime rate. The move away from using CDOR or BA rates as a benchmark for loans will mean that BA securities that were produced when a borrower drew down on their facility will no longer be issued after the cessation of CDOR. These changes will make Canadian lending practices more-closely aligned with international practices where the interest is paid at the end of the interest period.[2] The change will not impact those loans that reference Prime. The disappearance of BAs as an investment product will also impact the Canadian money market, with investors having to find new alternatives for their short-term money market investments.

To support the transition away from CDOR, the Canadian Alternative Reference Rate Working Group (CARR)[3] published a two-staged transition roadmap:[4]

- **End of Stage 1: June 30, 2023** – No new CDOR exposures for derivatives or securities is to be booked, with limited exceptions. Market participants are expected to transition to using CORRA in their derivative contracts or transactions after this date, unless those derivative transactions reduce CDOR risk or are associated with CDOR based loan facilities. Newly issued securities are also expected to reference CORRA instead of CDOR after this date.
- **End of Stage 2: June 28, 2024** – Loans and related derivatives[5] can continue to reference CDOR until this date, after which CDOR will no longer be published and applicable CDOR fallbacks come into effect for any remaining CDOR exposures across all products.

To facilitate the Canadian loan markets' move away from CDOR and BAs, CARR has implemented a new milestone in its transition plan whereby no new CDOR or BA related loan contracts should be entered into after November 1, 2023. This will help to ensure that the stock of loans that need to be remediated does not grow past that date and result in increased risk for the transition of the loan market. Similar milestones have been used effectively in other jurisdictions to smooth the transition away from the various LIBOR benchmarks. For the purpose of this new milestone, new contracts include any agreements that creates additional CDOR or BA exposure as well as material amendments, changes in pricing, term extensions requiring lender consent, and facility amount increases to existing loan agreements. For clarity, this

[1] Canada is the last major jurisdiction to have retained the BA lending model developed in the 1960s to facilitate the growth of a corporate lending market. This type of lending structure disappeared in the US in the mid-1980s, the UK in the late 1980s and from Australia about 10 years ago after the introduction of the Basel III liquidity metrics.
[2] For further information on the BA loan construct please see CARR's December 2021 whitepaper and the Bank of Canada's Primer on the Canadian Bankers' Acceptance Market.
[3] CARR was created to ensure Canada's interest rate benchmark regime remains robust, relevant and effective in the years ahead. For more information on CARR, please visit its website.
[4] Please see CARR's transition timeline and milestones.
[5] Please see CARR's market notice on the implications for transactions as stage 1 ends and stage 2 begins.

milestone does not impact the ability to draw on existing CDOR or BA loan facilities that have not yet matured, or that have been extended or been subject to material amendments prior to November 1.

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 (i.e. Borrowers' exercising a pre-existing term extension option that does not require additional lender consent) or pre-documented increases (e.g., construction facilities that become available after meeting any preconditions). Permitted activities include:

- Rollover 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 the No "New" CDOR or BA exposures date;
- New loan agreements and extensions of existing loan agreements that were underwritten or committed to prior to the No "New" CDOR or BA exposures date but that close after November 1;
- Accordion activation or usage in the normal course of business, not paired with extension of term; and
- Purchase of existing CDOR loans in the secondary market.

With the cessation of CDOR, most financial products, particularly derivatives and securities, will reference the Canadian Overnight Repo Rate Average (CORRA), a more robust and transparent interest rate benchmark. CORRA is an overnight risk-free rate that reflects overnight repurchase transactions using Government of Canada securities as collateral and is published daily for free at 9am ET by the Bank of Canada on a T+1 basis. This move to a risk-free rate is consistent with many other major jurisdictions, including the US.[6] The Canadian loan market can use (a) daily overnight CORRA calculated in arrears, (b) a new 1- or 3-month forward looking Term CORRA or (c) a bank's prime rate. CanDeal, in collaboration with TMX, will begin publishing Term CORRA in September 2023.[7]

This paper provides an overview of the cessation of CDOR and best practices for loan market participants in order to prepare and transition their loans to CORRA in advance of the CDOR Cessation Date.[8]

2. Key differences between CDOR, CORRA and Term CORRA

CDOR, CORRA and Term CORRA can all be used to calculate the interest due on loans. However, CORRA and Term CORRA are economically different from CDOR. CDOR incorporates a bank credit risk premium (i.e. a spread, added on to a risk-free rate, that reflects the market price for the credit risk of a bank or banks), while CORRA and Term CORRA are both risk-free rates (there is no compensation for bank credit

[6] This shift is also occurring in other LIBOR jurisdictions (the EU, Japan, Switzerland, the UK).

[7] The use of Term CORRA will be restricted through its licensing to only those use cases laid out by CARR. A license to use Term CORRA will be required by any market participants that provide financial products that reference Term CORRA. In general, corporate borrowers will not need a license, however, they may be required to acknowledge the terms and conditions related to its use. Term CORRA licensees and those that pay for real-time access will be able to obtain the rate at 1pm ET from TMX Datalinx or through licensed data distributors. CanDeal will publish the rate on its Term CORRA webpage free of charge the next day (T+1) at 4pm.

[8] This paper is focused on the impact of the transition from CDOR to CORRA on loans. Impacts to other financial instruments such as, for example, Letters of Credit and other Trade Finance products have not been specifically contemplated.

risk). CORRA is an overnight risk-free rate that closely tracks the Bank of Canada's policy, or target, rate. Term CORRA is a forward-looking version of CORRA that represents the market's future expectation, based on CORRA futures, of each daily CORRA setting compounded over a 1- or 3-month period. As a result of the fundamental difference between CDOR and CORRA-related rates, there are a few key factors that market participants need to understand or consider when using CORRA or Term CORRA in their loan agreement(s):

1. Since CORRA and Term CORRA do not incorporate a bank credit risk premium, they are generally a lower-yielding rates relative to CDOR.[9] In order to ensure that a CORRA or Term CORRA loan is economically equivalent to a CDOR loan, the specific borrower credit spread needs to be adjusted higher to compensate for this yield differential. The magnitude of this spread adjustment will depend on market and bank funding conditions, including whether there is any stress in the financial system. The new credit spreads to be applied to CORRA or Term CORRA based loans, will need to be individually negotiated between borrowers and lenders. As can be seen from Figure 1, the historical spread between CDOR and 1-month overnight index swaps (OIS) has been relatively volatile, especially during period of financial stress, including during the Global Financial and COVID-19 crisis.[10]
2. Loan facilities based on CORRA and Term CORRA are expected to see consistent or declining borrowing costs relative to CDOR during periods of financial stress. This phenomenon creates wrong-way risk for lenders that offer a revolving credit facility based on risk-free rates, as borrowers typically draw down on their revolvers in periods of financial stress. The wrong-way risk arises as lenders are forced to fund these draws at a time when their funding costs are elevated. When CDOR is used as the reference rate in lending, it acts as a form of self insurance as the loan benchmark would increase along with bank credit spreads. Therefore, the result of moving to a risk-free rate will benefit borrowers at the expense of lenders, particularly in revolving credit facilities. To address this risk, lending agreements may employ a variety of tools to offset this adverse impact created by the wrong-way risk.
3. CORRA is an overnight rate, so the actual amount of interest payable needs to be calculated in-arrears. In other words, CORRA's daily values over the interest rate period are compounded each day to calculate the interest rate for that period. [11] Therefore, the actual payment is backward-looking (instead of forward-looking, as occurs for loans priced off of CDOR).[12] However, as CORRA tracks the Bank of Canada's target rate very closely, market participants should be able to forecast relatively accurately the payment at the start of the period, especially if there is no expectation of a policy rate move by the Bank of Canada during the interest period. Should market participants want certainty as to the payment for the period they can enter into an overnight index swap for the term of the interest period with their bank. Borrowers who want cash flow certainty at the beginning of a period and do not want to hedge the payment using a swap, can use Term CORRA

[9] For illustrative purposes only on July 20: 1-month CDOR is 5.37000, 1-month Term CORRA (beta) is 5.00714, and CORRA is 5.00.

[10] For comparative purposes the graphs below show the spread between 1-month CDOR and OIS. The 1-month OIS rate is the market's future expected average value of CORRA over the specific time period from the overnight index swap market. Market participants can lock-in the OIS rate using an overnight index swap. Term CORRA is meant to represent a point in time indication of the OIS rate for a specific term.

[11] See this backgrounder for more detail.

[12] Note that for loans that reference Prime, the payment is also calculated in-arrears.

to ensure payment certainty at the beginning of the reset term. Figure 2 illustrates the methodology differences between CORRA, Term CORRA, and CDOR.

Figure 1 – Spread between 1-month CDOR and 1-month OIS

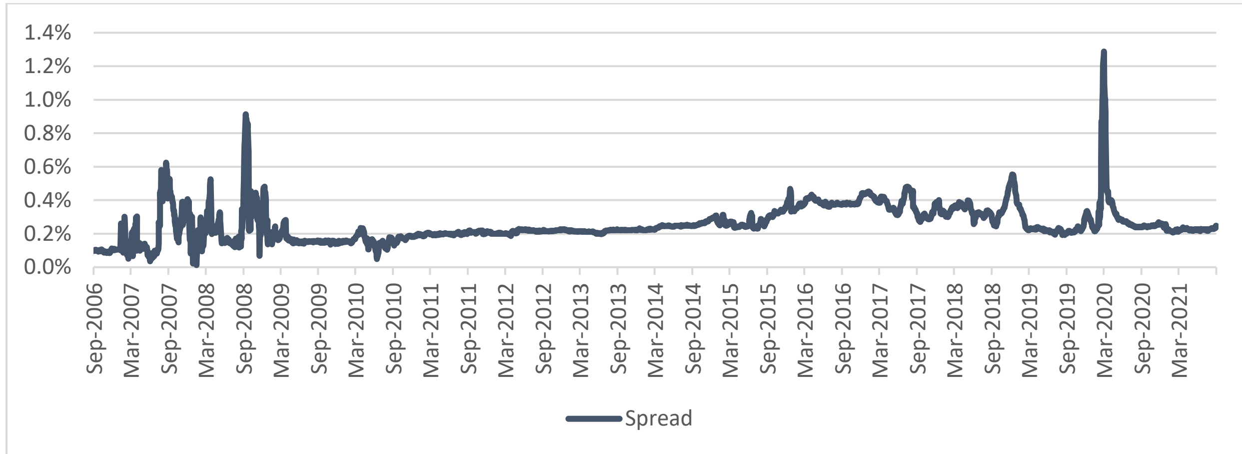
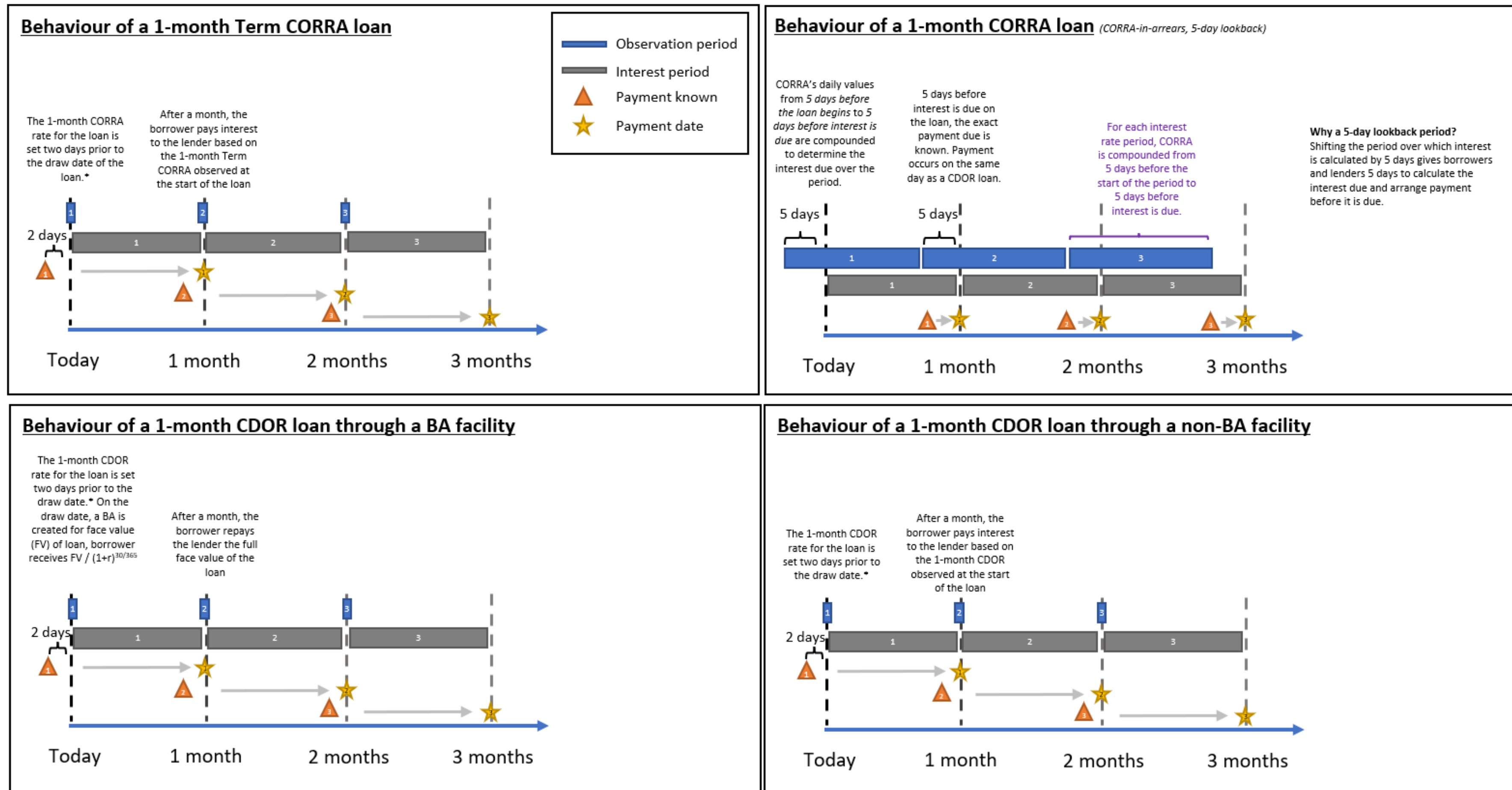


Figure 2 – Comparison of CDOR/BA and CORRA based loans



*: The 2-day lag used in this figure is for illustrative purposes. Some loan agreements may have different lags.

3. Best Practices for Remediation

3.1 Exposure Evaluation, Contract Robustness and Fallback

In remediating existing financial contracts, instruments and loan agreements referencing CDOR or a BA rate, it is recommended that market participants proceed as follows:

1. Evaluate their exposure to CDOR or BAs by reviewing relevant contracts, agreements and instruments (see Section 3.2 for considerations).[13]
2. Identify whether there is robust fallback language that would apply to CDOR or BA rate cessation; and where there is no robust fallback language, amend the agreement to incorporate CARR's recommended fallback language published in August 2022.[14] As per CARR's December 2021 White Paper, it is expected that BA based loans will no longer be offered by banks following CDOR cessation. Therefore, credit agreements that include a BA borrowing option, whether the discount rate is CDOR or a BA rate, require robust CDOR or BA rate fallback language and remediation plans prior to the CDOR Cessation Date.
3. Although agreements may already contain fallback language, borrowers will require an amendment to their agreements in order to transact in CORRA or Term CORRA.
4. Even if the borrower is using only Term CORRA, they should become familiar with the CORRA compounded in-arrears methodology and implement the operational capacity to transact in this rate as the fallback to Term CORRA, should Term CORRA not be available at any point in the future.[15]
5. Prior to the CDOR Cessation Date, loan agreements, financial contracts and instruments should be amended to replace CDOR and/or the BA rate as the interest rate benchmark with an appropriate benchmark replacement. For loan agreements where the only form of borrowing is under a BA facility, a CORRA loan mechanism (using either overnight CORRA or Term CORRA, or both) should be added to the loan agreement in advance of the CDOR cessation date.

3.2 Remediation: Considerations

Fallback language is intended to be an intermediate step and applicable in the event a loan cannot be transitioned in time; lenders and borrowers should consider developing a remediation plan and transitioning to an alternative rate as early as possible, and in any case prior to the CDOR Cessation Date. Relying on the Fallback provisions is not a best practice and should be avoided. Market participants may wish to take the following factors, among others, into consideration when developing their plan.

- **Loan Maturity:** Loans that mature after the cessation of CDOR should be opportunistically remediated at routine annual (or scheduled) negotiations to actively transition away from CDOR. Any renewals of loans that takes place after November 1, 2023, as per CARR's new loan milestone, must be documented without referencing CDOR or BAs. Only CORRA, Term CORRA or Prime should be referenced after that date for floating-rate Canadian dollar borrowings.
- **Fallback Language:** Products with hardwired fallback language provide greater certainty following a discontinuation event by specifying both the replacement rate and the applicable

[13] Note that most loans with a BA borrowing option typically reference the CDOR rate for discounting, and therefore fall within the scope for an impact analysis, although those loans that reference BAs for discounting need also to be included since BA rates will no longer be available after the cessation of CDOR.

[14] Credit agreements that do not reference CDOR and only reference a BA rate will be required to be amended to reference "CDOR" for the CARR recommended fallback to operate.

[15] CARR expects any users of Term CORRA to have robust fallback language in place that references, in most cases, overnight CORRA calculated in-arrears, and to build the operational capacity to transact in these fallbacks should Term CORRA cease to be published in the future.

credit spread adjustment. Consequently, contracts with amendment fallback language or no fallback language should be prioritized for remediation over those that contain hardwired fallback language.

- **Dollar Volume:** As the transition to alternative rates may lead to a change in the value, tax, or accounting treatment of a product or service, prioritizing exposure with larger dollar volume is advisable.
- **Corresponding Hedge:** Even though a swap contract may be remediated to include appropriate fallback language, participants may want to proactively renegotiate the hedging transaction to include new rates. Amending swap contracts hedging CDOR exposure should be coordinated to avoid a mismatch between the two instruments, and the possible basis risk. The possible impact on hedge accounting treatment will also need to be considered.

When remediating contracts, it is recommended that lenders and borrowers take the opportunity to review terms and conditions of products, including the adoption of robust fallback language that would apply to CDOR. In addition to fallback language for CDOR, where market participants contemplate Term CORRA as a benchmark replacement, there should similarly be robust fallback language that would apply to Term CORRA (such as a fallback to overnight CORRA), given that there are certain dependencies underpinning Term CORRA which may impact its long-term sustainability.

Market participants should continue to monitor future developments and seek independent professional advice on the potential impact of reforms on their products and their organization more generally. It is crucial that market participants remediate loan agreements and financial contracts prior to the CDOR Cessation Date, and not rely solely on the fallback language.

Please see CARR's recommended CORRA loan agreement definitions and loan mechanics, the CORRA loan comparison table, as well as CARR recommended terms for CORRA-based loans for more details on the adjustments required to move from CDOR to CORRA and Term CORRA based loan agreements.

4. Loan Hedges and Related Operational Considerations

4.1 Loan Hedges

CDOR derivatives that serve as floating loan hedges need to be transitioned to alternative rates ahead of the CDOR Cessation Date. Alternative interest-rate derivative products that reference CORRA, such as overnight index swaps, already account for the majority of derivative trading in Canada, and are available to borrowers to transact in. In addition, as the Term CORRA loan market starts to develop in Q4-2023, derivatives linked to this index are expected to be added to the hedging options available to borrowers. CDOR derivatives will continue to be available after June 30, 2023 (until June 28, 2024) for those transactions that are allowed to use CDOR derivatives after that date, but they are expected to be less liquid and will potentially trade at wider bid-offer spreads than CORRA-based derivatives.

CARR encourages borrowers, particularly those that hedge their loans, to use overnight CORRA, where possible. It is expected that the overnight CORRA derivative market will be much deeper and more liquid than the Term CORRA derivative market. Therefore, borrowers that wish to hedge Term CORRA loans with Term CORRA derivatives could see higher hedging costs than if they were using overnight CORRA for both their loan and their derivative hedge. This is due to the expected one-sided nature of the hedging demand from bank loan end-user clients for Term CORRA derivatives. The higher hedging costs would be in the form of a positive 'basis' (additional spread relative to overnight CORRA derivatives), similar to that seen

in the Term SOFR derivative market in the US. To encourage a more balanced market for Term CORRA derivatives, CARR has included lenders' Term CORRA hedging transactions in the approved Term CORRA derivatives use cases which could provide an offset to corporate hedging and potentially contain the incremental cost (i.e. basis) of using Term CORRA derivatives.

Further, all CDOR derivatives subject to the International Swaps and Derivatives Association (ISDA) IBOR Fallbacks Supplement or Fallbacks Protocol published on October 23, 2020, or ISDA 2021 Interest Rate Derivatives Definitions, will fall back to overnight CORRA plus the published ISDA spread adjustment after June 28, 2024, if they are not actively transitioned ahead of cessation. By contrast, the first step in the CARR recommended fallback language for CDOR loans is to Term CORRA plus the ISDA spread adjustment. As a result, loans and their related hedges have discrete fallbacks, increasing the potential for basis risk between the floating rate loan and its hedge. By electing to transition their floating rate loan and related hedge in advance of the cessation date, borrowers are better positioned to ensure that the hedge remains effective and the payment obligations match.

Unlike the *Adjustable Interest Rate (LIBOR) Act* in the United States, there is no federal legislation contemplated in Canada to remedy CDOR contracts without adequate fallback. Market participants are encouraged to begin planning for CDOR cessation immediately to ensure a smooth transition of all CDOR contracts to CORRA or Term CORRA.

4.2 Operational Preparations and Considerations

CARR is aware that loan market participants rely on an array of internal and third-party systems to support their business activity. With this in mind, CARR has conducted a Vendor Readiness Survey targeting suppliers of technology platforms and services to financial markets, including to the loan market. The survey aims to raise awareness and promote preparedness amongst these suppliers in anticipation of the needs of their customers arising from the transition to CORRA-based loan markets. The recipients of this survey were identified from amongst CARR's private sector members, who are taken as representative of the wider market. Nonetheless, CARR encourages individual firms to engage actively with their own set of vendors regarding their readiness to support CORRA-based loan products, including via activation of fallbacks.

To assist firms in the planning for cessation, CARR has also produced an Impact Assessment Checklist. We recommend that firms treat this as a useful reference when assessing the completeness of their transition arrangements.

CARR also plans to produce an Aid to Transition document, covering systems and processes, in late summer 2023 to provide further guidance, support and assistance to market participants, including for loan products. Given the parallels with markets in other currencies that have already completed their transition ahead of the Canadian one, we recommend that those firms keen to push ahead immediately with planning make use of existing materials already provided in this context. [16]

[16] Example resources created in the case of USD LIBOR transition include: ARRC-Internal-Systems-Processes-Transition-Aid.pdf (newyorkfed.org)