CARR amends the Recommended Fallback for CDOR NHA MBS

In 2021, CARR published "Recommended fallback language for FRNs referencing CDOR" ("**CDOR Fallback Language**"), which recommended that CDOR-linked floating rate notes (FRNs), including CDOR NHA MBS, fall back from CDOR to "**Fallback Rate (CORRA)**" (the "**Recommended Fallback**"). Fallback Rate (CORRA) has been adopted in many bond issues referencing CDOR since that date. As the cessation date of CDOR draws closer, however, CDOR NHA MBS issuers and investors have identified unique aspects with these securities necessitating a review of CARR's Recommended Fallback for CDOR NHA MBS.

Specifically, the calculations for Fallback Rate (CORRA) and for the CORRA compounded-in-arrears rate for newly issued CORRA NHA MBS ("**One-Month Daily Compounded CORRA**") differ slightly with respect to the determination of the interest observation period used to calculate the coupon. As a result, Fallback Rate (CORRA) and One-Month Daily Compounded CORRA do not always produce the same coupon for a given coupon period, which could result in CDOR NHA MBS that use Fallback Rate (CORRA) having a different underlying coupon rate than newly issued CORRA NHA MBS with the same coupon period. There are also core IT infrastructure system issues associated with handling two different methodologies, requiring manual overrides and temporary workarounds.

These issues could be obviated if CARR amends the Recommended Fallback for CDOR NHA MBS from Fallback Rate (CORRA) to match the One-Month Daily Compounded CORRA calculation methodology. This would align the calculation methodology of the CORRA rate that replaces CDOR in CDOR NHA MBS and calculation methodology of newly-issued CORRA NHA MBS after CDOR's cessation.

CARR has considered the uniqueness of CDOR NHA MBS compared to other CDOR-based legacy FRNs impacted by the CDOR transition:

- CDOR NHA MBS is a monthly pay, amortizing instrument. They also have a very standardised interest (coupon) period which starts and ends on the first calendar day of each month. As a result of this monthly coupon frequency, the difference between the two methodologies can manifest more often than for FRNs with quarterly (non-standardised) interest periods, posing a unique challenge to CDOR NHA MBS issuers and investors. This difference is amplified when statutory holidays, often celebrated on the first of the month, are taken into account.
- The majority of CDOR NHA MBS are owned by either the Canada Housing Trust (CHT) or the CDOR NHA MBS Issuers themselves, which means that external investor exposure is more limited and consistency with CARR's recommended CDOR FRN fallback language, which aligns with the ISDA fallback language, is not as necessary.
- The coupons on CDOR NHA MBS are also not usually swapped by the issuer or non-CHT investors and therefore having consistency with ISDA's CDOR fallback methodology for swaps is not as important.

Given the issues raised by the difference in calculation between the recommended CARR Fallback Rate (CORRA) and that of One-Month Daily Compounded CORRA used in newly issued CORRA NHA MBS and the unique nature of CDOR NHA MBS, after consulting with MBS Issuers Association (MBSIA), CMHC and other market participants, CARR recommends that:

<u>For CDOR NHA MBS that include CDOR Fallback Language:</u>

- The One-Month Daily Compounded CORRA calculation methodology currently being used in newly issued CORRA NHA MBS will be used to calculate the CORRA compounded-in-arrears rate for all CDOR NHA MBS outstanding on or after July 1, 2024, rather than the Fallback Rate (CORRA) calculation methodology that the CDOR Fallback Language included in such CDOR NHA MBS may currently refer to.
- The one-month CDOR to CORRA spread adjustment of 0.29547% announced by Bloomberg in May 2022, as defined in its IBOR Fallback Rate Adjustments Rule Book, should be added to the One-Month Daily Compounded CORRA to calculate the fallback rate for CDOR NHA MBS.
- CDOR NHA MBS issuers and CMHC should implement these recommended changes through operation of the ***Applicable Fallback Rate Conforming Change*** clause in the CDOR Fallback Language or the similar clause in the interim fallback language incorporated in certain CDOR NHA MBS. The conforming change clause permits issuers, as directed by CMHC or its designated calculation agent, to make certain adjustments to the applicable fallback rate that are consistent with accepted market practice.

For CDOR NHA MBS that do not yet include CDOR Fallback Language:

- As mentioned in CARR's paper on legacy securities linked to CDOR, issuers of tough legacy CDOR NHA MBS should seek the necessary consent from investors to incorporate CDOR Fallback Language. After receiving the necessary consent and incorporating CDOR Fallback Language, these tough legacy CDOR NHA MBS should also adopt the One-Month Daily Compounded CORRA calculation methodology as the basis to calculate the CDOR fallback rate.
- IF CONSENT ON A TOUGH LEGACY NHA MBS IS NOT POSSIBLE, the issuer should calculate and pay the coupon on the CDOR NHA MBS by applying CDOR Fallback Language modified to apply One-Month Daily Compounded CORRA with 0.29547 % spread adjustment as the basis to calculate the CDOR fallback rate in the same way as how the coupon is calculated and paid after July 1, 2024 for a CDOR NHA MBS containing such CDOR Fallback Language as outlined in this document.

This change to CARR's Recommended Fallback only applies to CDOR NHA MBS. All other CDOR-linked securities, including Canada Mortgage Bonds (CMB), should incorporate CARR's recommended Fallback Rate (CORRA) language and methodology.