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2022: A big year for benchmark interbank offered rate reform

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Over the past few years, the Canadian financial market has watched from the sidelines as other jurisdictions retired their benchmark interbank offered rates and adopted risk-free rates in their place. In particular, the Canadian market closely followed the transition from USD London Interbank Offered Rate (LIBOR) to Secured Overnight Financing Rate (SOFR). While the Canadian financial market felt some of the impacts of the transition from LIBOR to SOFR, it also awaited a greater market shift to come.

In 2022, Canada's turn finally arrived! In May, Refinitiv Benchmark Services (UK) Limited (RBSL) announced that it would cease publishing the Canadian benchmark rate, the Canadian Dollar Offered Rate (CDOR). Loan fallback language was published and the Canadian financial market has taken large steps to transition its financial instruments from CDOR to the Canadian Overnight Repo Rate Average (CORRA).

CDOR is referenced in a wide range of financial instruments and transactions worldwide, with a gross notional exposure of over $20 trillion. This includes corporate loans, bonds, derivatives, futures, mortgages and other financial products. As such, lenders, borrowers, issuers, noteholders and other participants in the global financial markets are faced with the challenge of transitioning away from the primary Canadian benchmark by June 2024. Below, we discuss a number of important considerations.

The Canadian Alternative Reference Rate working group

Leading the charge in the transition from CDOR to CORRA in the Canadian market is the Canadian Alternative Reference Rate working group (CARR). The Canadian Fixed-Income Forum, a senior level industry committee established by the Bank of Canada, formed CARR in March 2018 to guide benchmark reform efforts in Canada and to ensure that Canada's interest rate benchmark regime is robust, relevant and effective. Its membership includes senior representatives from a variety of stakeholders in the Canadian financial system.

One of CARR's primary objectives was to analyze the status of CDOR and its efficacy as a benchmark. CARR was also tasked with making recommendations for the future of CDOR based on that analysis. CARR formed a number of subgroups to focus on specific CDOR-related issues, including the Accounting, Tax and Regulatory subgroup, Term CORRA subgroup, Cash Securities subgroup and Derivatives subgroup, among others.

Cessation announcements

On December 16, 2021, CARR published a white paper [PDF] that summarized its findings and conclusions about CDOR. In the white paper, CARR recommended that RBSL, the administrator of CDOR, cease the calculation and publication of CDOR after June 30, 2024. It also recommended that CORRA be adopted as the replacement benchmark rate.

RBSL launched a public consultation [PDF] in January 2022 that sought feedback regarding the impact on affected stakeholders of a potential cessation of CDOR. Following the consultation, RBSL announced [PDF] on May 16, 2022 that it would cease the calculation and publication of all tenors of CDOR immediately following a final publication on Friday, June 28, 2024.

The Ontario Securities Commission (OSC) and the Autorité des marchés financiers (AMF) have each authorized RBSL to cease providing CDOR. The International Swaps and Derivatives Association, Inc. (ISDA) also published a statement in response to the RBSL announcement. ISDA confirmed that the RBSL announcement constitutes an “Index Cessation Event” under its definitions and fallback protocols.

Adopting CORRA

Prior to its white paper, CARR had already started laying the groundwork for the use of CORRA as the new benchmark rate. In November 2021, CARR published two papers, Recommended CORRA floating rate note conventions [PDF] and Recommended terms for CORRA-based loans [PDF]. These documents were part of a broader effort to develop and promote market standards for products referencing risk-free rates in the Canadian marketplace. Prior to the November publications, in July 2021, CARR also published Recommended fallback language for FRNs referencing CDOR [PDF]. These recommendations closely tracked the CDOR fallback language proposed by ISDA.

On August 3, 2022, in a white paper, CARR published its highly anticipated recommended fallback language (CARR Fallback Language) [PDF] for loan agreements that use CDOR as the interest rate benchmark, together with an overview of the language.

The CARR Fallback Language provides for an automatic transition from CDOR to CORRA on the date that Refinitiv ceases to publish CDOR in June 2024. The language also includes a number of other important features.

For example, the CARR Fallback Language provides for the ability of administrative agents under loan agreements to make any technical, administrative or operational changes that it decides are appropriate to reflect the adoption and implementation of CORRA and to permit the administration of CORRA.

Additionally, CARR has proposed a waterfall to determine the successor rate to be used to replace CDOR. The first rate in the waterfall is Term CORRA, with an added credit spread adjustment. Term CORRA is not yet available in the market, but it is subject to a consultation [PDF] that closed in June 2022. The results of the consultation are expected to be released shortly. The second rate in the waterfall is Daily Compounded CORRA, which is already published, with an added hardcoded credit spread adjustment (CSA).

CSAs are included in the replacement rate waterfall to account for the economic difference between CDOR and CORRA. Bloomberg Index Services Limited published the CSAs that are included in the replacement rate waterfall for use in ISDA Agreements. They crystallized as of RBSL’s announcement on May 16, 2022 of its intention to cease publication of CDOR in June 2024.

The Loan Fallback Language was based on language published by the Alternative Reference Rates Committee (ARRC) and the Loan Syndications & Trading Association (LSTA) that are related to LIBOR and SOFR. Market participants were already familiar with this language.

However, there are a number of differences between the Loan Fallback Language and the ARRC and LSTA language, including regarding early opt-in, “climbing the waterfall” and bankers’ acceptances.

The ARRC language included the ability for parties to opt to transition to SOFR ahead of LIBOR cessation. CARR decided not to include this mechanic in the Loan Fallback Language for several reasons, including the fact that the early opt-in was not widely used in Canada for the LIBOR to SOFR transition and it caused a lot of confusion in the Canadian market. In addition, the early opt-in mechanics were not completely effective on their own.

One feature of the Loan Fallback Language that was not included in the ARRC language is a “climb the waterfall” mechanism. The mechanism is relevant where Daily Compounded CORRA has been implemented as the fallback to CDOR because Term CORRA is not available at the time of CDOR cessation. The “climb the waterfall” mechanism would, following the availability of Term CORRA, give an administrative agent under a loan the ability to provide notice to the borrower and lenders to replace Daily Compounded CORRA with Term CORRA.

Many Canadian credit facilities contain a bankers’ acceptance (BA) funding mechanic. However, as CARR notes in its white paper, there is a strong indication that many Canadian banks will move away from this BA lending model upon CDOR’s discontinuation.

To address this, the Loan Fallback Language provides administrative agents with the option, upon notice to the lenders and borrower, to cease BA funding when CDOR ceases. If the “required lenders” under the credit agreement do not object within five business days, there are several important outcomes. First, the BA mechanic would be replaced by “CORRA Loans.” Second, any requests to rollover or convert a loan to a BA would be ineffective. Finally, any requests for a new BA would be deemed to be a request for a “CORRA Loan.” Determining whether the required lender threshold has been satisfied will depend on the applicable credit agreement. However, the threshold is usually achieved by the support of lenders representing a majority or more than two-thirds of the total commitments under the facility.

BAs that are already outstanding would continue to maturity under the Loan Fallback Language, since the rate is set at the issuance of the BA. While this addresses the cessation of CDOR and cessation of BAs, there is one further step that parties will need to take, which involves incorporating a CORRA Loan mechanism into the credit agreement. The Loan Fallback Language does not provide such a mechanic and it will be up to the parties to the agreement to include such language.

Looking forward

While there has been significant progress in Canada over the past year regarding the CDOR transition, important matters still need to be addressed before CDOR ceases to be published in June 2024. Market participants must become familiar with and understand CORRA. They will also need to amend their contracts to include adequate fallback language and will eventually need to incorporate CORRA loan mechanics into their agreements. Lenders will have to update their systems to operationalize the use of CORRA-based interest rates, and Canadian banks will need to decide whether to move away from the BA lending model.

Additionally, feedback from the Term CORRA consultation reflected strong demand in Canada for a forward-looking Term CORRA benchmark. As a result, we expect that Term CORRA will need to be developed, calculated and published, and an administrator for Term CORRA will need to be selected.