TIME TO GET TOUGH! CARR PROVIDES GUIDANCE FOR CDOR TOUGH LEGACY CONTRACTS

Posted on June 18, 2024

Categories: Insights, Publications

On June 10, 2023, the Canadian Alternative Reference Rate working group ("**CARR**") released Canadian Dollar Offered Rate ("**CDOR**") transition guidance (the "**Guidance**") with respect to contracts that are loans, derivatives and securities that do not have workable CDOR fallback language, which are referred to in the market as "tough legacy contracts".[1] The Guidance was released in advance of the CDOR cessation date of June 28, 2024.[2]

In this bulletin we discuss why the Guidance is necessary, who it is intended for and what CARR is recommending for tough legacy contracts.

1. Why was the Guidance Issued?

Unlike in the US, where tough legacy contracts were addressed through the use of legislation, and in the UK, where synthetic London Interbank Offered Rate ("**LIBOR**") was available for a period of time, there is no external method available for dealing with tough legacy contracts in Canada.

CARR surveyed the Canadian market and determined that there are few instruments in Canada that reference CDOR and cannot be resolved by the agreement of the parties, without requiring unreasonable effort to identify the parties involved in the applicable instrument. Nevertheless, there are some instruments in Canada that fall into this category. While the Guidance references loans and derivatives, CARR primarily published the Guidance as a means of protecting the issuers of widely held cash securities, because it has been very difficult to identify all of the holders of some of the securities which require 100% of holders to consent to amend the interest rate.

Although CARR does not have formal authority to mandate how CDOR fallbacks are administered, the Guidance establishes CARR's view of best market practices with respect to tough legacy contracts. The intention is that if a cash security holder were to raise concerns with the interest rate used to replace CDOR, the issuer could rely on the Guidance and argue that the Guidance provided the commercially reasonable way to proceed.

2. For Whom is the Guidance Intended?

The Guidance is intended for: (a) cash security issuers who can use the Guidance as a shield when determining fallbacks for tough legacy cash securities and (b) persons who are working with unsophisticated borrowers or derivatives counterparties or persons not familiar with the Canadian market who are being unreasonable when presented with proposed amendments. The first group can use the Guidance for tough legacy cash securities and the second group can rely on the Guidance to support their position about what is best market practice in Canada.

3. What does the Guidance Recommend?

(a) Loans

Loans must be amended to reference an alternative rate, such as Daily Compounded CORRA or Term CORRA, with market accepted credit spread adjustments. This is consistent with previous CARR recommendations.

(b) Derivatives

Derivatives should transition to Fallback Rate (CORRA), which is the International Swaps and Derivatives Association, Inc.'s robust fallback rate for CDOR, unless otherwise agreed by the counterparties. CARR also recommends that the Calculation Agent use Fallback Rate (CORRA) for replacing CDOR.

(c) Cash Securities

Cash securities without a robust fallback, except National Housing Act Mortgaged Backed Securities ("**NHA MBS**"), should transition to Fallback Rate (CORRA) with related amendments to interest determination and observation dates, unless otherwise agreed by the parties. CARR also encourages issuers to publicly disclose the specific CDOR fallback methodology, spread and adjustments they used through a public web service, such as CDS Enhanced Bulletin.

Some capital securities that convert from a fixed to a floating rate at a specified reset date in the future may contain contingent CDOR exposure after June 28, 2024. In this case, CARR reiterates its previous guidance.

With respect to NHA MBS, CARR recommends that issuers calculate and pay the coupon on the CDOR NHA MBS by applying one-month Daily Compounded CORRA with a 0.29547% spread adjustment. This aligns with the way the coupon is calculated and paid after July 1, 2024 for a NHA MBS that contains CARR's recommended CDOR fallback language.

4. Conclusion

We continue to monitor the cessation of CDOR and will publish a final reminder about the end of CDOR next week. If you have any questions about the cessation of CDOR, please reach out to the authors.

[1] Bank of Canada, "CARR provides guidance for CDOR-based loans, derivatives and securities that do not have a robust fallback in place for CDOR's cessation post June 28, 2024" (June 10, 2024).
[2] For a discussion of the upcoming cessation date and related trends, please see our previous bulletin.

by Shahen Mirakian, Maria Sagan, and Lyndie Charlton

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.