Practical Guidance for Treasurers

2021: A Benchmark Odyssey

January 2018

Andrew Bailey announced the FCA's intention to withdraw its support for LIBOR last July. In November it was confirmed that the banks participating in LIBOR have agreed to continue until the end of 2021. Whether ICE Benchmark Administration, the current administrators, will be able to produce LIBOR in its current form beyond that date is at best uncertain.

In the six months since Mr Bailey's speech, the challenges of transitioning the range of products that currently reference LIBOR to an alternative rate have become better understood. It is likely that transition from LIBOR will involve amendments to documentation terms as well as updates to IT systems and administrative processes on a market-wide scale. To achieve an orderly transition, in particular for multi-lateral products such as syndicated loans and bonds, regulators and market participants in each relevant sector will need to agree on alternative rates and reach consensus on an implementation process as soon as possible.

This guidance note outlines the current status of this "benchmark odyssey" and some of the difficult questions that remain. It also suggests some practical steps that treasurers might take to prepare themselves and with a view to contributing to the discussion[1].

The first step - overnight RFRs

The Financial Stability Board ("**FSB**") recommended in 2014 that stakeholders should identify risk-free rates ("**RFRs**") that might be used as alternatives to LIBOR. Working Groups were set up in each of the relevant currencies, almost all of whom have now identified overnight RFRs that might be used as a substitute for LIBOR for derivatives and other products that currently reference an overnight LIBOR rate.

The Bank of England's Working Group on Sterling-Risk Free Reference Rates (the

[1] For further background, see "LIBOR: Goodbye to all that", The Treasurer November/December 2017

"**SONIA Working Group**") has chosen a reformed SONIA rate as its preferred RFR for sterling derivatives, which will be available from 23 April 2018. The Federal Reserve's Alternative Reference Rates Committee ("**ARRC**") has recommended a broad Treasuries repo financing rate, the Secured Overnight Financing Rate ("**SOFR**") for certain US dollar derivatives and other financial contracts. Publication of SOFR is expected to commence during the second quarter of this year. The Swiss and Japanese authorities have identified pre-existing overnight rates as their preferred RFRs.

An overnight RFR for euro remains work in progress. The European authorities announced the launch of a working group in September 2017. In November, a consultation was published on the high-level features of a proposed new unsecured overnight rate, with a view to implementing it in 2020. It is anticipated that, as with other RFRs, the rate will be published daily and will reflect the overnight funding costs of euro area banks.

The development of overnight RFRs is an important step forward for the derivatives market and for other products where an overnight rate is required. The next stage is to implement the overnight RFRs and determine how they might need to be adapted for particular products.

Transition arrangements - derivatives

ISDA, which has been involved as an observer in all of the RFR working groups, is currently undertaking a comprehensive analysis of how new and existing derivatives contracts might be transitioned to these new RFRs. Areas of focus include documentation issues, the potential for value transfer, threats to market liquidity, the requirement for term fixings and differences in credit spreads between existing and new rates.

ISDA is expected to report on these matters in the first quarter of 2018. It is also expected to provide a roadmap of identified solutions and a proposed timetable for implementation.

Separately, ISDA is considering updates to its definitions to cater for the use of the relevant RFRs as floating rate options and is proposing to amend the current fallback options to provide for the use of the relevant RFR as a fallback for LIBOR. Details of when the updated definitions might be available are anticipated shortly.

CURRENCY	RFR	O/N?	Secured?	Publication
GBP	SONIA	✓	✗	9am GMT from 23 April 2018
USD	SOFR	✓	✓	8.30am ET from Q2 2018
JPY	TONAR	✓	✗	Available at 10am JST
CHF	SARON	✓	✓	Available at 12pm, 4pm and approx. 6pm CET

Beyond derivatives

The RFRs are very different from LIBOR:

- **Availability of term rates:** LIBOR is a forward-looking term rate quoted across a range of maturities from overnight to 12 months. The RFRs are all backward-looking overnight rates.
- **Basis of calculation:** Each of the RFRs are calculated in a different way. For example, some are secured rates, others are unsecured.
- **Risk profile:** LIBOR was designed to reflect the cost of inter-bank lending and factors in a measure of bank credit risk. RFRs are, by definition, near "risk-free".
- **Consistency across currencies:** LIBOR is quoted on the same basis for each of the five LIBOR currencies. The RFRs are currency-specific and are published at different times to LIBOR.

The pricing, documentation and administration of many floating rate products, in particular commercial loans and floating rates notes ("**FRNs**") depend, in some cases quite heavily, on the current features of LIBOR.

For example, the use of RFRs in place of LIBOR or even as a fallback for LIBOR would require a number of changes in the way commercial loans are operated and documented:

- When a loan is drawn, the LIBOR rate at the beginning of each interest period determines the amount of interest payable at the end of that period. The availability of term rates at the beginning of each period ensures that lenders and borrowers are able to predict the payments required at the end of the period. This is important for cashflow management.

- LMA documentation, on which most lending documentation is based, is drafted to accommodate the calculation and publication conventions applicable to LIBOR. These provisions would need to be amended to accommodate any new rate.
- Loans are often available in multiple LIBOR currencies under the same documentation. These transactions will need to accommodate the solutions adopted in respect of each ex-LIBOR currency.

Importantly, the substitution of a RFR for LIBOR would also have financial implications for lenders and borrowers.

LIBOR is the mechanism through which lenders are reimbursed their funding costs. The direct replacement of LIBOR with a lower RFR potentially leaves a pricing gap which will need to be filled with some other reimbursement mechanism, or otherwise built into loan pricing.

Similar issues arise in relation to the pricing, documentation and administration of FRNs and other floating rate products.

Building on RFRs

Regulators and trade associations have started to look for solutions for loans, FRNs and other products.

In the UK, the SONIA Working Group has announced the expansion of its mandate (and the number of participating members) to include developing transition arrangements for the loan and FRN markets as well as for derivatives. It will look at all potential uses for term benchmarks, and consider potential data sources and fixing methodologies. A key priority is the development of a term SONIA rate. Written recommendations are expected in Q1 2018, with a public consultation to follow.

It has also been announced that a sub-committee of the SONIA Working Group, is being established specifically to assess alternatives to LIBOR for the loan market, including how the issues highlighted above might be addressed. A parallel sub-committee will consider the FRN market. These sub-committees are to be chaired by the LMA and ICMA respectively.

In the US there are plans to develop a term SOFR, based on SOFR futures or OIS. The ARRC has also reconstituted its membership to focus on (among other things) the impact on legacy contracts, and plans to establish working groups looking at specific issues, including FRNs and loans.

Other countries are at varying stages in the process. It is not currently clear whether a currency-by-currency solution both in terms of the relevant rates and how they are to be implemented will be required. It is possible it will be, but even if that is the case, some level of co-ordination would seem to be important to ensure that each country is working towards the same deadline.

A key question yet to be answered is whether term rates based on the relevant RFRs can be made available within the timeframe required. The development of robust term rates requires the development of a liquid market in those rates. For example, the ARRC has indicated that term SOFR fixings should be available in Q2 2021. Whether that gives users enough time to implement transitional arrangements remains to be seen.

Another hot topic for all of these committees is how to price bank credit risk into the new RFRs. Some have suggested that an “add-on” rate, equating to the bank credit risk element of LIBOR, and to be used alongside the term RFRs might be considered for the loan market. It is unclear whether it would be possible to publish this kind of rate or what its components might be.

Contingency planning - fallback rates

Many floating rate instruments will provide for the use of fallback rates if LIBOR is unavailable. The typical fallback regimes that might apply to currently outstanding loans, FRNs and derivatives are summarised in the Appendix to this note.

In general, fallback rates are designed to bridge temporary disruptions, rather than for a situation where a rate is discontinued or is materially altered. As such, there are concerns that current fallback arrangements may not operate effectively over anything other than a short period of time. In the context of a potential discontinuation of LIBOR, there is also concern about whether fallback rates would be available at all – or if available, whether they would be possible to administer on a market-wide basis.

Nonetheless at this stage changes to existing rate fallbacks are not being proposed in most cases. If a more appropriate fallback for LIBOR exists, the identification of LIBOR alternatives would not be such a challenge.

A separate question is whether the triggers for the application of fallback rates should be revisited. Most current fallback provisions apply if the chosen benchmark (eg LIBOR) is unavailable. Some lenders, most likely prompted by their regulatory obligations under the EU Benchmarks Regulation, have been thinking about whether documentation should provide specifically for fallback rates to apply at an earlier point eg if LIBOR ceases to maintain its current characteristics or is “materially altered”.

From the borrower’s point of view, such suggestions are unattractive on the assumption that lenders would only move to fallback rates while LIBOR still exists if the fallback rate is higher than LIBOR.

It might be argued that LMA-based loan documentation already caters for this contingency. The "market disruption" provisions provide for lenders who are unable to fund themselves at LIBOR to be paid their cost of funds instead, provided a sufficient proportion of the lenders are in the same position.

The only change in practice relating to fallback rates currently is in the context of FRNs where some issuers are including risk factors relating to LIBOR transition (tailored to reflect the applicable fallback provisions) in their prospectuses.

It is anticipated that the nature of current fallback regimes may change over time as successor rates are identified. As already noted, ISDA is proposing to update its definitions to include the RFRs as a fallback for LIBOR. As alternative rates are developed for loans and FRNs, it is possible parties may similarly agree to use those rates as fallbacks for LIBOR.

Contingency planning - consent requirements

Concerns about the availability of fallback rates suggest that most current documentation will require amendment to accommodate replacement rates (whether as substitutes for LIBOR or as fallback rates). The Appendix notes the typical consent process that might apply in loan, FRN and derivatives documented on current market terms. In most instances, the consent of all parties will be required, which presents difficulties for multi-lateral transactions such as syndicated loans and FRNs. In those cases, it is likely to be in the interests of the administrative parties and the borrower if provision can be made for the appropriate amendments to be achieved without the active involvement of all of the investor parties.

Syndicated loans

The LMA agreements have since 2014 included an optional provision that allows the chosen benchmark to be substituted with Majority Lender consent if the chosen rate is unavailable. This clause is being included in many agreements, although we are aware of some instances where lenders have been resistant.

Borrowers should note however, that the LMA clause will only assist if LIBOR is unavailable on screen. If amendments are desired prior to that point, the consent of all the lenders will still be required.

Adjusting this optional LMA clause to cater for the adoption of a substitute rate at an earlier point than LIBOR being discontinued - for example, in circumstances where LIBOR is still available but has ceased to be a representative rate, or is no longer the market's preferred benchmark - might also be considered. This has been discussed in some transactions, but there is no consensus either with regard to wording or whether this would be acceptable to lenders.

It is anticipated that borrowers will not wish to be cut out of the amendment process altogether. Suggestions from lenders in some recent syndicated loan transactions that the Agent should be permitted to make the required amendments have generally been resisted.

FRNs

In new FRNs and programme updates, consideration is being given to whether consent provisions should allow the adoption of a successor rate with negative consent, rather than requiring the positive consent of bondholders. As far as we are aware, this change is not being generally adopted other than for long-dated FRNs in the context of a securitisation.

Derivatives

The derivatives market is awaiting guidance from ISDA, which as already noted, is working on a comprehensive analysis looking at transitioning market contracts to the new RFRs. ISDA working groups are developing RFR definitions and new fallback provisions for the 2006 ISDA definitions.

When ISDA's updated definitions are available, market participants will be able to incorporate them by reference in new trades. Amendments to legacy trades might be implemented using a protocol arrangement.

ISDA protocols have proved an effective means of amending ISDA terms on a widespread basis on a number of occasions. Any two counterparties to an ISDA Master Agreement which adhere to the terms of an ISDA protocol, in effect agree to amend the terms of any trades between them to incorporate the relevant change.

ISDA has already suggested that it will develop a protocol to incorporate the appropriate RFR as a fallback rate in legacy trades. It remains to be seen whether a protocol developed by ISDA would be a suitable means of switching legacy contracts from LIBOR to a RFR.

What can corporate treasurers do?

The quest for an alternative to LIBOR that will work for the full range of products continues. There remain a number of fundamental questions to be answered, including whether LIBOR itself will continue to be produced.

At this stage, the action points for treasurers involve due diligence, monitoring developments and where appropriate, contributing to the consultation process.

Both the regulators and the financial sector trade associations are focussed on identifying rates and transitional arrangements that can be adopted market-wide and implemented with minimum fuss or discussion. Once conclusions have been reached, the sheer volume of affected contracts within each product class means it will not be practically possible for banks and investors to negotiate different solutions on a case-by-case basis.

Proposals for term RFRs and any rates that are developed as proxies for bank credit risk could have financial and operational implications for treasurers and it is important that their views are represented alongside those of the financial sector. Treasurers may therefore want to monitor the progress of or even participate in the various working parties.

The ACT is encouraging input from its membership on all of these matters. Treasurers should also consider reviewing the range of ways in which the business currently uses LIBOR. A “LIBOR audit” might extend to the implications of LIBOR ceasing to exist, either in its entirety or in its current form under applicable contractual terms, as well as what would need to be done under those terms to transition to a new rate. Treasurers will appreciate that “market standard” terms are often negotiated in practice, so documentation will need to be reviewed on a case by case basis.

Summary of action points:

- **Review how the business uses LIBOR and in which contexts.**
- **Consider fallback provisions in existing financing documentation and the process for making changes to the benchmark provisions.**
- **Monitor and where possible, feed into any relevant consultation processes via the ACT, your legal advisers or directly.**
- **Evaluate adjustments to existing documentation terms in new transactions on a case by case basis.**

APPENDIX - Documentation issues

The main consequences of LIBOR being unavailable under current market standard terms and what might be required to transition to a new rate are noted below. This is for illustrative purposes only. The consequences of LIBOR being discontinued and the process for amending existing documentation to accommodate a successor rate requires consideration on a case by case basis.

Fallback rates	Consent requirements
Syndicated loans	
If LIBOR is unavailable, the fallback, in most loans documented on LMA terms, is a Reference Bank Rate. If the Reference Bank Rate is not available, the borrower becomes obliged to pay the lenders' self-certified cost of funds for the relevant interest period. Some agreements may adopt the LMA's alternative rate fallback option, which provides for the use of interpolated and historic LIBOR rates before reverting to a Reference Bank Rate and ultimately, lenders' costs of funds. Applicable fallback rates are also triggered under LMA terms if the agreed proportion of lenders (normally 35-50%) notify the Agent that they are unable to fund themselves at the chosen benchmark rate.	If the borrower becomes obliged to pay the lenders' self-certified cost of funds, either the borrower or the Agent may instigate a 30 day negotiation period, with a view to agreeing an alternative basis for the payment of interest. If the Agent and borrower agree on an alternative, implementation requires the consent of each of the lenders. An optional LMA provision, which may not feature in all current loan agreements, permits any amendments to the agreement necessary to cater for a substitute benchmark if the existing rate is not available, to be made with Majority Lender consent. The clause applies only where the existing rate (eg LIBOR) is unavailable. It also relates only to substitute benchmarks. Any adjustment to the margin, should that be necessary, generally requires the consent of each of the lenders and the borrower.
Bilateral loans	
Varies. Some bilateral loans may replicate the LMA fallback rate regime. Others may provide for the use of a reference bank rate provided by the lender or provide for the payment of interest on a cost of funds basis.	Amendments will require the consent of the borrower and the relevant lender. Borrowers with bilateral loan arrangements with multiple banks may need to be mindful of any obligations to maintain consistent terms across the suite.
Intra-group loans	
Varies. May be no provision for fallback rates.	Amendments will most likely require the consent of the borrower and the relevant lender.

FRNs	
If the chosen rate is unavailable, most FRNs look to two iterations of a reference bank rate. If these are not available, a fixed rate applies, which will be the last calculated floating rate.	Amending the terms and conditions typically requires noteholder consent.
Derivatives	
Varies according to the options chosen by the parties. The 2006 ISDA definitions provide that if a chosen rate is not available, a reference bank rate will apply (eg "GBP-LIBOR Reference Banks"). If less than two Reference Banks quotations are provided, the rate will be determined by reference to quotes by major banks selected by the Calculation Agent.	An ISDA master agreement is a bilateral contract that can be amended with the agreement of both parties. To facilitate market-wide amendments, ISDA often develops a protocol. All trades between two counterparties will incorporate the amendments covered by the protocol if both have agreed to adhere to it. ISDA has suggested a protocol to incorporate a fallback to the new RFRs in legacy trades. It is currently not clear whether a protocol will be suitable to cover the substitution of LIBOR for a RFR in legacy trades.