HERBERT SMITH FREEHILLS

Corporate Treasurer e-briefing

LIBOR TRANSITION: WHERE THINGS STAND AND WHAT YOU SHOULD DO NOW

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Herbert Smith Freehills

As treasury teams receive letters from their lenders reminding them of the discontinuation of LIBOR from the end of 2021, we set out here the current state of LIBOR replacement across different debt and treasury products, the principal remaining issues that the market has not reached a common position on and what steps treasury teams should be considering at this stage.

COMMON AREAS IN WHICH LIBOR IS USED

In a loans context, to avoid reverting to the lender cost of funds fall-back (which is not transparent nor easily ascertainable and was only intended to deal with short-term unavailability of LIBOR rather than its discontinuation), it will be necessary to replace the LIBOR interest mechanics in existing finance documents. Any fixed rate arrangements, such as those under a US private placement, will not require amendment.

In addition, many other arrangements often reference LIBOR, for example commercial agreements which use LIBOR to set default interest, interest rates in intra-group loans, calculating some pension liabilities in some sectors and financial reports, whether internal or in financial statements.

The phrase “tough legacy” is currently frequently bandied about; a reference to those agreements which have no fall-back to address LIBOR replacement, and while a legislative solution is being proposed in some jurisdictions, this is intended for those contracts which simply cannot be amended and will not be an easy fix. In the UK, for example, the proposal is that it would be achieved by granting the FCA certain “appropriate” regulatory powers to enable it to direct the administrator of LIBOR to change the methodology used to compile the benchmark and produce a “synthetic” LIBOR, if doing so will protect consumers and market integrity. The detail of this has not yet been settled and (most importantly) there is no certainty on how that rate will be constructed nor if it will be suitable for any financial product. The mechanisms will also vary in other jurisdictions for other currencies. In order to retain control of the terms of the relevant documents, a proactive approach to amendment of existing contracts is required.

Action point: Ensure that the business is aware of where LIBOR is used in its agreements and systems, noting, in particular, any tough legacy issues. This in itself can be a challenge, and one that we have developed semi-automated solutions to assist clients with.

THE LOAN MARKET AND NEW RFR LOAN AGREEMENTS: KEY ISSUES

In comparison to the derivatives and debt capital markets, the loan market is still grappling with the best approach to the use of RFRs to suit the needs of borrowers and lenders, and in ensuring operational readiness. Some banks have progressed faster than others on this, and are ready to offer RFR-based loans now or shortly, whereas others are further behind, so corporates are likely to see a variety of approaches.

The loans market has taken the approach that new RFR-based loan products will be developed first and legacy LIBOR transactions will be moved on to RFRs later once the conventions have been settled. New transactions may offer RFR-based loans from signing in a few cases or, perhaps more commonly, from the occurrence of a switch date which will be expected to be at some point in 2021. The LMA has developed a new draft rate switch facility agreement which contemplates this structure, so with loans being initially based on LIBOR and then switching to the relevant RFR at a particular point in time. The key issues which remain to be finalised are:

- **Currencies:** If the loan is multicurrency, what approach will be taken to each currency? Sterling, US Dollars and Swiss Francs are the most advanced currencies in terms of developing RFRs to replace LIBOR, and Euros are generally remaining based on EURIBOR for the time being (though EONIA will be discontinued from 3 January 2022). Note that for a number of currencies the applicable fallbacks (ie the rates which apply if the RFR is not available) are still being developed.
- **Switch Trigger:** What will trigger the switch to the RFRs? Will each currency switch on the same date? Is any hedging switch trigger aligned? What happens to drawn loans if the switch occurs mid-interest period? Should a trigger event that applies only to one tenor of a screen rate cause a rate switch for that currency in its entirety?

  Action Point: Consider plans for coordinated transition to RFRs across debt and interest rate derivatives to ensure alignment where required eg aligning the switch for interest rate hedging and the facility being hedged.
- **RFR Calculations:** The sterling Working Group has recently published detailed recommendations for the calculation of RFRs for loans, and these are reflected in the LMA rate switch facility agreement.

  In the LMA rate switch facility agreement the calculation of the rate, using a compounded in arrears RFR for the relevant currency to produce a daily rate, is set out in detail and it will be incumbent on treasurers to understand its operation. The expectation is that a third party will provide a “golden source” rate, so that the extensive calculations can be verified by borrowers and, ultimately, dispensed with in favour of reliance on the “golden source” rate. There is not yet any source of this rate in the loans market (and central banks have expressed some reluctance to perform this role) although Bloomberg has begun to publish the relevant rates for ISDA.

  Action Point: For those treasury professionals, particularly those looking to refinance/raise new finance in the short term, it would be prudent to discuss with your lenders how they expect to approach RFR transition as new bank policies emerge. At this stage it may also be prudent to start considering the LMA switch rate agreement rate calculations.
- **Credit Spread Adjustment:** One important commercial question relates to the credit adjustment spread that it is expected will be added to the relevant RFR in order to more closely approximate LIBOR. There are two different possible approaches to this: the approach in the derivatives market of a 5 year average historic look back at the difference between LIBOR and the relevant RFR (which provides a slow-moving average that will become fixed on actual cessation of LIBOR), or an approach based on the forward market by means of linear interpolation. The actual number can be fixed on signing for each currency and interest period, or calculated by means of a formula which allows it to change over time and again become fixed on cessation, which may be a cumbersome solution. Different approaches may be

desirable for the fallbacks on LIBOR cessation or pre-cessation, and for early opt-in transition post-switch but before formal announcement of LIBOR cessation.

Action point: Banks may be keen to opt for a one month interest period only where the number is fixed on signing, so consider if this is workable from an interest rate planning perspective and how this would align with your interest rate hedging.

- **RFR Reference Periods:** The manner in which RFRs could be calculated varies:
  - an “observation shift” could be used, where the RFR for the interest period is calculated and weighted by reference to the days and applicable rates in a set observation period which is not completely aligned with the relevant interest period;
  - alternatively, a lag process is proposed, where RFR for the interest period is calculated and weighted according to the number of days that apply in the actual interest period and the applicable rates in that period.

  The time period on which the compounded rate is calculated is still open for debate for loans, and currently varies between markets. The derivatives market (and the Bank of England SONIA index) have adopted an observation shift approach, but the operational systems required for a lag approach are seen as simpler, so this approach is currently favoured by the sterling Working Group for loans. There is therefore potential for a mismatch between a loan and its hedging arrangements if different approaches are taken, and also for two different treasury management mechanisms to be required for the different products.

  Action point: Consider which approach is preferred and discuss with your banks to ensure that market preference is taken into account. Also consider whether treasury systems can adapt to the relevant or both bases if required.

  The length of the lookback or lag can be varied, depending on the notice required for the amount of accrued interest, but 5 banking days is the suggested starting point. This would be the maximum length of notice of the amount of interest to be paid at the end of the relevant interest period.

- **Negative RFRs:** The possibility of negative interest rates brings into sharper focus reference rate floors, and the RFR switch agreement assumes that, to the extent a zero floor is agreed, it is the RFR plus credit adjustment spread that is floored, mirroring the approach to LIBOR and EURIBOR and consistent with a switch from LIBOR to the RFRs.

- **Fallbacks:** While it seems counter-intuitive to consider fallbacks to the RFRs, which would only come into play if the RFRs themselves are discontinued, given the issues with fallbacks to LIBOR in existing documents the fallbacks to the RFRs are likely to come under scrutiny in this period of market development where screen rates are being developed. The primary fallbacks post-switch are to central bank rates for each currency, and a spread adjustment may also be applied. One open question is whether an ultimate fallback to cost of funds is appropriate, though a pragmatic approach could be taken given the interim fallbacks to central bank rates.

- **Break Costs and Market Disruption:** Certain features of LIBOR-based loans appear less relevant to RFR-based loans, though market practice continues to evolve. For example, for a backward looking rate there is much less justification for the imposition of break costs as currently constructed and it is debatable whether market disruption provisions as currently drafted remain appropriate (and in particular whether tying them to lenders’ costs of funds is the right approach).

- **Majority Lender Consent:** It is important to ensure that future amendments to finance documents can be made to deal with changes in practice in terms of determining the new RFR, with no more than Majority Lender consent.

  Action Point: In any consent or waiver process ensure that LIBOR related amendments under existing Finance Documents can be made with Majority Lender consent and, if not, consider whether to effect that change now.

THE LOAN MARKET: TRANSITIONING TO RFRS

The loans market has developed more slowly than for example, the derivatives market. This has been for a variety of reasons including the preference for advance notice of interest amounts for cash management purposes, the likelihood of potential mid-interest period events such as prepayments as well as the secondary trading of debt. These characteristics also mean that the complexity of lender and treasury management systems is such that it has taken some time to develop adequate replacements for current practices that will be able to cope with the calculation of rates from the various different (backward-looking, overnight) RFRs.

Many of these issues also arise in relation to bonds, but the DCM markets have reacted more quickly to the use of RFRs, as we discuss below, and there are already functioning derivatives and DCM markets for RFR-linked products.

In order to transition legacy loans to RFRs a specific amendment process is required (given the inadequacy of the fallback waterfalls that loans currently include). This has been contemplated by the LMA replacement of screen rate language that has been included in most loans for some time.

RFR transition process: The LMA has produced a draft legacy transaction rate switch agreement to facilitate the transition where a large syndicate is involved, which the requisite percentage of lenders (usually the majority lenders) and company must sign. It is based on the same idea as the secondary trading documents: the intention is to streamline the amendment process by using the same form of agreement across transactions though a separate amendment agreement will also be required, so, unless there is a very large syndicate there may be little point in using this two-step process.

Two stage process: The LMA legacy transaction rate switch agreement sets out the replacement reference rate (RFR) and the commercial terms to be changed as a consequence of that replacement and authorises the Agent and Borrower to agree the drafting of the actual amendments to the underlying legacy facility agreement, which would be documented in a separate amendment agreement in the usual way. The discretion given to the Agent in the current exposure draft is limited, and the amendments must incorporate terms which are substantially similar to, and consistent with, those set out in the relevant LMA recommended form of RFR facility agreement (so can only be used once the RFR facility agreement terms are settled) otherwise the consent of the requisite percentage of lenders to the actual amendments would be required in the usual way (and it is quite likely that the Agent will require lender consent to the final amendments in any case).

Single stage process: In many cases this dual step process may well be avoidable, and a single amendment process used. The LMA does not propose to produce an actual amendment agreement: the complexity of the drafting means that amending and restating the facility agreement (into which the new RFR provisions will be incorporated) is likely to be the preferred route for ease of use going forward. For this purpose the RFR provisions in the new LMA rate switch facility agreement would also likely be used.

Costs: Of course the prospect of an amendment process raises the spectre of costs, and who should bear those. And the lenders' approach to the accoutrements of amendments, such as legal opinions and confirmations of security and guarantees will also likely feature in these amendment processes.

Action Point: For now, it is possible to include the recently-updated LMA replacement screen rate rider in loan documents and consider when in 2021 you would likely have the most time to commit to the documentation amendment process. Avoiding the time and costs involved in creating a bespoke solution is likely to be the best option for many.

Action Point: Raise awareness with key stakeholders in the business of the transition and its potential impact.

THE DERIVATIVES MARKETS

Some markets, such as the UK structured finance market, are issuing virtually all new transactions based on RFRs. In the derivatives market, ISDA has been very active in spearheading the transition process, with conventions for use of RFRs in derivatives products established and RFR rates for use in derivatives products published on Bloomberg. ISDA has also developed RFR documentation, including for new transactions, a supplement to the 2006 ISDA Definitions (which is the market standard definitional booklet for interest rate derivatives). It deletes the historical IBOR definitions and inserts relevant RFR fallbacks, which come into effect on the occurrence of the Index Cessation Event (so that the transaction continues to reference the relevant IBOR until the Index Cessation Event occurs and the fallbacks to the adjusted RFR are invoked). For legacy products, ISDA has also developed a Protocol to facilitate mass market wide amendment of existing transactions. The Protocol operates on a similar basis to the Supplement, as it amends existing transactions to introduce hardwired fallbacks from the LIBOR rates to the relevant RFR, which are triggered on the relevant Index Cessation Event. We will publish a separate briefing on the detail of the approach that ISDA is taking.

Action Point: Treasury Teams should familiarise themselves with the new ISDA Documents, and the consequences of incorporating them into existing and new transactions, including for interest rate derivatives hedging loans.

THE DEBT CAPITAL MARKETS

In the debt capital markets, the transition from IBORs to alternative RFRs has continued to progress in 2020. Whilst momentum may have slowed somewhat due to market participants' resources being diverted due to the Covid-19 pandemic, official guidance from regulators has confirmed that the goal post of transition to RFRs by the end of 2021 has not shifted.

There are three aspects to consider in relation to LIBOR transition in the debt capital markets. The first is the transition to new RFRs, the second is the inclusion of fallback provisions in bond documentation, and the third is the means by which the market deals with 'tough legacy' bonds.

RFR Transition: Significant progress has been made in the transition to RFRs, particularly for new issues. All new sterling bond issues in the form of floating rate notes (FRNs) and most securitisations have for some time been referencing SONIA rather than LIBOR. SONIA issuance in the first half of 2020 amounted to over £21 billion despite the impact on the market of the Covid-19 pandemic. Issuance volumes of Secured Overnight Financing Rate or SOFR linked notes, the heir to USD LIBOR, have also increased in the last year, although in the US market, some issuances of USD LIBOR still remain.

One area that is still being bedded down is the market convention for interest calculation for SONIA FRNs. The convention has typically involved referencing SONIA compounded in arrears over an interest period, with a margin added, and a "lag" in respect of each interest period. However, in February 2020, EBRD issued a SONIA FRN which used a five day observation period "shift" approach (similar to the "lag" approach but the compounding formula weighted the SONIA rate to account for calendar days when the SONIA rate is not published according to the observation period (rather than the interest period)). It remains to be seen if the market moves towards the "shift approach" in calculating interest, particularly as this approach is compatible with the daily SONIA compounded index published by the BoE from August this year.

Some market participants are embedding the optionality of issuing SONIA FRNs via both the "shift" and "lag" approach in their base documentation given that the market is not yet settled in this area. However, the "lag" and "shift" approach could continue to exist side by side as there is no substantive difference in coupon amount for each approach. if both of these approaches are to co-exist, it will be important for investors to be able easily to identify which approach is used for each individual bond. Unlike in some other markets, it is not currently expected that a forward looking term rate will be used in the bond market.

Action Point: Treasury teams should consider whether, on annual updates, they should update their programme documentation to allow for the flexibility to issue RFR linked notes in the formats discussed. For

those that do not plan to issue such notes in the coming year, it may be more appropriate to wait for next year's update when the interest calculation conventions are likely to be bedded down.

Fallback provisions: As most market participants are now aware, the permanent cessation of LIBOR was not contemplated in sterling bond documentation prior to the FCA announcement in July 2017. Bond terms and conditions typically contained fallback provisions which would fall back to the last available LIBOR rate as a temporary fix, and on the permanent cessation of LIBOR, this would result in the bond being a fixed rate instrument (which would not have been the original intention of the parties).

Since the FCA announcement, fallback provisions in bond programme terms and conditions have been amended, during the course of annual programme updates, to take account of the permanent cessation of LIBOR by providing for the issuer or an independent adviser to select a successor or alternative rate, and an appropriate adjustment spread, which would apply at the permanent cessation of LIBOR, or in the event of a pre-cessation trigger. A pre-cessation trigger would take place before permanent cessation of LIBOR if the FCA, as regulator of LIBOR, declares that LIBOR is no longer representative of its underlying market. These fallbacks typically provide that a relevant nominating body (for example, the Risk Free Rate Working Group (RFRWG)) should nominate a successor rate and an appropriate adjustment spread.

Action Point: Fallback provisions are now typically included in bond programme terms and conditions. Treasury teams should take advice on annual updates as to whether the fallback language included in the programme remains up to date.

Tough legacy bonds: While considerable progress has already been made in relation to transition to RFRs in new issues of FRNs, there are many existing bonds that still reference LIBOR that are due to mature beyond 2021 that do not contain robust fallbacks (legacy bonds).

For legacy bonds, a transition away from LIBOR can be achieved by way of consent solicitation: a market-based process which enables an issuer to amend bond conditions by way of bondholder consent. However, progress has been slow in this area due to the fact that consent solicitations can be time consuming, costly and, in the case of bonds with high consent thresholds, unsuccessful. This was recognised by the Sterling RFR Working Group's taskforce who issued a paper on "tough legacy" issues in the transition from LIBOR in May 2020. The taskforce proposed that the UK Government considers legislation to address tough legacy exposures. In response, the UK Government announced that it intends to amend and strengthen the Benchmarks Regulation, rather than directly impose legal changes on LIBOR-referencing contracts that are governed by English law. In its written statement, the Government stated that "the legislation will ensure that, by the end of 2021, the FCA has the appropriate regulatory powers to manage and direct any wind-down period prior to eventual LIBOR cessation in a way that protects consumers and/or ensures market integrity".

Whilst the legislative solution has been welcomed by the market, the authorities still consider that the best and smoothest transition from LIBOR will be one in which contracts that reference LIBOR are replaced or amended before the fallback provisions are triggered. This was recognised by the RFRWG's paper on active transition of GBP LIBOR referencing bonds. There have been some issuers who have started the liability management process and it is hoped that others will follow suit.

In the US, the position is slightly different as the consent threshold in New York law governed bonds is typically 100 per cent and therefore consent solicitation exercises may not be as effective. Therefore, unlike in the UK, the US authorities are not actively encouraging market participants to transition as many bond contracts as possible by way of consent solicitation. A likely outcome of this is that upon the permanent cessation of LIBOR, there would be a significant volume of New York law-governed bonds that fall back to a fixed rate. Therefore, in March 2020, the Alternative Reference Rates Committee (ARRC) in the US released details of a proposed legislative solution for New York law-governed transactions, which would require the use of the ARRC recommended benchmark replacement instead of falling back to a fixed rate on the permanent cessation of LIBOR, and in contracts where there are no fallbacks.

Action point: Treasury teams should consider potential liability management options for any legacy bonds in issue that will mature beyond 2021.

CONTACTS

Kristen Roberts, [Partner]
T +44 20 7466 2807
kristen.roberts@hsf.com

Nick May, [Partner]
T +44 20 7466 2617
nick.may@hsf.com

Amy Geddes, [Partner, Head of Debt Capital Markets]
T +44 20 7466 2541
amy.geddes@hsf.com

Emily Barry, [Professional Support Lawyer]
T +44 20 7466 2546
emily.barry@hsf.com

Minolee Shah, [Senior Associate / Professional Support Lawyer]
T +44 20 7466 2074
minolee.shah@hsf.com

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