SLAUGHTER AND MAY

Transforming Interest Rate Benchmarks

June 2020

While you've been dealing with COVID-19, transition from LIBOR continues

With the effects of COVID-19 front and centre over the last few months, some treasurers may have had to park LIBOR transition as a matter for another day. However the official sector, the trade associations and working parties remain undeterred by a global pandemic.

The FCA, Bank of England and Working Group on Sterling Risk-Free Reference Rates (the **Sterling Working Group**) are of the view that COVID-19 must not slow down transition efforts and the deadline for completion remains. Market participants must continue to work on the basis that LIBOR will not be published after the end of 2021. In light of this, the various working groups have continued to meet and make progress on the outstanding issues over the last few months.

In this briefing, we summarise what has been happening in the world of risk-free rates (**RFRs**) while treasury functions may have been dealing with more immediate challenges.

Adoption of RFRs is becoming more widespread

Progress on transition from LIBOR is gathering pace. The transition from LIBOR to RFRs is well underway in the derivatives market and the LIBOR-linked securities market has ceased almost entirely in favour of compounded RFRs.

Progress in the loan market has been and remains more gradual, although RFR-linked deals are being done. The Loan Market Association (**LMA**) has started to maintain a list of loans referencing RFRs and their key terms, based on publicly available information, with the aim of raising awareness of such transactions and the conventions being used. Currently, the list is relatively short, but the publication of details of completed transactions, including in one instance, the form of facility agreement, is very helpful.

COVID-19 delays interim milestones in the sterling market

The UK regulators have, while retaining the hard end-2021 deadline, revised their initial target of no new sterling LIBOR-referencing cash products after Q3 2020. According to their most recent statement, lenders should be in a position to offer non-LIBOR linked products to customers by the end of Q3 2020. All new and refinanced LIBOR-referencing loan products issued after that date should include clear contractual arrangements to facilitate conversion to SONIA (the sterling RFR) or other alternatives ahead of 2021, through pre-agreed conversion terms or an agreed renegotiation process. All new issuance of sterling LIBOR-referencing loan products must, however, cease by the end of Q1 2021.

ARRC sets new interim milestones for the USD market

In May, the US Alternative Reference Rates Committee (**ARRC**) published a set of recommended best practices to support the transition from USD LIBOR. These set targets for the cessation of new USD LIBOR business by product. For floating rate notes (**FRNs**), the target date is 31 December 2020. For business loans, the target date is 30 June 2021. ARRC recommended fallback language must be adopted in all new FRNs and loans as soon as possible and in no event later than 30 June 2020 and 30 September 2020 respectively.

Progress on conventions for referencing RFRs in cash products

One of the biggest roadblocks to transition in the loan market has been a lack of consensus on the conventions for referencing RFRs. The last few months have seen a number of positive developments on this front.

The decision of the Bank of England and the ARRC to publish Compounded SONIA and SOFR indices, aimed at simplifying the calculation of the relevant compounded RFR, is a notable step forward. The Bank of England's February 2020 discussion paper drew broad support for the publication of a SONIA compounded index, and publication is now due to commence in early August. The corresponding SOFR index has been published since March 2020.

Statements from both the Sterling Working Group and the ARRC have provided clarity on the use of these indices in FRNs. Discussions around how such indices might be applied in practice in the loans context are advancing. The London-based working groups are currently engaged in a final push to finalise conventions for referencing compounded SONIA. It is hoped that this work will reach a conclusion before the summer break, to provide vendors with time to build/update systems to accommodate the agreed outcomes, and enable documentation to be further refined.

Consensus on credit spread adjustments in fallbacks for cash products

The move from LIBOR to RFRs is intended to be economically neutral. Fallbacks in LIBOR deals will therefore need to apply a credit spread adjustment to the relevant fallback compounded RFR as an approximation of the credit risk element of LIBOR. A credit spread adjustment may also be relevant for new RFR-linked loans – the facilities completed so far have in most cases added a separate spread adjustment to the compounded RFR.

Consultations in the UK and US have found broad consensus for a credit spread adjustment for fallbacks in cash products based on the historic median between LIBOR and the relevant RFR over a five-year look back period, in line with the approach adopted by ISDA. (See the summary of responses to the Sterling Working Group's consultation on credit adjustment spread methodologies for fallbacks in cash products referencing GBP LIBOR (March 2020), and the ARRC's recommendation of a spread adjustment methodology for cash products referencing USD LIBOR (April 2020).)

The details of these spread adjustments, and how they will apply in the context of cash products, are now in the course of being finalised.

Bloomberg, the vendor selected by ISDA to calculate and publish the agreed-on credit spread adjustment for the derivatives market and the "all-in" fallback rate (being the sum of the compounded RFR and credit spread adjustment), started publishing test data for sterling and USD in May. (For further information, see ISDA's Benchmark Reform and Transition from LIBOR webpage.) How the cash markets will address calculation and publication of credit spread adjustment data is yet to be resolved.

ISDA fallback provisions to be released in July

Having settled the credit spread adjustment for fallbacks in derivatives, ISDA's focus shifted to fallback triggers. The results of ISDA's latest consultation revealed support for both pre-cessation triggers (an announcement that LIBOR is no longer representative of the underlying market) and cessation triggers (the cessation of LIBOR).

ISDA is finalising its supplement to the 2006 ISDA Definitions to incorporate fallbacks for new trades and a protocol to enable market participants to incorporate the updates to the definitions in legacy trades. These will incorporate pre-cessation and cessation triggers. ISDA expects to publish the supplement and protocol in July, with both coming into effect before the end of the year.

LMA RFR-linked facilities agreements remain in testing phase

The LMA's Exposure Drafts of Compounded RFR Facilities Agreements, single currency facilities agreements referencing compounded SONIA and SOFR respectively and published in September 2019, continue to be used as a reference point for RFR-linked facilities.

As consensus is achieved on how to reference RFRs in loans, it is expected that these drafts will be published as LMA recommended forms. The LMA released a summary of the outstanding information it needs to finalise the drafts in February. These include an agreed formula for calculating the compounded RFR, which in turn requires consensus on the calculation methodology and a screen rate or index for all relevant currencies, both matters on which progress has since been made, as outlined above.

The LMA is also working on a template multicurrency facilities agreement referencing RFRs (for sterling, USD, euros and Swiss francs).

Hardwired fallbacks and "rate switch" agreements

As already noted, UK regulators have stated that all new and refinanced LIBOR-referencing loans issued after Q3 2020 should include pre-agreed conversion terms or an agreed renegotiation process to facilitate transition ahead of end-2021. This, together with a desire amongst lenders to reduce the volume of contracts requiring amendment ahead of end-2021, has led to increased interest in "hardwired" fallbacks in the loan market, particularly as a fix for deals where not all parties may be operationally ready to accommodate RFRs just yet.

There has been a particular focus on the "rate switch" mechanic adopted by Shell and British American Tobacco in their recently signed syndicated facilities. These facilities reference LIBOR at the outset, but switch to the relevant RFR on a specified future date or on the occurrence of specified triggers. The LMA is working on a template "rate switch" agreement, which it is hoped will be available shortly. The LMA has also made available a spotlight interview on British American Tobacco's LIBOR to SONIA/SOFR RCF, which provides further information on the rate switch mechanic.

The ARRC published hardwired fallback language for loans, FRNs and other products some time ago. It is currently in the process of updating its hardwired fallback language for business loans. The revised language is expected to be published later this month. It is anticipated that the LMA's approach will be adopted in English law deals in USD. The ARRC's drafting is aimed at the US, largely New York law, market.

Solutions for "tough legacy" contracts

Certain LIBOR-referencing contracts will be almost impossible to transition from LIBOR. These so-called "tough legacy" contracts include FRNs and widely syndicated loans with high or unanimous consent thresholds.

The Sterling Working Group's "Tough Legacy Taskforce" published a report in May which considers tough legacy contracts across asset classes. It proposes that, to the extent feasible, the UK Government consider legislation to address such contracts. The ARRC has reached a similar conclusion and has already proposed draft legislation for New York State.

Recognising that there is no guarantee that legislation will materialise, will materialise across all relevant jurisdictions or be available for all products and circumstances, the report proposes that alternative solutions be pursued in parallel, including the development of a "synthetic methodology" to facilitate the stable continuance of LIBOR for a wind-down period following the expected panel bank departure after the end of 2021.

Following the Taskforce's report, the UK Government has taken action towards legislating to support tough legacy contracts, although perhaps not in the manner some were expecting. HM Treasury has announced that it intends to amend the UK Benchmarks Regulation (the post-Brexit version of the EU Benchmarks Regulation), in a manner that will enable the FCA to direct an alteration to the methodology of a critical benchmark such as LIBOR and enable its continuing use in certain legacy contracts for a wind-down period, to protect consumers and market integrity. The FCA's supporting statement and Q&As provide some further details.

The Government's intention to facilitate a "synthetic LIBOR" rate is a welcome development, but quite how the FCA might alter LIBOR's methodology, in what circumstances, for the purposes of which contracts and how action by the FCA might affect cross-border contracts remains to be seen. Both the report from the Taskforce and HM Treasury's announcement emphasise the importance of continued focus by market participants on actively transitioning legacy contracts, this being the only way for parties to be certain that contracts will be effectively transitioned by the cut-off date and about the economic effects of transition.

Ongoing development of term rates derived from RFRs

COVID-19 has delayed the development of a forward-looking term rate derived from SONIA. The May 2020 newsletter from the Sterling Working Group notes that two administrators expect to release a beta form term rate within weeks and a further two expect to follow by the end of Q3 2020. During this beta period, the term rate will be indicative only and will not be available for use in contracts. The Sterling Working Group intends to discuss the removal of the beta period at the end of the year.

In the US, the ARRC intends, by 30 September 2020, to establish an RFP process and criteria for recommendations in order to select an administrator of a forward-looking term SOFR rate to be published in the first half of 2021 if liquidity in the SOFR derivatives markets has developed sufficiently. The ARRC will also establish recommended scopes of use for such a term rate.

Scopes of use for a term SONIA rate have already been published by the Sterling Working Group, the message being that use cases for such a rate will be very limited and that SONIA compounded in arrear is appropriate and likely operationally achievable for most of the sterling LIBOR loan market.

Delays to final recommendations on EURIBOR fallback measures

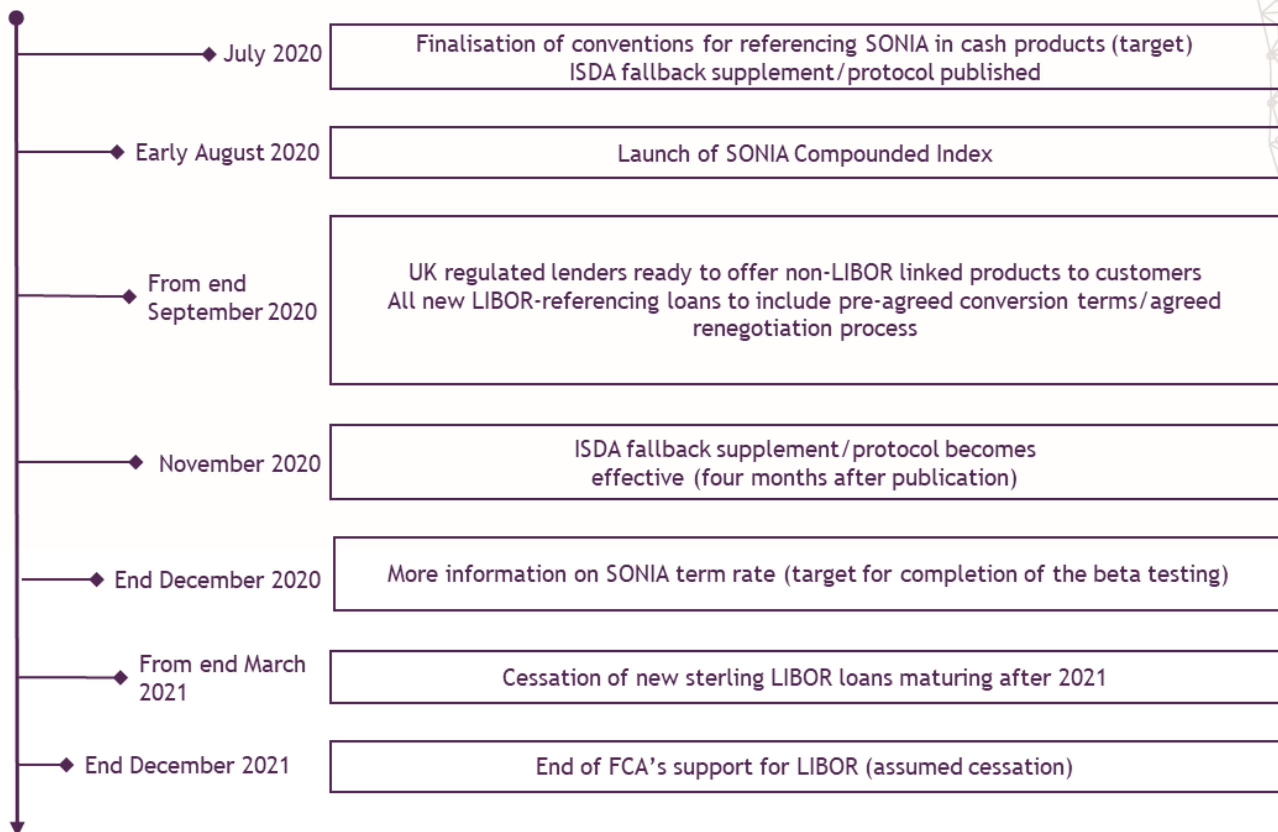
There are currently no plans to replace or discontinue EURIBOR. The focus of the Working Group on euro risk-free rates (the **Euro Working Group**) has been on identifying €STR-based fallbacks for EURIBOR to cater for a future scenario in which EURIBOR may permanently cease to exist. Both backward- and forward-looking rates are being considered.

The Euro Working Group published high-level recommendations for fallback provisions in contracts referencing EURIBOR in November 2019. These recommendations are to be developed further by early 2021 (delayed due to COVID-19). The final recommendations will be drawn up following two public consultations, both still awaited. The first will cover the preferred EURIBOR fallback rate for each financial product and the preferred spread adjustment. The second will cover a set of trigger events for the application of the respective fallback rates. (For further information, see the Euro Working Group's €STR-based fallbacks for EURIBOR webpage.)

Next steps

The LIBOR transition project is inching towards conclusions in a number of areas. There remain a number of running hares, but the interim targets set by regulators and working groups suggest that the latter half of this year will be a busy period as the market starts to get to grips with the final pieces of the jigsaw.

Key dates for UK issuers



Slaughter and May are monitoring closely developments in relation to transition from LIBOR, EURIBOR, EONIA and other major benchmarks across all of the major financial products. For further information, please contact any of the lawyers listed below or your usual adviser at Slaughter and May.

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