SLAUGHTER AND MAY/

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# Transforming Interest Rate Benchmarks

## Recent IBOR Developments in the Loan Market

With the mammoth task of transitioning away from LIBOR coming to an end, the focus has turned to interest rate benchmark reform in non-LIBOR currency jurisdictions. Recent developments in two such jurisdictions - Canada and Europe - have prompted the Loan Market Association (**LMA**) to add additional drafting to its library of risk-free rate (**RFR**) terms comprising:

- A schedule of reference rate terms for loans referencing the Canadian Overnight Repo Rate Average (**CORRA**) (the RFR for CAN$). These terms provide the option of using either CORRA compounded in arrears or Term CORRA (which is a valid option for CAN$ loans).
- Updated €STR-based fallback provisions for loans referencing EURIBOR. Parties have the option of using €STR compounded in arrears or Term €STR as the primary fallback from EURIBOR.

The CORRA provisions are relevant to all CAN$ loans. Existing CAN$ facilities that reference CDOR and run beyond the end of June 2024 will need to be amended to reference alternative rates; new CAN$ loans should reference alternative rates from now on.

The updated fallbacks for EURIBOR-referencing loans do not require parties to existing loans to re-open documentation to incorporate them. However, the updated fallbacks will be relevant to new EURIBOR facilities (or if the terms of existing facilities are being amended on a refinancing or for other reasons).

The new LMA drafting is useful and predominantly mechanical in nature, but is (of necessity) quite intricate and requires the parties to make a choice with regard to the use of the relevant compounded in arrears and/or term RFRs.

In this briefing, we summarise the background to these developments and the key features of the LMA's new provisions.

## Developments in CAN$ lending (CDOR to CORRA)

In July 2023, the Canadian Alternative Reference Rate Working Group (**CARR**) announced a "no new CDOR or BA loan" milestone date of 1 November 2023, to facilitate a tapered transition for the CAN$ loan market ahead of CDOR's cessation after 28 June 2024. All new CAN$ loan agreements entered into since the beginning of this month and from now on, should reference either a CORRA rate or CAN$ prime.

The LMA's reference rate terms for CAN$ loans referencing CORRA compounded in arrears were published as a schedule in February 2023 (the **CORRA Schedule**). The conventions reflected in the compounding calculation are aligned with those applicable to sterling loans referencing compounded in arrears SONIA (an approach the LMA has taken to all non-sterling RFR terms in the interests of consistency). Users are reminded that they should consider the appropriateness of these conventions as applied to currencies other than sterling. While this is an issue that treasurers may wish to explore with their lenders upon a first move to CORRA rates, guided by established practice in relation to other non-sterling RFRs in English law loans, we would anticipate that adjustments are unlikely.

More recently, Term CORRA rates were launched by CanDeal Benchmark Solutions and TMX Datalinx, which the CARR confirmed in its allowable use cases for Term CORRA can be used in business loans (although the CARR has expressed a preference for market participants to use overnight CORRA where possible).

On 31 October, the LMA therefore updated its CORRA Schedule to add reference rate terms for Term CORRA loans. The choice between Term CORRA and compounded in arrears CORRA is up to the parties.

The CARR's position on the use of Term CORRA echoes the position expressed by the US authorities in relation to Term SOFR (which is being regularly used as a reference rate in US$ loans), but is in contrast with the position of the UK authorities in relation to Term SONIA, which is, in general, not available for use in the sterling loan market.

Treasurers who have considered the relative merits of Term SOFR vs. compounded in arrears SOFR will be aware of the issues to take into account. The most important commercial consideration is normally whether the interest rate is to be hedged (compounded rates being the norm in the derivatives market). Other considerations are predominantly operational from the borrower's point of view (are its systems set up for compounded in arrears RFRs and is consistency across currencies preferred – and is it important that the reference rate is available at the beginning of an interest period?).

## Developments in euro lending (EURIBOR with €STR-based fallbacks)

There are no current plans to discontinue the publication of EURIBOR and the bulk of euro lending continues to reference EURIBOR (rather than the euro RFR, €STR). The Working Group on Euro Risk-Free Rates (the **Euro Working Group**) is, however, keen to ensure that contracts referencing EURIBOR contain robust fallbacks in the event that EURIBOR is discontinued or becomes non-representative at some time in the future.

In May 2021, the Euro Working Group published recommendations for €STR-based fallbacks from EURIBOR, offering two alternatives for corporate loans:

1. A backward-looking lookback period methodology with no requirement for a waterfall structure i.e. a one-step fallback to compounded in arrears €STR (the **First Recommendation**).

2. A two-step waterfall consisting of a forward-looking methodology on the first level i.e. a fallback to Term €STR on the first level, and a backward-looking lookback period methodology on the second level i.e. a subsequent fallback to compounded in arrears €STR on the second level (the **Second Recommendation**).

These initial recommendations were not widely adopted, leading the Euro Working Group to publish further guidance on EURIBOR fallbacks for corporate lending products earlier this year, which reiterated and clarified the application of its May 2021 recommendations to corporate loans.

The messaging from the Euro Working Group - and the availability of Term €STR rates (both EMMI Efterm and FTSE Term €STR (previously Refinitiv Term €STR) are now available for use) – enabled the LMA to (i) amend its compounded/term rate facilities agreements to better align with the Euro Working Group's First Recommendation and (ii) prepare drafting to reflect the Euro Working Group's Second Recommendation. The LMA's approach is outlined further below.

The choice between the First Recommendation and the Second Recommendation amounts to a choice of whether to incorporate Term €STR or not; this decision is up to the parties and depends primarily on whether consistency between the loan and any related hedging is required (which points towards €STR compounded in arrears), plus the same operational factors outlined above in relation to CORRA.

### *LMA approach to the First Recommendation (one step fallback from EURIBOR to compounded in arrears €STR)*

If the parties choose to implement the First Recommendation (a fallback to €STR compounded in arrears), the new LMA drafting reflects two substantive changes to the pre-existing EURIBOR fallbacks.

Firstly, euro is designated as a "Rate Switch Currency". This means that if EURIBOR is permanently discontinued or ceases to be representative, EURIBOR will be replaced automatically with compounded €STR, unless the parties agree otherwise. This caters for the permanent discontinuation of EURIBOR.

Secondly, to cater for circumstances where EURIBOR is temporarily unavailable, the existing fallback waterfall is adjusted to provide a choice between cost of funds (the pre-existing position) and €STR compounded in arrears as an ultimate fallback. The addition of this option aims to address concerns expressed by both the Euro Working Group and the Financial Stability Board about the suitability of cost of funds as an ultimate fallback.

### *LMA approach to the Second Recommendation (fallback to Term €STR in the first instance)*

If the parties choose to implement the Second Recommendation (Term €STR as the primary fallback for EURIBOR), the adjustments are more complicated. The LMA has published these provisions in exposure draft form for now, pending market feedback[1].

Again, to cater for the permanent discontinuation of EURIBOR, euro is designated as a "Rate Switch Currency". If EURIBOR is permanently discontinued or ceases to be representative, EURIBOR will however be replaced automatically with Term €STR (rather than compounded in arrears €STR), unless the parties agree otherwise. In the absence of established market practice or any endorsement from the Euro Working Group, the choice as to which Term €STR rate applies – EMMI Efterm or FTSE Term €STR – is left to the parties to decide[2].

If EURIBOR becomes temporarily unavailable, the drafting provides a waterfall of fallback rates via interpolated rates (and optionally via shortened interest periods and historic rates) to Term €STR, and then to a fixed central bank rate, with an optional ultimate fallback beyond this to cost of funds. An ultimate fallback to compounded €STR, even optional, in the event of the temporary unavailability of EURIBOR was thought to be out of place in a document which envisages a rate switch to Term €STR rather than compounded €STR in the event of a permanent discontinuation of EURIBOR.

Finally, the exposure draft provides a separate waterfall of fallbacks to apply if Term €STR becomes unavailable (temporarily or permanently) – which provides for the use of interpolated rates (and optionally shortened interest periods, historic rates and an alternative Term €STR rate), ultimately to compounded in arrears €STR. This ultimate fallback to compounded in arrears €STR reflects the second step in the Euro Working Group's Second Recommendation for a two-step waterfall from EURIBOR to Term €STR, and then Term €STR to €STR compounded in arrears.

These fallback waterfalls are further illustrated below (with square brackets indicating the optional elements). Which of the options are preferable from the borrower's point of view? In our view, the optional interim fallbacks are in most cases likely to be considered helpful to address temporary unavailability (whether of EURIBOR or Term €STR). The additional question is whether to retain cost of funds as an ultimate fallback if EURIBOR is temporarily unavailable. Given it is expressed to apply only as a fallback from a central bank rate, borrowers may not have strong views either way.

[1] The LMA is inviting its members to provide comments on the new drafting by 8 December 2023.

[2] The Euro Working Group has produced a comparative table of available Term €STR rates.

***Waterfall 1: EURIBOR becomes temporarily unavailable***

Interpolated EURIBOR

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[Shortened Interest Period

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Shortened Interest Period and Historic EURIBOR

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Shortened Interest Period and Interpolated Historic EURIBOR]

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Alternative Term Rate i.e. Term €STR

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Interpolated Alternative Term Rate i.e. Interpolated Term €STR

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Fixed Central Bank Rate

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[Cost of funds]

***Waterfall 2: Term €STR becomes temporarily or permanently unavailable***

Interpolated Term €STR

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[Shortened Interest Period

↓

Shortened Interest Period and Historic Term €STR

↓

Shortened Interest Period and Interpolated Historic Term €STR]

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[Fallback Alternative Term Rate i.e. different Term €STR

↓

Interpolated Fallback Alternative Term Rate]

↓

Compounded in arrears €STR

## What next?

The LMA continues to expand its library of RFR terms. It has indicated its intention to produce both a Term €STR-Term SOFR document and a single currency euro loan template once the Term €STR drafting discussed above is in recommended form.

More broadly, benchmark reform remains a focus of many non-LIBOR currency jurisdictions, and in some jurisdictions is just getting underway. Where the currency in question is commonly used in the European market, we can expect the LMA to continue to address, and where appropriate reflect, key developments in its guidance notes and documentation. LIBOR may have ceased publication, but interest rate benchmark reform in the wider context remains in full swing, as the developments highlighted in this briefing attest.

*Slaughter and May continues to closely monitor developments in relation to LIBOR, EURIBOR and other significant 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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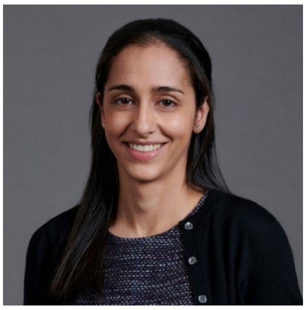

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