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Legal Update

LIBOR to RFR transition progress across the financial markets

Executive Summary

- The FCA continues to expect market participants to transition away from LIBOR before the end of 2021.
- Whilst different currencies, regions and markets are at different stages in terms of transition, there has been real progress in the adoption of risk-free rates ("RFRs") in the DCM, securitisation and derivatives markets.
- The syndicated loan market has seen less progress, although a lot of work is being done around overcoming the credit spread between LIBOR rates and RFRs and to generate term RFRs that are more appropriate for use in this market.

Andrew Bailey, the Chief Executive of the UK's Financial Conduct Authority (FCA), recently reiterated the FCA's expectation that LIBOR will cease to be published beyond 2021. There has been significant progress in the move away from LIBOR in the last 18 months, and Andrew Bailey's speech of 15 July 2019 (available from the FCA website) corroborates that view and provides a number of facts and figures to support it. Further to our 29 March 2019 update entitled "Breakage and Yield Protection in a post-LIBOR World", this note includes a high-level update on the progress of transitioning away from LIBOR across different financial markets, with a particular focus on the syndicated loan market.

Risk-free rates (RFRs)

So-called 'risk-free rates' (RFRs) will replace LIBOR as the benchmark for calculating interest. National working groups for each of the LIBOR currencies have now selected an overnight risk-free rate (RFR) as their preferred LIBOR replacement rate, for example:

Currency	Risk free rate (RFR)	Transaction basis for rate
US dollar	Secured Overnight Funding Rate (SOFR)	Secured Treasury repo rate
Pound sterling	Sterling Overnight Index Average (SONIA)	Unsecured wholesale rate
Euro	Euro Short Term Rate (ESTER)	Unsecured wholesale rate

Credit adjustment spread

RFRs are not economically equivalent to LIBOR. They largely reflect the rate at which an investor would expect to be compensated in the relevant currency for an overnight loan without a risk of loss. LIBOR, on the other hand, is a forward-looking cost of funds rate. Unlike LIBOR, RFRs do not contain either a bank credit risk element or a term liquidity premium. Syndicated loan market participants therefore expect RFRs to be lower than their LIBOR equivalent and consequently a credit adjustment spread will be required to minimise the economic impact of moving to these RFRs in that market. We discuss credit adjustment spreads in the context of various financial markets further below.

Forward-looking term RFRs?

Another issue various working groups are wrestling with is the development of forward-looking term RFRs. In the UK, a huge amount of work is being done to come up with term SONIA reference rates (TSRRs) that would, consistent with Sterling LIBOR, provide market participants with certainty of cash flow and assist in managing interest rate risk. In the US, the Federal Reserve's Alternative Reference Rates Committee (ARRC) is seeking the production of a SOFR-based term rate for similar reasons.

The Bank of England's Working Group on Sterling Risk-Free Reference Rates (Working Group) began a consultation on TSRRs in July 2018 and, following feedback from stakeholders throughout the remainder of 2018, announced on 15 May 2019 that FTSE Russell, Ice Benchmark Administration (IBA) and Refinitiv have each presented to the Working Group their versions of a TSRR and have been tasked with launching their term rates as soon as possible. The IBA's TSRR has been up and running since October 2018, with the vendor currently publishing one month, three month and six month versions of a TSRR that is based on futures quotes, but the IBA has announced that it will adopt a hybrid methodology in the near future that incorporates overnight indexed swaps ("OIS") and futures quotes. Despite this progress toward TSRRs, it remains to be seen which vendor's rate will be adopted by the market.

Are RFRs being used instead of LIBOR already?

The end of 2021 is fast-approaching. So are financial markets adapting?

Debt capital markets/Securitisation

In debt capital markets, there has been an ever increasing supply of bonds that reference a SONIA reference rate that is compounded daily during interest periods consistent with the formula that has traditionally been used for the floating rate leg of Sterling denominated OIS. See the box on page 4 for further details as to how these are formulated. From almost no SONIA issuances before the FCA's 2017 announcement that it would stop encouraging banks to contribute to LIBOR post-2021, there has now been close to £30 billion of new issuances referencing a compounded daily SONIA.

Issuance of US dollar bonds referencing SOFR were estimated to have reached US$ 135 billion at the end of the first half of 2019.

There has recently been a dramatic change in securitisation markets in the UK. The first ever securitisation referencing SONIA completed in December 2018. In Q2 this year, two thirds of new public deals referenced SONIA, many of which Mayer Brown acted on (including the recent UK RMBS of loans originated by Pepper UK, which was its first issuance to be pegged to SONIA).

Derivatives

The use of RFRs in derivative transactions has been growing, both in the UK and the US.

The FCA has noted that, by the end of the first half of 2019, open interest in SONIA futures has climbed steadily to £129 billion from almost nothing in April 2018. Open interest in SOFR futures has now grown to almost half a trillion dollars.

The numbers of SOFR-referencing swap transactions are relatively small but are growing. Although – at the moment – LIBOR still dominates swaps markets in the United States, the growth in SONIA swaps in the UK is illustrative of how change can happen. The notional of outstanding cleared SONIA swaps now exceeds £10 trillion.

The growth of RFR volumes is particularly notable at longer maturities and some forward thinking market participants have already closed out their LIBOR-referencing contracts in favour of RFRs. ISDA is expected to publish its suggested credit adjustment spread methodology by the end of this year.

Syndicated loan market

There has been a lot more hesitancy to adopt RFRs in the syndicated loan market, both in Europe and in the US. This market involves entities of various sizes and structures with differing priorities and flexibility as to loan mechanics and terms. As a result, the regulators and the RFR working groups recognised in their early acknowledgments that the syndicated loan market could not transition to a replacement rate as quickly as other markets. Although there have been bilateral loans referencing SONIA in the UK, we are not aware of any syndicated loan deals in the UK using RFRs…yet.

Many banks are concerned that RFRs are not economically equivalent to LIBOR, so recent discussions have focused around what the credit adjustment spread should be and how to determine it, as discussed on page 1 above. Earlier this month, the Loan Market Association (the "LMA") published a note highlighting a number of considerations relating to the necessary credit adjustment spread between LIBOR and RFRs in the context of the syndicated loan market. In the US, the ARRC is expected to publish its methodology for SOFR spread adjustment during the first half of 2020.[1]

In the US, the Federal Reserve has recommended that market participants target greater upfront clarity by adopting the ARRC's "hardwired" approach, which would specify a waterfall for determining the replacement rate to use beginning with Term SOFR, followed by compounded SOFR, then another RFR as agreed to between the borrower and the administrative agent with a negative consent right for the lenders. The other alternative for determining the replacement rate is the ARRC's "amendment" approach, which provides that upon the occurrence of a benchmark trigger event, the borrower and the administrative agent will enter into an amendment agreeing to the new replacement rate, giving due consideration to the prevailing market convention, including, if applicable, SOFR. Such amendment would be subject to a negative consent right for the lenders.[2]

Our experience on US transactions and following a review of recent publicly filed credit agreements shows that wording tracking the ARRC's "amendment" approach is being included in a growing number of transactions. To date, we have seen little sign of the ARRC's "hardwired" approach. This view supports the position that the ARRC reported in response to its syndicated loan consultation: that the "amendment" approach (versus the "hardwired" approach) is being favoured until the market has better visibility on how successor rates and related spreads and mechanics develop, and how closely those rates and spreads align with similar fallback provisions for derivatives. We expect market acceptance and governmental pressure to continue to prompt the inclusion of ARRC-recommended LIBOR fallback language in transaction documentation for various product categories.

1 For more detail, see our update "The ARRC's Final Fallback Language Recommendations for New LIBOR Syndicated Loans".

2 Coming up with a credit adjustment spread for SOFR looks to be a particularly tricky exercise given that LIBOR (being a cost of funds rate) and SOFR (being secured by obligations of the US) tend to move in opposite directions in times of market distress.

Not just an issue for banks

"The level of LIBOR is a combination of several different factors, including expectations of central bank policy rates, but also including a credit premium seeking to reflect the cost of unsecured wholesale funding to banks.

Borrowers paying LIBOR are therefore taking on an exposure to credit premiums that are determined by reference to a very thin market, which accounts for a very small portion of overall bank funding, and bank funding costs. One may wonder why many borrowers should be asked to take on this kind of risk, and how many of them really wish to do so."[3]

We have been advising our corporate clients to actively engage in the transition to risk-free rates, in order to better understand the likely challenges and opportunities for their businesses. Indeed, regulators have recently highlighted that this is a necessity. For example, the SEC released a statement on July 12, 2019, highlighting the need for corporates to understand and disclose applicable information regarding their transition away from LIBOR.[4]

What does the future hold for the syndicated loan market?

On numerous recent syndicated loan transactions, we have seen borrowers seeking greater clarity as to how interest on their loans will be priced and calculated post-2021, as well as greater control around future amendments to provide for a replacement benchmark rate. However, whilst there are many loan market participants actively working on the transition from LIBOR to RFRs, the syndicated loan market has not yet followed the DCM and securitisation markets in adopting RFRs wholesale (or the derivatives market in referencing RFRs in some but not all transactions). There are good reasons for this (for example, differences in actual pricing and operational issues) but both banks and borrowers are a lot more focussed on this issue recently and so we expect variations of RFRs to become the norm for new deals in this market, although there is some uncertainty as to how quickly this transition will take place.

3 Andrew Bailey, FCA CEO, 15 July 2019.
4 https://www.sec.gov/news/public-statement/libor-transition

Many borrowers and lenders will need to negotiate amendments to existing loan documentation between now and the end of 2021. The amount of consultation with, or consent required from, syndicates of lenders to such amendments will depend on factors such as the form of LIBOR fallback language used (including whether a "hardwired" or "amendment" approach to future amendments to pricing has been used). Market participants should also consider whether other amendments should be made (for example, changes to the yield protection clauses as referred to in our March 2019 note[5]), though we have not seen this being discussed with any vigour so far, perhaps because lenders will have little discretion with respect to such changes, even if there are conceptual arguments as to why they might not be needed in an RFR (as opposed to a LIBOR) world.

For the time being, parties should beware of provisions in loan documentation relating to possible future amendments that are unclear or ambiguous, especially in syndicated deals, which may require more time to resolve. Unless drafted very clearly, it is conceivable that such provisions could be the subject of future regulatory scrutiny and/or disputes between lenders, facility agents and borrowers.

Trigger for transition

Clearly, working groups and trade associations want to ensure minimal market disruption in the transition from LIBOR to RFRs. One of the key issues is determining an appropriate trigger for the move. Options include where the LIBOR reference rate ceases to be published, but also pre-cessation triggers. ISDA is in the process of consulting the derivatives market on possible pre-cessation triggers where certain LIBOR reference rates no longer represent an underlying market, but defining a trigger in those circumstances can involve a degree of subjectivity. To date, the result of ISDA's consultation on these pre-cessation triggers has been inconclusive with market participants' responses failing to support one option decisively. ISDA's further analysis of the consultation responses is now awaited. It is worth noting that the UK's FCA considers that the best and smoothest transition from LIBOR would be to circumvent these triggers and for the reference rate transition to be one in which contracts that reference LIBOR are replaced or amended before fallback provisions are ever triggered.

5 "Breakage and Yield Protection in a Post-LIBOR World", 29 March 2019.

Debt capital markets/ Securitisation

The terms of SONIA-referencing bonds adjust the traditional OIS formula referred to above to include an uncompounded margin and, in addition, provide that the interest amount is calculated over a period that lags the daily SONIA reference rate by a prescribed number of days - which, so far, has usually been a five London banking day period - so that the final interest amount is known before it is due to be paid; this provides issuers and bondholders alike with a degree of cash flow certainty. Consistent also with requirements under the EU Benchmark Regulation, the formula contains standardised fall-back provisions that are set at the Bank of England's Bank Rate (the Bank Rate) plus the mean of the SONIA reference rate to the Bank Rate over the previous five London banking days.

It is worth noting that whilst the market is moving towards a daily compounded SONIA formula, most bond prospectuses contain a risk factor that outlines that the issuer may issue bonds in the future that reference a SONIA reference rate that is determined using a different formula or methodology altogether. Market participants in the debt capital markets remain advocates for the development of TSRRs that would provide for certainty of cash flow for issuers and bondholders at the beginning of each interest period and assist them in managing interest rate risk, however, there have not been any issues of bonds referencing a TSRR to date.

If you have any questions about the issues raised in this legal update, please get in touch with your usual Mayer Brown contact or:

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