

# Legal Update

## LIBOR Transition – A Compounding Problem for Emerging Markets

Financial regulators in the UK have declared 2020 to be a “key year for [LIBOR] transition” and reiterated the need to accelerate progress<sup>1</sup>. On 26 February 2020, the Bank of England announced its intention to publish a daily SONIA compounded-in-arrears index from July 2020 to support the use of SONIA in as wide a range of financial products as possible by simplifying the calculation of compounded interest rates. This is in line with an earlier announcement from the Federal Reserve Bank of New York relating to SOFR.

At the same time, the Sterling Risk-Free Reference Rates Working Group (the “**Working Group**”) has published a working paper<sup>2</sup> (the “**Working Paper**”) outlining why, in their view, overnight SONIA compounded in arrears is appropriate and likely to be operationally achievable for approximately 90% by value of the sterling LIBOR loan market. However, this Working Paper also recognises the remaining 10% of loan deals by value would likely require some sort of alternative rate (i.e. not LIBOR and not overnight SONIA compounded in arrears).

### So, what makes up this 10%?

The loans for which the Working Paper acknowledges overnight SONIA compounded in arrears would not work include lower value loans to smaller corporates as well as a number of products where an overnight compounded in arrears risk-free rate (“CIA RFR”) would create operational problems, irrespective of the sophistication of the borrower. We concentrate on these in this series of notes<sup>3</sup>.

These products include export finance, emerging markets loans, trade and working capital products and Islamic finance. Also, where a loan is in a specialist area (such as project finance, where the project being financed is in an emerging market), market participants should consider whether alternative rates other than CIA RFRs are appropriate, even where this is not expressly mentioned in the Working Paper.

*For more on CIA RFRs, see the Appendix.*

<sup>1</sup> See, for example, the widely publicised letter from the Bank of England Prudential Regulation Authority (the “**PRA**”) and the UK Financial Conduct Authority (the “**FCA**”) to senior management of certain regulated institutions in January 2020: <https://www.fca.org.uk/publication/correspondence/dear-smf-letter-next-steps-libor-transition.pdf>

<sup>2</sup> “Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives” January 2020

<sup>3</sup> To view our other product specific updates on LIBOR transition, please see our IBOR Transition page (<https://www.mayerbrown.com/en/capabilities/key-issues/libor-transition?tab=overview>).

## What might the alternatives be?

The Working Paper recognises that where simplicity or payment certainty are key factors, fixed rates, or the overnight central bank rate<sup>4</sup>, may be preferred. The Working Group is keen to limit the use of forward-looking term reference rates<sup>5</sup>, but they have acknowledged there may be instances where a forward-looking term rate is a good fit with business needs; the issue at present is that although work on developing forward-looking term reference rates is progressing, IOSCO-compliant versions acceptable to the regulators are not yet available and it is not certain when they will be made available.

### Looking in more depth...Emerging Markets

LIBOR linked loans to borrowers in emerging markets with maturities beyond the end of 2021 will need to be amended, as LIBOR will cease to be published from that time.

It will be challenging to communicate the LIBOR issue, agree on replacement rates and execute the necessary amendment documentation with borrowers in emerging markets.

Borrowers sometimes require local budgetary or central bank approvals before interest payments can be converted into hard currency and transferred to lenders outside of the relevant jurisdiction. Such processes can require the exact amount of interest to be known and may take weeks to complete.

As such, the Bank of England's Working Group has recognised that RFRs compounded in arrears, whereby the amount of interest payable is only determined a few days before an interest payment date, are ill-suited to loans in emerging markets and Islamic finance. But what alternatives can be used?

Market participants should consider using a fixed rate or a central bank rate (such as a reference rate produced by the Federal Reserve Bank of New York). The base rate of the relevant emerging market central bank is unlikely to be suitable.

Alternatively, will a forward looking term rate be available in the relevant currencies in time? This is uncertain currently but should become clearer during 2020.

Lenders should engage with their borrowers in emerging markets now to understand the process and timeline required for a change to the basis on which interest is calculated.

On sovereign financings in particular, borrowers/guarantors may require parliamentary or other local approvals in order to enter into such documentation, which could be a time consuming process or even not possible at all.

Borrowers in emerging markets should ensure that any transition from LIBOR to an alternative rate in their loans occurs at the same time as, and is aligned with, any similar transition in any interest rate hedges it has in place in relation to such loans.

<sup>4</sup> The Working Paper concentrates on sterling loans and so suggests the overnight Bank of England rate, but another overnight central bank rate may be more appropriate depending on the parties and currency of the transaction.

<sup>5</sup> The Working Paper states, "The UK authorities have made clear their preference for the market to adopt a broad-based transition to SONIA compounded in arrears, with the use of a [term SONIA reference rate] being limited."

## What should market participants be doing now?

Whether a CIA RFR is likely to work for your financing products or not, we recommend market participants should at least:

**Diligence** existing transactions referencing LIBOR that are set to continue beyond the end of 2021 as soon as possible.<sup>6</sup> Identify whether there are currently any fall back provisions to the extent that LIBOR ceases to be published (in both loan agreements and hedge documents) and, if not, what consents are likely to be required to make the necessary amendments to reference a risk-free rate ("**RFR**") rather than LIBOR<sup>7</sup> (which might include third parties as well as lenders and obligors).

**Consider** what you will do if forward-looking term RFRs are available in the currencies relevant to you by the time LIBOR ceases to be published, but also what you will do if they are not. The Working Paper contemplates the use of a fixed interest rate or a floating rate based on the Bank of England's Base Rate where CIA RFRs are not appropriate. Could either of these work as a fall back (either on a temporary basis, until an appropriate forward-looking term RFR is available, or on a permanent basis)?

**Discuss** LIBOR transition upfront for any financing products being entered into over the coming months. Where an alternative rate to LIBOR that is suitable for the product/market is yet to be developed, parties should be clear that LIBOR will need to be replaced midway through the deal, otherwise pricing will default to an agreed fall back. Discussing positions and understanding possible solutions to LIBOR transition with counterparties at the time facilities are entered into is likely to assist the process when the time comes.

**Identify** your preferred implementation strategy (e.g. amendment, replacement, redemption, no action) and any third party engagement needed to implement that strategy (this is closely linked with the diligence exercise referred to above).

**Plan** for the inevitable resources, both time and money, that the transition process will take this year and next within all of your relevant internal teams (most banks expect this to encompass a dedicated LIBOR transition team but also many relationship managers, lawyers, originators, transaction managers and agency and operations teams).

**Stay up-to-date** with market developments in this space. Follow the publications and webinars from bodies such as the Loan Market Association (LMA), the Loan Syndications and Trading Association (LSTA), the Association of Corporate Treasurers (ACT), the FCA and the PRA (including the Working Group) and UK Finance.

<sup>6</sup> For transactions which are set to expire shortly after LIBOR is expected to cease to be published, market participants may want to consider whether it is in fact simpler to rely on existing fall back provisions for a short period, rather than negotiating and documenting an amendment process. There are various factors to consider in this respect and it will be a deal specific analysis (see "Identify your preferred implementation strategy" box below).

<sup>7</sup> Your strategy may be heavily influenced by these considerations.

## Interesting, but most of our deals are not in sterling. Is this relevant?

Although the Working Group is focused only on sterling, similar issues apply to other currencies (in particular, US dollar). It will be interesting to see whether other regulators recognise that CIA RFRs are unsuitable in some areas of the lending market. In the meantime, the markets for other currencies are also developing forward-looking term rates; when or if these will become available remains to be seen.

## Conclusion

LIBOR transition is undoubtedly a huge task that the financial markets are wrestling with and, as the regulators have been stressing, parties need to take action as soon as possible. One of the issues with the transition is, and will continue to be, the fact that there is no “one size fits all” solution. Having said that, market participants who can identify the scale of the challenge for their organisation, formulate a plan (including working out which replacement benchmark rate is most suitable) and therefore implement that transition will undoubtedly be in a stronger bargaining position as we approach 2021.

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## Appendix

### What are 'compounded in arrears' rates and why don't they work for some loan products?

So far, the Bank of England Prudential Regulation Authority (the "PRA") and the UK's Financial Conduct Authority (the "FCA") have made clear their preference for almost everyone in the sterling financial markets to move from using LIBOR pricing to using a backward-looking compounded in arrears risk-free rate ("CIA RFR").<sup>8</sup>

CIA RFRs are constructed from past realised daily fixings of the relevant overnight risk-free rate ("RFR") over a given period. In order to determine an interest payment obligation of, say, six months, the overnight RFRs are compounded over the same six-month period. This calculation will only be possible once the full set of overnight RFRs are known, i.e. at the end of the period. In order to provide greater certainty of cash flows ahead of interest payment dates, the syndicated loan market seems likely to follow the floating rate note market in using a five day lag period, i.e. the period over which the daily SONIA rate is compounded lags the interest period by five London banking days. In this way, the final interest payment will only be known five London banking days before it is due to be paid. Clearly, such an approach is likely to cause a range of difficulties for some borrowers where payment certainty is key and for certain products where a backward-looking rate may cause substantial operational problems, irrespective of how sophisticated the borrower is.

For some time, the syndicated loan market has argued that it needs a forward-looking RFR for each currency.<sup>9</sup> However, though administrators continue

to work on their creation,<sup>10</sup> market participants should not assume that IOSCO-compliant forward-looking SOFR or SONIA reference rates will develop quickly enough or robustly enough to be widely available for SOFR or SONIA linked debt instruments by the time LIBOR ceases to be published.

### Recent updates from the UK regulators

The FCA and the PRA have endorsed the 2020 targets set by the Working Group, stating that firms should have LIBOR transition plans that address the Working Group's priorities, including:

- ceasing the issuance of sterling LIBOR-based cash products maturing beyond 2021 by Q3 2020; and
- establishing a clear framework to manage the transition of legacy LIBOR products to significantly reduce the stock of LIBOR referencing contracts by Q1 2021.

In remarks at the Benchmark Strategies Forum in London on 26 February 2020, Andrew Hauser (executive director for Markets of the Bank of England) stated (emphasis added):

- 2020 is a critical year for LIBOR transition.
- Great progress was made in 2019, particularly in sterling wholesale markets.
- However, with the finish line for LIBOR now clearly in view, there is still a lot of ground to cover – particularly in the cash markets. We need to see another decisive acceleration in effort in 2020 to ensure risk-free rates are adopted across the full range of sterling business, and LIBOR is left behind for good.

<sup>8</sup> As Andrew Bailey (Chief Executive of the FCA) said in July 2019, the only exception to using CIA RFRs should be for "parts of some markets that do want a forward-looking term reference rate... Some borrowers, for example, may prefer precise cash flow certainty months in advance even if it would be less costly to use the overnight rate in arrears... This forward-looking term version of SONIA should be useful to some niche users in cash markets."

<sup>9</sup> A forward looking rate would be known at the beginning of an interest period and it would embed the "time value of money" (as LIBOR does today) and it would obviate the need to create "time value of money" by compounding a rate during the interest period.

<sup>10</sup> Four administrators (FTSE Russell, ICE Benchmark Administration, Refinitiv and IHS Markit) have confirmed that they are working on the development of a term SONIA reference rate ("TSRR") and have presented their plans to the Working Group. There are methodological differences across the administrators, meaning that the rates produced are likely to be marginally different. The Working Group has suggested that TSRRs are likely to be made available before the Q3 2020 date to support market participants that would require alternative rates. In the US, the issue is whether there is enough futures trading to create forward-looking term SOFR rates that are robust, sufficiently stable and immune to manipulation – and thus can be used as IOSCO-compliant reference rates for a wide swath of the market.

- The increased focus and energy from sterling market participants this year is palpable. But they cannot run this race alone. **As track marshals and safety officials, the Bank of England and the FCA also have important roles to play – and we are using all the tools at our disposal in that quest.**
- **Understandably, perhaps, focus often alights on the ‘sticks’ we can wield.** And it’s true that the regulatory authorities have stressed that firms’ boards and executives must take ownership of the transition and its key milestones, through ‘Dear CEO’ and ‘Dear Senior Manager’ letters, and through direct supervisory engagement.
- The FCA has set out how it will exercise its powers of life and death over LIBOR, including the critical judgment on representativeness. And the Bank of England’s Financial Policy Committee (the **“FPC”**) has said that it will consider using other policy and supervisory tools to encourage transition if progress is too slow.

And after reviewing recent Bank of England and other official action regarding LIBOR, Mr. Hauser continued (emphasis added):

- It is in that spirit that I want today to announce two new initiatives aimed at further supporting LIBOR transition:
  - » First, and in direct response to feedback from market practitioners, **the Bank of England is intending to publish a compounded SONIA index from July 2020.** Complementing our existing overnight SONIA rate, the index will provide a flexible tool to help market participants construct compounded SONIA rates in an easy and consistent way, supporting achievement of their 2020 Q3 target for new issuance.

- » The second relates to the Bank of England’s own lending operations for banks and other financial intermediaries. **From October this year, we will begin increasing haircuts progressively on LIBOR-linked collateral we lend against.** This will give firms the time they need to replace that collateral with risk free rate alternatives, ensuring their borrowing capacity is maintained while also protecting public funds. This approach reflects the clear preferences of respondents to our discussion paper last year.
- **These initiatives are aimed at turbo-charging sterling transition, helping the market deliver against its commitment to transition away from LIBOR and further de-risking sterling markets.**

These remarks certainly suggest a higher order of regulatory engagement and move beyond prior encouragement and requests for LIBOR transition plans. We anticipate similar actions from other international regulators over time as the deadline for LIBOR cessation comes closer and inadequate (or perceived inadequate) market response continues.

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