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LIBOR: WHAT YOU NEED TO KNOW

August 2019

TRANSACTIONAL POWERHOUSE

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Executive Summary

To date, 2019 has seen significant developments in connection with LIBOR transition. There is still much to do, however, and regulators have continued to urge market participants to step up the pace of transition.

Originations in RFRs

Continuing a trend from 2018, there has been an increasing volume of floating rate note transactions that bear interest by reference to risk-free rates (RFRs). Issuances in SONIA and SOFR have been gaining popularity amongst issuers and investors of floating rate notes (FRNs). In addition, a SONIA loan transaction recently closed in London and there have been a number of securitizations referencing SONIA. While transition momentum is building in the FRN market, there remains much to do to convince market participants to commit fully to a transition to RFRs.

Finalized ARRC fallback provisions

In the US, the Alternative Reference Rates Committee (ARRC) finalized its recommended contractual fallback language for US dollar LIBOR in syndicated loans, floating rate notes, securitizations and bilateral loans. There is evidence that some issuers and investors have included these provisions in documentation.

ISDA consultation on pre-cessation issues

In March, the Official Sector Steering Group (OSSG) encouraged ISDA to ask for market opinion on the addition of a third trigger event to ISDA's suggested contractual fallback language. This trigger would take effect prior to the permanent cessation of LIBOR if the UK Financial Conduct Authority, in its capacity as the regulator of LIBOR, were to find LIBOR to be unrepresentative of underlying financial reality. In May, ISDA launched a consultation on pre-cessation issues for LIBOR and certain other IBORs, which, if supported by sufficient market consensus, would lead to a pre-cessation trigger being added to the two permanent index cessation triggers that ISDA first consulted on in 2018. While the deadline for responses to this consultation has now passed (as of 12 July), the results have not yet been published by ISDA.

EONIA to €STR

EONIA is to be replaced by a new short-term rate that reflects the wholesale euro unsecured overnight borrowing cost of euro-zone banks (€STR), which is to be launched on 2 October 2019. As part of the transition, from 2 October until the beginning of 2022, EONIA will continue to be published (at T+1), but calculated as €STR plus a fixed spread of 8.5 basis points.

Forward-looking term rates

Work continues on the development of IOSCO-compliant forward-looking term rates that would be used as substitutes for LIBOR in cash markets, but such rates do not yet exist. The ARRC has suggested that a private administrator might be able to construct an IOSCO-compliant forward-looking term rate based on SOFR derivatives markets after those markets develop enough liquidity. However, Andrew Bailey, Chief Executive of the UK Financial Conduct Authority, recently stated that it was a "mistake" for market participants to delay LIBOR transition until forward-looking term rates arrive.[1]

Consultation in Japan

In July, the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks commenced its "Public Consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks." The deadline for submissions is 30 September 2019. This consultation seeks input from market participants on several matters, including alternative benchmarks to JPY LIBOR and contractual fallbacks.

LIBOR transition at different stages in different jurisdictions

LIBOR transition continues to be at different stages of progress in the different jurisdictions of the LIBOR currencies. In the US and the UK, the official sector and working groups have taken steps that are more concrete and are further advanced than elsewhere, but regulators and working groups in other jurisdictions, such as Asia Pacific, are accelerating efforts to finalize their own fallback proposals.

BMR Amendments

Amendments will be made to the EU Benchmark Regulation (BMR) that will provide that all critical benchmarks (including LIBOR) may be used for both existing and new contracts until 31 December 2021.

Accounting developments

The IASB is consulting on proposals regarding both the old and new financial instruments standards (IAS 39 and IFRS 9) in light of IBOR reform. The proposals would provide relief from rules that could otherwise lead to the discontinuation of existing hedge accounting treatment due to IBOR reforms. FASB in the US added a project to its agenda to address the accounting implications relating to LIBOR discontinuation. In addition, FASB issued an update that allows for the OIS rate based on SOFR to be designated as a benchmark interest rate for hedge accounting purposes.

Differing LIBOR fallbacks among asset classes

LIBOR fallbacks will likely differ among asset classes. While a "one size fits all" solution is certainly appealing, it is far more likely that market participants will need to carefully evaluate the effect of various fallback provisions in transactions involving several asset classes, such as CLOs and other ABS transactions, hedged loans or standalone rate swaps, to ensure that they understand any basis risk arising from the fallback provisions not being aligned.

The "multiple rate" approach

At present, Japan and Europe (and certain non-LIBOR jurisdictions including Australia, Canada and Hong Kong) are following a "multiple rate" approach for interest rate benchmarks for the applicable currencies, which sees their reformed and improved local IBORs (e.g., TIBOR, EURIBOR, BBSW, CDOR and HIBOR) set to co-exist with the identified RFRs (e.g., TONAR, EONIA/€STR, the Australian cash rate, CORRA and HONIA).

Consumer products

The ARRC launched a consumer products working group, which includes the US Consumer Financial Protection Bureau (CFPB). The ARRC commenced a consultation regarding LIBOR fallback contract language for new residential adjustable rate mortgages.

[1] Speech by Andrew Bailey, Chief Executive of the FCA, at the Securities Industry and Financial Markets Association's (SIFMA) LIBOR Transition Briefing, 15 July 2019

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Introduction

To date, 2019 has seen significant developments in connection with LIBOR transition. The official sector and industry groups have continued to work to develop alternative reference rates and contractual fallbacks.

Issuers and borrowers in some products have taken to these replacement rates and there is evidence that liquidity is building in LIBOR replacement rates in some currencies.

However, the building of liquidity is not uniform across currencies; for example, quotations in €STR, which is intended to replace EONIA, as well as serve as a basis for EURIBOR contractual fallbacks, will not become available until later this year. The volume of interest rate derivatives (IRD) in SONIA continues to far exceed the aggregate IRD in SOFR, which is understandable because SONIA has existed since 1997, whereas SOFR only recently came into being.

In addition, the degree to which proposed replacement interest rates and contractual fallbacks are being adopted is not uniform among asset classes. While there are good reasons for many of the differences between the asset classes, it may be challenging to align rate and fallback provisions across products, even in circumstances where the interest rate exposure was originally intended to be consistent (which is desirable to mitigate basis risk), such as with respect to loan-linked hedges or in CLOs or other securitizations of assets that have LIBOR exposure.

ISDA is currently consulting on several issues relating to LIBOR transition, including a consultation on the possible introduction of a pre-cessation trigger.

This consultation examines whether the trigger events for a contractual fallback for swaps should include a pre-cessation trigger in addition to the two index cessation triggers on which ISDA consulted in 2018. This pre-cessation trigger would align with the pre-cessation trigger included in the finalized ARRC fallback provisions for use across loan, note and securitization products. ISDA also continues work on developing spread and term adjustments that would apply to a replacement rate at the point of transition following the trigger of a contractual fallback.

Considerable challenges remain. Despite the many thoughtful changes that have been made to promote the development of liquidity in rates to replace LIBOR, and to potentially mitigate the effects of a discontinuance of LIBOR for contracts that still refer to it, adoption of the new rates has been slower than regulators would prefer. The development of IOSCO-compliant forward-looking term rates based on overnight risk-free rates (RFRs), which would be similar to LIBOR's current forward-looking term structure and which are desired in the loan, bond and other cash markets, depends on the development of deep, liquid derivatives markets in RFRs, which might not occur before LIBOR's expected discontinuance at the end of 2021. For example, although the ARRC has proposed a waterfall to determine a LIBOR replacement rate in its recommended contractual fallbacks, the first step in such waterfall—an IOSCO-compliant forward-looking term SOFR to be recommended by the ARRC-- does not yet exist.

Because LIBOR is so deeply embedded in financial contracts, the proposed discontinuation of the rate and transition to alternatives has been an intricately complex and multi-layered undertaking, and will continue to be so.

During the remainder of 2019, market participants should, therefore, monitor developments closely, in particular the results of ISDA's ongoing consultations on pre-cessation issues and the development of spread and term adjustments to applicable replacement risk-free-rates, as well as ongoing developments with respect to increased liquidity in RFR-denominated instruments.

This is the fourth in a series of reports Baker McKenzie has written since 2017 on LIBOR discontinuance and replacement. Our previous reports are available here, here and here.

Global Developments

Global regulatory bodies, such as the Financial Stability Board's (FSB) Official Sector Steering Group (OSSG), continue to drive much of the agenda for LIBOR transition. In addition, certain regulatory developments at the regional and country-specific level, such as the EU and the UK Financial Conduct Authority (FCA), have had a global impact. ISDA also continues to lead the private sector's efforts to address LIBOR transition. On 31 July, IOSCO issued a statement on benchmark transition for market participants.[2] The increasing volume of new debt originations priced by reference to RFRs is also a global development.

Adoption of RFRs in FRN originations

As 2019 progresses, floating rate note (FRN) issuers and investors are increasingly being urged to embrace the swing away from IBOR-linked benchmarks towards use of the alternative RFRs in their new contracts, and to ensure their legacy contracts include sufficiently robust fallback language to avoid the risk of their FRNs converting to fixed rates in the event of a permanent cessation of the referenced IBOR.

Although LIBOR continues to remain the benchmark rate of choice in the majority of FRNs issued globally, SONIA and SOFR have been gaining popularity amongst FRN issuers and investors. In total, over 40 SONIA-linked FRNs and over 120 SOFR-linked FRNs have been issued to date, with total values of over £27 billion and c.$92 billion, respectively. Their growing popularity is evidenced when comparing deal figures from the last two six-month periods, with SONIA showing a six-month comparative growth in its market share of GBP FRN deals of over 260%, from 25.9% in H2 2018 to over two-thirds of all new FRN issues, 68.5%, in H1 2019. SOFR also posted a comparative 6-month growth in its market share of USD FRN deals of over 250%, from 5.8% in H2 2018 to 14.9% in H1 2019, though still has a way to go to overtake LIBOR as the USD benchmark of choice.

The growing popularity of these RFRs with FRN issuers and investors has been buoyed by the publication of literature on how to use the RFRs in new FRNs.[3]

However, issuers (like borrowers in the loan markets) have identified a significant disadvantage to using RFRs to price a bond instead of an IBOR, namely that RFRs are only backward-looking and published as overnight or spot rates, without incorporation of a term element. This means parties cannot determine the interest payable during an interest period until the end of that period (unless using a "lag" mechanism, starting and ending the relevant interest period a specified number of days before). SONIA's particular success of late may also be attributed in part to the work of the Working Group on Sterling Risk-Free Reference Rates (Sterling Working Group) to develop a Term SONIA Reference Rate (TSRR) to remedy this RFR weakness, with ICE one of three benchmark administrators confirming in May that they are working on a TSRR calculation methodology.[4]

While less marked, in 2019, progress was also made in respect of the RFRs set to replace or run alongside local IBORs in the other three LIBOR currencies. EUR LIBOR will be replaced by €STR, following the same path as EONIA (see below), while the National Working Group on Swiss Franc Reference Rates (NWG) concluded in February that there are no impediments to issuing SARON (the Swiss Average Rate OverNight chosen as the RFR alternative to CHF LIBOR) FRNs. The NWG recommended that exchanges should facilitate the listing of SARON FRNs. The NWG's Derivatives & Capital Market sub-working group has published a discussion paper containing draft standard fallback language for SARON FRNs.[4]

Japan, like Europe and several non-LIBOR jurisdictions, such as Australia, Canada and Hong Kong, has opted for a "multiple rate" approach for interest rate benchmarks.[6] This sees their reformed and improved local IBORs, TIBOR, EURIBOR, BBSW, CDOR and HIBOR, set to co-exist with the identified RFRs: TONAR (Tokyo OverNight Average rate); EONIA (set to be replaced by €STR plus a fixed 0.085% spread from 2 October 2019, before being discontinued completely on 3 January 2022), the Australian cash rate, CORRA (Canadian Overnight Repo Rate Average) and HONIA (HKD Overnight Index Average). In each of these jurisdictions, FRN issuers will have a choice when pricing their notes, and investors will have a choice in which benchmark to invest.

However, with that choice comes the risk that if the IBOR remains, market players may see little incentive to develop and trade the alternative RFR-based notes.

Such an approach may also result in not developing sufficient liquidity to support a forward term rate based off a jurisdiction's identified RFR.

So, while transition momentum is certainly building in the FRN market, with the more established RFRs posting strong growth figures against their traditional IBOR counterparts, there remains much still to do to convince market participants to commit fully to a transition to RFRs.

The increased volume of FRN originations denominated in RFRs may also assist the development of sufficient liquidity to enable the development of forward-looking term rates based on RFRs.

[2] IOSCO Statement on Communication and Outreach to Inform Relevant Stakeholders Regarding Benchmarks Transition 31 July 2019.
[3] Examples of this include: the Sterling Working Group's Conventions for referencing SONIA in new contracts (March 2019); the ARRC's A User's Guide to SOFR and Recommendations regarding more robust fallback language for new issuances of LIBOR floating rate notes (both April 2019), and the FSB's Overnight Risk-Free Rates - A User's Guide (June 2019).
[4] Available here.
[5] Available here.
[6] The FSB Progress Report, "Reforming major interest rate benchmarks" 14 November 2018, contains a discussion of jurisdictions following a multiple rate approach.

Global Developments

The EU Benchmark Regulation

The FCA supervises LIBOR, which is categorized as a critical interest rate benchmark under the EU Benchmark Regulation (BMR) that came into force on 1 January 2018. As a critical benchmark, there is a college of national supervisors (including the European Securities and Markets Authority (ESMA)) that is consulted on key decisions.[7] While this is an EU Regulation, given LIBOR's importance, the FCA's decisions over cessation and material changes have global implications. The BMR is based on the IOSCO Principles for Financial Benchmarks that set out voluntary guidelines for benchmark administrators on governance, methodology and accountability. The BMR is, however, of binding effect and applies to contributors and certain users, as well as indices used to evaluate investment fund performance.

Under the BMR, LIBOR's administrator, ICE Benchmark Administration (IBA), and the FCA as supervisor must assess LIBOR's capability to be representative of the underlying market and economic reality. This is an assessment the FCA would need to make were a contributing panel bank to announce its intention to stop submitting data — however, in this context, the FCA has publicly stated that it will use its regulatory powers to persuade or compel sufficient banks to submit data to LIBOR until year-end 2021. Although LIBOR may not fully satisfy the BMR's requirements, the FCA could approve its continuing use should cessation (or adaption to meet those requirements) cause a force majeure event, frustrate or otherwise breach the terms of any financial contract or instrument, or the rules of any investment fund referencing that benchmark.[8] Edwin Schooling Latter, the FCA's Director of Markets and Wholesale Policy, confirmed that this would be the regulator's approach in a speech made this January.[9] Amendments to be made to the BMR will provide that all critical benchmarks may be used for both existing and new contracts up to 31 December 2021.[10]

The BMR also requires EU financial services firms and market infrastructure operators to "produce and maintain robust written plans" that set out the steps they would take should LIBOR materially change or cease to be published.[11] Where practicable, these plans should nominate one or more alternative benchmarks explaining why they are suitable and see them reflected in contractual relationships with clients. For legacy transactions in effect prior to 1 January 2018, ESMA have clarified that they expect amendments to contractual documents only where "practicable and on a best-efforts basis."[12]

Regulatory announcements

In its Business Plan for 2019/20,[13] the FCA emphasizes that the replacement of LIBOR is a key priority for its supervision of wholesale markets. In this regard, it is continuing to support the Sterling Working Group to enable transition to SONIA. Similarly, the UK's prudential regulator, the Prudential Regulation Authority (PRA), has reiterated in its 2019 Annual Report that its regulatory objective of maintaining financial stability includes seeking assurance from firms that they understand the risks associated with the transition from LIBOR to risk-free rates and are taking appropriate action in the run-up to year-end 2021.[14] In this respect, last autumn the PRA and the FCA sent a "Dear CEO" letter[15] to UK-supervised major banks and insurers asking for details of the steps they had taken to date. Similarly, on 3 July 2019, the European Central Bank (ECB) published a "Dear CEO" letter to the CEOs of significant banks requiring a board-approved summary of their risk assessment on benchmark reform and a detailed action plan by 31 July 2019.[16] CEOs must also respond to a questionnaire on this subject by 15 September 2019.

In June 2019, the PRA and FCA published the key findings from the responses received to the UK "Dear CEO" letter and their regulatory expectations.[17] These refer to the following:

- Firms using a range of quantitative and qualitative tools and metrics to monitor their exposure to LIBOR and related risks;
- Firms putting clear and appropriate governance in place, supported by reporting to senior managers and the relevant committees, and nominating a senior executive under the UK's Senior Manager Regime to be responsible for the transition;
- Firms developing a project plan with key milestones and deadlines, as well as identifying and managing potential prudential and conduct risks (e.g., conflicts of interest and market abuse) arising from transition; and
- Firms pro-actively seeking to use risk-free rates (RFR) or, if this is not possible, taking steps to incorporate robust fallback language.

The FCA has announced that it will widen its supervision of firms' transition from LIBOR and focus on firms that it considers are failing to manage their transition risks. In turn, the PRA, in respect of banks, insurers and larger investment firms, has promised a "strong focus" on the markets' transition to SONIA acting through the Sterling Working Group and its Senior Advisory Group, and will increase, if necessary, its supervisory engagement with individual firms' plans. Meanwhile it will continue to work with other regulators through the FSB.

FSB, the OSSG and ISDA on pre-cessation triggers for contractual fallback language

In March, the heads of the FCA and the Federal Reserve Bank of New York, in their capacities as co-chairs of the OSSG, encouraged ISDA to ask for market opinion on the addition of a third trigger event to ISDA's proposed contractual fallback language if the FCA were to find LIBOR to be non-representative in its capacity as the regulator of LIBOR.

In May, ISDA launched a consultation on pre-cessation issues for LIBOR and certain other IBORs, which if supported by sufficient market consensus, would lead to a pre-cessation trigger being added to the two permanent index cessation triggers that ISDA first consulted on in 2018. While the deadline for responses to this May 2019 consultation has now passed (as of 12 July), the results have not yet been published by ISDA.

[7] FCA, LIBOR Supervisory College, Written Arrangements, March 2018.
[8] This pre-cessation trigger is intended to reflect the fact that the BMR requires the FCA to assess whether LIBOR is representative of the underlying market or economic reality and that, if the FCA determines that LIBOR is not representative, EU-supervised entities could be prohibited from referencing LIBOR in new derivatives and securities. Although ISDA did not include a pre-cessation trigger in its 2018 fallbacks consultation, it has launched a new consultation specifically evaluating pre-cessation triggers.
[9] Speech, FCA, Edwin Schooling Latter, Director of Markets and Wholesale Policy, 28 January 2019.
[10] Low Carbon Benchmarks Regulation, Provisional Text, 26 March 2019.
[11] Article 28(2) of the BMR.
[12] Question 8.1 of ESMA's Q&A on the BMR (published 23 May 2019).
[13] FCA Business Plan 2019/20, April 2019.
[14] PRA, Annual Report, 2018/19.
[15] PRA and FCA Dear CEO Letter, 19 September 2018.
[16] ECB, Dear CEO Letter, 3 July 2019
[17] PRA and FCA, Firms' Preparations for LIBOR transition, June 2019.

Global Developments

ISDA supplemental consultation on spread and term adjustments for fallbacks in derivatives referencing USD LIBOR, CDOR and HIBOR and certain aspects of fallbacks for derivatives referencing SOR

The 2018 ISDA consultation on IBOR fallbacks covered GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW. In May, ISDA launched a supplemental consultation on spread and term adjustments for fallbacks in derivatives referencing USD LIBOR, CDOR and HIBOR and certain aspects of fallbacks for derivatives referencing the Singapore Dollar Swap Offer Rate (SOR). The deadline for responses was 12 July 2019. On 30 July, ISDA published a statement[18] summarizing the preliminary results of this consultation. Consistent with the 2018 ISDA consultation, the overwhelming majority of respondents to the 2019 consultation preferred the "compounded setting in arrears rate" for the adjusted risk-free rate (RFR) and the "historical mean/median approach" for the spread adjustment.

ARRC - Incremental Objectives

In June 2019, the US Alternative Reference Rates Committee (ARRC) published Incremental Objectives to complement its "Paced Transition Plan."[19] These outline key priorities and milestones for the coming year to support market participants preparing for transition.

The Incremental Objectives also described ongoing efforts by the ARRC to assess the appropriateness of fallback spread adjustment methodologies for cash products, to identify needed regulatory relief and tax and accounting requirements to promote the adoption of the ISDA protocol[20] and to explore potential options for seeking legislative relief to implement fallbacks for legacy products.

Accounting developments

The International Accounting Standards Board (IASB) is consulting on proposals regarding both the old and new financial instruments standards (IAS 39 and IFRS 9) in light of IBOR reform.[21] The issue arises because the uncertainty affects the ability to make the forward-looking assessments necessary to apply hedge accounting. The proposals would provide relief from rules that could otherwise lead to its discontinuation. The IASB recently published an exposure draft on interest rate benchmark reform, which addresses certain hedge accounting issues in the period leading up to the replacement of an existing interest rate benchmark.[22] The IASB will in the future assess the potential implications of reform when more information is available about the replacement benchmarks.

In July, the Euro Working Group wrote a letter to the IASB requesting clarification and relief on several accounting issues relating to the replacement of EONIA with €STR.[23]

The US financial accounting standards board (FASB) has a project under way to address the accounting implications relating to LIBOR discontinuation.[24] In June and July, FASB announced "tentative" decisions (subject to further development, and the completion of the FASB rule-making process) for relief on contract modification and hedge accounting issues arising from interest rate benchmark transition.[25] In addition, FASB issued an Accounting Standards Update that allows for the OIS rate based on SOFR to be designated as a benchmark interest rate for hedge accounting purposes.[26]

Reforms to ICE LIBOR

The IBA has completed several steps to reform LIBOR, consistent with plans it had previously announced.[27] Since the mid-1990s, LIBOR panel banks had been asked to base their submissions in response to a well-known question: "At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11 am?"

In 2018, the IBA commenced a transition whereby LIBOR panel banks were asked to make submissions based on a revised Waterfall Methodology, in accordance with the ICE LIBOR Output Statement.[28] On 1 April 2019, the IBA announced that it had completed the transition of all LIBOR panel banks to making submissions in accordance with the ICE LIBOR Output Statement.

Under the ICE LIBOR Output Statement, LIBOR panel banks now base their submissions on a standardized, transaction data-driven waterfall methodology which looks at eligible wholesale, unsecured funding transactions. The waterfall has three levels. The first level considers the volume weighted average price (VWAP) of transactions in unsecured deposits and primary issuances of commercial paper and certificates of deposit with eligible counterparties. The second level looks to derive pricing information from other transaction data, including time-weighted historical transactions adjusted for market movements and linear interpolation. The third level involves the use of expert judgment.

The IBA also conducted a survey on the use of LIBOR in December 2018. The survey was designed to identify the LIBOR settings that are most widely used. The survey closed in February 2019.[29] The IBA currently intends to work with globally active banks to seek to publish certain LIBOR settings after year-end 2021. The IBA has stated that its primary goal in this connection is to "provide these settings to users with outstanding LIBOR-linked contracts that are impossible or impractical to modify."

The IBA recognizes that any such post-2021 LIBOR would need to comply with the BMR and IOSCO guidelines, and has cautioned that market participants should not count on any such rate being developed.[30]

[18] Available here.
[19] ARRC, 2019 Incremental Objectives, June 2019.
[20] See, e.g., 13 May 2019 letter from the ARRC to J. Christopher Giancarlo, Chairman of the US Commodity Futures Trading Commission regarding treatment of derivatives contracts referencing alternative risk-free rates; 8 April 2019 letter from the ARRC to the US Department of the Treasury and the US Internal Revenue Service requesting guidance on US federal income tax issues relating to the transition from IBORs to RFRs; and this 6 June 2019 document submitted by the ARRC to the US Department of the Treasury with proposals to address certain tax concerns.
[21] News Release, IASB proposes targeted amendments to IFRS Standards in response to IBOR reform, 3 May 2019.
[22] See https://www.ifrs.org/-/media/project/ibor-reform/ed-ibor-reform-may-19.pdf.
[23] Available here.
[24] See https://fasb.org/jsp/FASB/FASBContent_C/ProjectUpdateExpandPage&cid=1176171426463.
[25] See here.
[26] FASB Accounting Standards Update 2018-16, Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes (available here).
[27] See, e.g., Roadmap for ICE LIBOR dated 18 March, 2016 and updated pursuant to the Evolution of ICE LIBOR – Feedback Statement On Additional Consultation dated 3 March 2017.
[28] Available here.
[29] The results of the survey are available here.
[30] "Notwithstanding the results of the survey and IBA's work, there is no guarantee that any LIBOR settings will continue to be published after year-end 2021. Users of LIBOR should not rely on the continued publication of any LIBOR settings when developing transition or fall back plans." See IBA survey results, supra.

Developments in EMEA

Loans

The London loan market is currently working to establish how exactly each relevant RFR will work in the context of term loans and loan transactions more generally, including from the banks' operations perspective. The working groups have done a lot of work, although a permanent, market-wide solution has yet to be identified. It should be noted that, recently, NatWest announced that it is piloting a new SONIA-based loan product with a limited number of its large corporate customers and that the first such loan (believed to be the first such product in the market) has been delivered to National Express Group PLC.

Currently, the London market generally follows the amendment approach recommended by the LMA. In December 2018, the LMA published its Recommended Revised Form of Replacement Screen Rate Clause, which allows greater flexibility to make amendments to loan documentation with a lower consent level than would otherwise be required upon the occurrence of a trigger event – a "Screen Rate Replacement Event." The London loan market has generally accepted the language recommended by the LMA, although we are seeing alternative language being proposed by the parties to loan documentation, as well as discussions between lenders and borrowers around who should bear the cost of the amendment and the lender consent threshold where LMA wording is used.

In respect of the euro zone, we discuss developments on the transition from EONIA to €STR and the recommendations of the euro working group on RFRs (Euro Working Group). As for its recommendation that new cash contracts and instruments maturing after December 2021 should include fallback provisions, as regards loans, the view has been expressed that fallback provisions should be the LMA provisions.[31] The Euro Working Group considers it likely that such wording will be available in the near future and has recommended that the market consider using the standard market documentation when developed by the LMA for syndicated loans.

FRNs

In May 2019, the Sterling Working Group stated "sterling-denominated financial markets have begun to shift decisively away from LIBOR and towards SONIA." In June 2019, the Bank of England called "last orders" on sterling LIBOR. In his speech, Dave Ramsden, Deputy Governor for Markets and Banking said "risk free rate transition is a core part of the Bank's strategic goal to catalyse reforms in financial markets to make them fairer and more effective".[32]

As noted above, certain FRN issuers and investors in EMEA have taken to RFR originations. The Sterling Working Group noted in May that "SONIA-linked Floating Rate Notes (FRNs) have rapidly become the market norm, with around £25bn issued since June last year, and LIBOR-linked sterling FRN issuance beyond 2021 has all but ceased."[33]

In a landmark transaction, Associated British Ports was able to convert legacy FRNs maturing in 2022 from LIBOR to SONIA by obtaining requisite noteholder consent.

While transition momentum is certainly building in the FRN market, with the more established RFRs posting strong growth figures against their traditional IBOR counterparts, there remains much still to do to convince market participants to commit fully to a transition to RFRs.

Securitization

The Sterling Working Group noted that, following a number of retained SONIA linked securitization transactions, a distributed SONIA-linked Residential Mortgage-Backed Security (RMBS) had been issued.[34] Since that transaction (a transaction from Nationwide's Silverstone master trust structure) there have been a number of SONIA linked securitizations across various asset classes. These have tended to use a daily compounded SONIA rate with a 5 day time lag. A number of the UK RMBS master trust issuers (e.g. Lloyds and Santander) have amended their base prospectuses to allow for SONIA issuance. New issuance documents are often building in wording to allow for amendments to benchmark rates based on the AFME model wording.

Insurers

The Sterling Working Group has welcomed a decision by the European Insurance and Occupational Pensions Authority (EIOPA), one of the EU's three supervisory authorities, to add the monitoring of LIBOR transition to their general work on insurance risk-free rates. However, it has called on EIOPA to go further and provide more clarity to European insurers on the timescale for change. Perversely, current regulations in Solvency II impede change by requiring EU insurers to value liabilities using "risk-free" discount rates derived from LIBOR and other IBORs.

The Sterling Working Group has identified additional issues. The discontinuance of LIBOR at year-end 2021, and the resulting change of benchmark from which to derive "risk free" discount rates will have an effect on the value of insurers' liabilities requiring "recalibrations" of investments and hedging instruments. Secondly, as a wider point, "risk free" discount rates derived from alternative risk-free rates (e.g., SOFR, €STR and SONIA) will render inappropriate the credit risk adjustment currently required under Solvency II.[35]

SONIA

The Sterling Working Group plans a consultation on credit adjustment spread for the cash markets in Q4 2019.

[31] Third Public Consultation on the EONIA to €STR Legal Action Plan, Summary of Responses, June 2019. The Euro Working Group also noted that it had provided suggestions for two alternative fallback provisions for new cash products in Annex 1 of the Third Public Consultation on the EONIA to €STR Legal Action Plan dated 15 May 2019.

[32] See https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/last-orders-calling-time-on-libor-speech-by-dave-ramsden.pdf?la=en&hash=33494FD6C505C800B7FB535A766A7B9B247BD0AE.

[33] Statement on behalf of the Working Group on Sterling Risk-Free Reference Rates Progress on adoption of risk-free rates in sterling markets 15 May 2019.

[34] Statement on behalf of the Working Group on Sterling Risk-Free Reference Rates Progress on adoption of risk-free rates in sterling markets 15 May 2019.

[35] Letter, Sterling Working Group to EIOPA, 9 July 2019.

Developments in EMEA

€STR and EONIA

In September 2018, the Euro Working Group recommended €STR as the new euro risk-free rate to replace EONIA. There was also concern over whether there would be sufficient time to develop liquidity in €STR, prior to the 2020 deadline under the BMR — when EONIA will likely be judged non-compliant. Specifically, there were fears of valuation issues in derivatives markets (e.g., overnight index swaps). Last September, the Euro Working Group, which is supported by the ECB, asked the European Commission for an extension of time. As referred to above, amendments to be made to the BMR will allow critical benchmarks to be used for both existing and new contracts until 31 December 2021.[36] In the absence of this legislative change, EONIA's national supervisor, the Belgian Financial Services and Markets Authority, could only have permitted its use for existing contracts.

On 14 March 2019, the Euro Working Group recommended modifying EONIA's methodology to become €STR plus a fixed spread of 8.5 basis points from the date €STR is first published on 2 October 2019 until 3 January 2022. The Euro Working Group is of the view that a fixed EONIA-€STR relationship provides a temporary stable platform to facilitate a smooth transition. Although EONIA would continue to represent the euro overnight unsecured market, it will draw on more representative and stable input data reflecting a higher volume of transactions.[37] This is consistent with the IOSCO Principles to anchor benchmark methodologies in transactions.

On 15 May 2019, the Euro Working Group began a consultation on its recommendation that market participants:

- Replace EONIA with €STR as a reference rate for all products and contracts; and
- Take all steps necessary to use €STR as their standard benchmark as soon as possible.

To the extent new contracts reference EONIA, these should include "robust" fallback provisions and acknowledge that, from 2 October 2019, EONIA's methodology will be modified. As for existing contracts that reference EONIA and mature after December 2021, EONIA should be replaced as soon as possible or robust fallback clauses added. The Euro Working Group has recommended €STR plus the 8.5 basis point spread as the EONIA fallback rate. The consultation closed on 12 June 2019 and the ECB published a summary of responses on 27 June that were largely supportive of the proposals.[38] After consultation, on 16 July 2019, the Euro Working Group confirmed its recommendation on the replacement of EONIA with €STR as soon as possible and with respect to fallback provisions.[39]

As part of the transition, from 2 October until 3 January 2022, EONIA will continue to be published (at T+1), but calculated as €STR plus a fixed spread of 8.5 basis points. Under its legal action plan, after consultation, on 16 July 2019 the Euro Working Group recommended replacing EONIA with €STR as soon as possible. Further, new contracts that reference EONIA should have robust fallback provisions and acknowledge the change to its methodology. In the case of existing contracts that reference EONIA and mature after December 2021, the market should either replace EONIA as soon as possible or embed robust fallback clauses referencing the recommended fallback rate (i.e., €STR plus a fixed spread). The Euro Working Group also considers that, for new OTC derivative transactions using the 2006 ISDA Definitions, the ISDA Benchmarks Supplement offers a convenient means to implement its recommendations.

On 26 July 2019, the ECB published a guideline[40] governing €STR and establishing the ECB's responsibility for its administration and oversight of the €STR determination process. This guideline sets out the responsibilities of the ECB and national central banks with respect to their contribution to the €STR determination process and contains provisions for €STR's methodology and cessation.

[36] Low Carbon Benchmarks Regulation, Provisional Text, 26 March 2019.
[37] Report by the Working Group on Euro Risk-free Rates on the Transition from EONIA to €STR, Revised March 2019.
[38] See here.
[39] Recommendations of the Working Group on Euro Risk-free Rates on the EONIA Legal Action Plan, 16 July 2019.
[40] Available here.

Developments in Switzerland

The NWG has recommended the use of the Swiss Average Rate Overnight (SARON) as an alternative to LIBOR. SARON was established in 2009 together with the Swiss National Bank and is administered by the Swiss Market Exchange.

SARON was established in 2009 together with the Swiss National Bank and is administered by the Swiss Market Exchange. SARON is an overnight interest rate representing the secured funding market for the Swiss franc. In contrast to LIBOR, SARON is based on actual transactions and represents the market's most liquid segment. With a transparent calculation methodology and clear governance structures, it is a robust and representative benchmark and as a compounded indicator, it is less volatile and relatively predictable.

The NWG has put forward a variety of uses for SARON by market players and recommends that new transactions use SARON to enable a gradual transition away from LIBOR. Besides the work of the NWG, the Swiss Financial Market Authority (FINMA) is monitoring risks associated with transition and providing guidance to the market.

On 13 June 2019, the NWG presented discussion papers on SARON FRNs[41] and on the effects of the IBOR transition on hedge accounting.[42] The discussion paper on SARON FRNs includes preferred interest rate provisions, which implement a lookback period, and sample fallback language.

For other LIBOR related legal developments in Switzerland, see our alert in relation to the Swiss Federal Supreme Court's landmark decision on negative interest in loan agreements.

[41] Available here
[42] Available here

Developments in the US

ARRC recommended fallbacks

In the US, the ARRC finalized its recommended contractual fallback language for US dollar LIBOR in syndicated loans, FRNs, securitizations and bilateral loans.[43.] These recommendations followed consultations undertaken by the ARRC beginning in 2018.

The ARRC fallback recommendations contain differences between asset classes. The ARRC stated that it had attempted to minimize such differences, but it recognized that "different cash products can have idiosyncratic features that in some cases warrant different treatment."[44.]

The recommendations for syndicated loans and bilateral loans each offer two alternative approaches: (i) an "amendment approach," which would provide a mechanism for borrowers and lenders to negotiate and implement a replacement benchmark rate by means of an amendment to the credit facility in the future; and (ii) a "hardwired approach," which would implement a replacement benchmark without the need for a future amendment to the loan documents, based on triggers, terms and conditions agreed to upfront. The amendment approaches seek to take advantage of the fact that loans are relatively easier to amend than other types of debt instruments.

The recommendations for FRNs and securitizations do not offer an amendment approach, and are instead conceptually similar to the hardwired approaches for loans.

[43.] See ARRC recommendations regarding more robust fallback language for new originations of LIBOR syndicated loans, ARRC recommendations regarding more robust fallback language for new issuances of LIBOR floating rate notes, ARRC recommendations regarding more robust fallback language for new issuances of LIBOR securitizations and ARRC recommendations regarding more robust fallback language for new originations of LIBOR bilateral business loans.

[44.] See ARRC recommendations regarding more robust fallback language for new originations of LIBOR syndicated loans, Part V.

ARRC recommended fallbacks; amendment approach for loans

The amendment approach for syndicated loans provides that, upon the occurrence of a trigger event, the administrative agent and the borrower may amend the credit agreement to replace LIBOR with a replacement interest rate benchmark.

The trigger events for the amendment approach for loans include, in addition to LIBOR cessation triggers similar to those in the recommended ISDA fallback language, a pre-cessation trigger in the event that the regulatory supervisor for the administrator of LIBOR makes a public statement or publication of information announcing that LIBOR[45.] is no longer representative.

The user's guide to the ARRC recommended provisions for syndicated loans also suggests a possible fourth pre-cessation trigger. This trigger, which does not appear in the ARRC recommended provisions themselves, was suggested for consideration by administrative agents due to the unique role of the administrative agent in a syndicated loan. This suggested trigger would "allow for a transition away from LIBOR in the highly unlikely event that there is a public statement by any governmental authority having jurisdiction over the administrative agent announcing that LIBOR is no longer representative or may no longer be used by the administrative agent."[46.]

Any such amendment would become effective unless objected to by the required lenders within five business days.

Each of the amendment approaches for syndicated loans and bilateral loans also includes an "early opt-in election," which would trigger the amendment process based on an election by the administrative agent or the required lenders (or the lender, in the case of bilateral loans) to effect a LIBOR replacement (following a determination that there are US dollar-denominated credit facilities being executed or amended at such time to incorporate or adopt a new benchmark interest rate to replace LIBOR).

The amendment approach for bilateral loans is similar to that for syndicated loans, with the following material difference: the lender may effect the amendment unilaterally, and if the borrower does not object within a specified period after the lender proposes the amendment to the borrower, the amendment will be effective without the borrower's consent.

If a trigger event occurs, LIBOR will cease to be available as an interest rate option, and the borrower will be limited to loans priced at the US base rate until an amendment replacing LIBOR becomes effective.

[45.] We note that the ARRC recommended provisions refer to "Benchmarks," and initially refer to LIBOR, but refer also to replacements of LIBOR. These provisions are intended to be "future-proofed."

[46.] See ARRC recommendations regarding more robust fallback language for new originations of LIBOR syndicated loans, Part III.A.

Developments in the US

ARRC recommended fallbacks; hardwired approach for loans and recommended fallbacks for FRNs and securitizations; waterfalls to determine replacement interest rate

The hardwired approaches for syndicated loans and bilateral loans involve the use of waterfall provisions to determine both the replacement interest rate and a spread adjustment, in each case following the occurrence of a trigger event. The hardwired approaches for loans are conceptually similar to the fallback provisions recommended by the ARRC for FRNs and securitizations.

The trigger events for the hardwired approaches for loans and for FRNs and securitizations each include, in addition to LIBOR cessation triggers similar to those in the recommended ISDA language, a pre-cessation trigger in the event that the regulatory supervisor for the administrator of LIBOR makes a public statement or publication of information announcing that LIBOR is no longer representative. In the case of securitizations, the trigger events also include an optional pre-cessation trigger to address a possible increase in basis risk in the event that the securitized assets were to convert from LIBOR to an alternate interest rate.[47]

Each of the hardwired approaches for syndicated loans and bilateral loans also includes an "early opt-in election," which would trigger the rate replacement mechanism based on a joint election by the administrative agent, the required lenders and the borrower (or the sole determination of the lender, in the case of bilateral loans) to effect a LIBOR replacement (following a determination that there were at least [five][48] then-currently outstanding US dollar-denominated credit facilities that contained, in lieu of LIBOR, Term SOFR (defined below) plus a spread equivalent to the spread determined by the ARRC recommended language).

The fourth pre-cessation trigger suggested by the user's guide for the ARRC recommended provisions for syndicated loans is also relevant to the hardwired approach.

The first step in each recommended waterfall to determine the replacement interest rate is a forward-looking term SOFR (Term SOFR) that has been selected or recommended by a "Relevant Governmental Body" (meaning the Federal Reserve Board, the Federal Reserve Bank of New York, or a committee officially endorsed or convened by the Federal Reserve Board or the Federal Reserve Bank of New York (e.g., the ARRC)). This rate does not yet exist. Although the ARRC has stated that it intends to select such a rate in the future, it has cautioned that it will only do so if a consensus can be reached among its members that an IOSCO-compliant forward-looking term SOFR exists and meets appropriate criteria set by the ARRC.

The waterfalls for loans each contain a Step 1(b), which would apply in the event that Term SOFR could not be determined for a particular tenor. In such an event, Step 1(b) would refer to "Next Available Term SOFR," which is defined as the longest tenor that can be determined by the administrative agent or the lender that is shorter than the affected tenor.

The waterfalls for FRNs and securitizations provide that if some tenors of a benchmark (including a replacement for LIBOR) are not available, but both shorter and longer tenors remain available, then the transaction is to use an interpolated rate based on the nearest tenors that can be determined.

The second step in each interest rate waterfall is compounded SOFR, with an option to calculate SOFR on a simple average basis rather than on a compounded basis.[49]

Each of the compounded SOFR and the simple average SOFR for FRNs would be determined in arrears and would not be known at the beginning of the relevant interest period. The ARRC recommended language for syndicated loans, bilateral loans and securitizations indicates that compounded SOFR may be calculated either in advance or in arrears, leaving the choice up to the parties. The definitions of compounded SOFR and simple average SOFR all contemplate lookback or suspension periods for calculations in arrears.

The ARRC recommended fallback language for securitizations includes optional language if the replacement rate is determined pursuant to Step 2 (i.e., if the waterfall settles at compounded SOFR or simple average SOFR). Under this optional language, the waterfall would be retested at regular periodic intervals to see if Term SOFR were then available, and if it were, such rate would replace compounded SOFR or simple average SOFR thereafter.[50]

The third (and final) step in the waterfall for syndicated loans is the alternate rate of interest that has been selected by the administrative agent and the borrower as the replacement for LIBOR for the applicable tenor, "giving due consideration to (i) any selection or recommendation of a replacement rate or the mechanism for determining such a rate by the Relevant Governmental Body at such time or (ii) any evolving or then-prevailing market convention for determining a rate of interest as a replacement for the then-current Benchmark for U.S. dollar-denominated syndicated credit facilities at such time."

The third (and final) step in the waterfall for bilateral loans is similar, except the rate is one selected by the lender (not the borrower) and the "due consideration" language is in brackets.

The third step in the waterfalls for FRNs and securitizations is a rate selected by a Relevant Governmental Body. These third steps are designed to apply in the context of the longer maturities of FRNs and securitizations in the event that a SOFR-based rate (after it has been effected) is discontinued and the benchmark replacement cannot be determined on the basis of a SOFR-linked replacement rate as provided in the first two steps of the waterfall. This language is intended to mirror the first fallback for SOFR embedded in the ISDA definitions. The rationale is that if a SOFR-based rate is discontinued, a committee similar to the ARRC may be formed to recommend a replacement for such rate.

The fourth step in the waterfalls for FRNs and securitizations is the "ISDA Fallback Rate," which is defined as the applicable fallback rate (without any spread adjustment) that is embedded in the ISDA definitions in effect at the time. Such rate is currently embedded in the ISDA definition of "USD-SOFR-COMPOUND."[51]

The interest rate waterfall for FRNs concludes with a fifth step that allows the issuer or its designee to select a replacement rate, which selection must give "due consideration to any industry-accepted rate of interest as a replacement for the then-current Benchmark for U.S. dollar denominated floating rate notes at such time."

The interest rate waterfall for securitizations continues with an optional fifth (and final) step that allows the Designated Transaction Representative for the securitization to select a replacement rate, which selection must give "due consideration to any industry-accepted rate of interest as a replacement for the then-current Benchmark for U.S. dollar denominated securitizations at such time." The ARRC noted that due to the disparate nature of the asset classes that are securitized, any particular language "may necessarily need to vary from asset class to asset class, or within a particular asset class."[52]

[47] This trigger would occur if the "Asset Replacement Percentage" of the securitized assets is greater than a to-be-agreed percentage, as reported in the most recent servicer report. "Asset Replacement Percentage" is defined to refer to the ratio that the outstanding principal balance of the securitized assets that are indexed to a replacement for LIBOR (or other corresponding benchmark) bears to the total outstanding principal balance of the securitized assets.

[48] The recommended language leaves this threshold to negotiation between the parties.

[49] The ARRC published a User's Guide to SOFR in April 2019, which among other things discusses the technical differences between simple average and compounded SOFR.

[50] The ARRC noted that, in deciding whether to require this periodic retesting, the parties might need to consider the effect such provision might have on the ability for investors to hedge the issued securities and other potential operational impacts, such as the administrative difficulty involved with such retesting.

[51] Available here.

[52] See ARRC recommendations regarding more robust fallback language for new issuances of LIBOR securitizations at n. 7.

Developments in the US

The ARRC noted that the primary fallback rate contained in its waterfalls — Term SOFR — would diverge from the primary fallback rate effected by the ISDA standard definitions. The ARRC stated that it wished "to make it clear that choosing to fall back to a compound average of SOFR in cash products would in no way be in conflict with its recommendations. Any choice to remove references to term SOFR and the related ARRC-recommended spread adjustment should be viewed as fully aligned with the ARRC's principles and recommendations."[53]

A comparison of the replacement interest rate waterfalls for the hardwired approaches for syndicated and bilateral loans and for floating rate notes and securitizations is set forth below.

[53] See ARRC recommendations regarding more robust fallback language for new originations of LIBOR syndicated loans, Part V.

	Syndicated loans	Bilateral loans	FRNs	Securitizations
Step 1	Term SOFR + Adjustment (Step 1a) if Term SOFR for the applicable Corresponding Tenor cannot be determined, Next Available Term SOFR + Adjustment (Step 1b)	Term SOFR + Adjustment (Step 1a) if Term SOFR for the applicable Corresponding Tenor cannot be determined, Next Available Term SOFR + Adjustment (Step 1b)	Term SOFR + Adjustment	Term SOFR + Adjustment
Step 2	Compounded SOFR + Adjustment/ Simple Average SOFR + Adjustment	Compounded SOFR + Adjustment/ Simple Average SOFR + Adjustment	Compounded SOFR + Adjustment/ Simple Average SOFR + Adjustment	Compounded SOFR + Adjustment/ Simple Average SOFR + Adjustment (Provides for optional periodic retesting if the replacement rate is determined pursuant to this step)
Step 3	Agent and Borrower (giving due consideration to recommendation by Relevant Governmental Body and market convention) + Adjustment	Rate selected by Lender (giving due consideration to recommendation by Relevant Governmental Body and market convention) + Adjustment	Rate selected by Relevant Governmental Body as replacement + Adjustment	Rate selected by Relevant Governmental Body as replacement + Adjustment
Step 4			ISDA fallback rate + Adjustment	ISDA fallback rate + Adjustment
Step 5			Issuer or designee selected rate (giving due consideration to any industry-accepted rate) + Adjustment	**Optional**: Rate selected by Designated Transaction Representative (giving due consideration to any industry-accepted rate) + Adjustment

Developments in the US

ARRC recommended fallbacks; hardwired approach for loans and recommended fallbacks for FRNs and securitizations; waterfalls to determine spread adjustment

The first step in each recommended waterfall to determine the spread adjustment is the spread adjustment, or method for calculating or determining such spread adjustment, that the Relevant Governmental Body has selected, endorsed or recommended for the interest rate selected by the interest rate waterfall. This spread adjustment does not yet exist. The ARRC has stated that it currently intends to recommend a spread adjustment or methodology. The ARRC has said it would conduct a separate market consultation on the spread adjustment.

The second step in each recommended waterfall to determine the spread adjustment is the "ISDA Fallback Adjustment," which is defined as the spread adjustment that would apply for derivatives transactions referencing the ISDA Definitions to be determined for the applicable tenor. While ISDA is working on the development of such adjustments, they do not currently exist.

The recommendations differ by asset class as to how this adjustment is to be applied. In the fallback recommendations for FRNs and securitizations, the ISDA Fallback Adjustment would apply only if the fallback interest rate determined by the interest rate waterfall was the ISDA Fallback Rate (i.e., Step 4 of such interest rate waterfalls). In the fallback recommendations for syndicated loans and bilateral loans, the ISDA Fallback Adjustment would be used if the rate determined by the interest rate waterfall were determined pursuant to either Step 1 or Step 2 of such waterfall (i.e., Term SOFR, Next Available Term SOFR or Compounded/Simple Average SOFR). We note that the interest rate waterfalls for loans do not include a step equivalent to Step 4 of the interest rate waterfalls for FRNs and securitizations (the ISDA Fallback Rate).

The third (and final) step in the spread adjustment waterfall for syndicated loans is the spread adjustment, or method for calculating or determining a spread adjustment, that has been selected by the administrative agent and the borrower for the applicable tenor, giving due consideration to (i) any selection or recommendation of a spread adjustment, or method for calculating or determining a spread adjustment, for the replacement of the benchmark with a new benchmark by the Relevant Governmental Body at such time or (ii) any evolving or then-prevailing market convention for determining a spread adjustment, or method for calculating or determining a spread adjustment, for the replacement of the benchmark with the new benchmark for US dollar-denominated syndicated credit facilities at such time.

The third (and final) step in the waterfall for bilateral loans is similar, except the spread adjustment is one selected by the lender (not the borrower) and the "due consideration" language is in brackets.

The third (and final step) in the spread adjustment waterfall for FRNs is the spread adjustment that has been selected by the issuer or its designee giving due consideration to any industry-accepted spread adjustment, or method for calculating or determining a spread adjustment, for the replacement of the benchmark with the new benchmark for US dollar-denominated FRNs at such time.

The third (and final step) in the spread adjustment waterfall for securitizations is the spread adjustment that has been selected by the Designated Transaction Representative giving due consideration to any industry-accepted spread adjustment, or method for calculating or determining a spread adjustment, for the replacement of the benchmark with the new benchmark for US dollar-denominated securitization transactions at such time.

The ARRC noted that parties to a transaction might view this additional responsibility as too burdensome to justify its inclusion. The ARRC also noted that this provision might also need to be revised to comply with any specific regulatory or tax considerations that might be applicable to a particular transaction.

A comparison of the spread adjustment waterfalls for the hardwired approaches for syndicated and bilateral loans, and for FRNs and securitizations, is set forth below.

	Syndicated loans	Bilateral loans	FRNs	Securitizations
Step 1	ARRC selected adjustment	ARRC selected adjustment	ARRC selected adjustment	ARRC selected adjustment
Step 2	ISDA fallback adjustment (to apply if replacement rate is Term SOFR, Next Available Term SOFR or Compounded/Simple Average SOFR)	ISDA fallback adjustment (to apply if replacement rate is Term SOFR, Next Available Term SOFR or Compounded/ Simple Average SOFR)	ISDA fallback adjustment (to apply only if replacement rate is the ISDA Fallback Rate)	ISDA fallback adjustment (to apply only if replacement rate is the ISDA Fallback Rate)
Step 3	Adjustment selected by Agent and Borrower (giving due consideration to recommendation by Relevant Governmental Body and market convention	Adjustment selected by Lender (giving due consideration to recommendation by Relevant Governmental Body and market convention)	Adjustment selected by issuer or its designee (giving due consideration to any industry-accepted spread adjustment (or method for calculating a spread adjustment))	Adjustment selected by Designated Transaction Representative (giving due consideration to any industry-accepted spread adjustment (or method for calculating a spread adjustment))

Developments in the US

ARRC recommended fallbacks: hedged loan approach for bilateral loans

The ARRC bilateral loans recommendation contains recommended fallback provisions that would align the loan with the fallbacks contained in an interest rate hedge that was tied to the loan. This will minimize the likelihood of a mismatch, but the ability to take advantage of such language will depend on running a hedge that matched the loan. It would be more complicated to use in the case of partially hedged loans.

Benchmark Replacement Conforming Changes

Each set of the ARRC's recommended fallback provisions permits the underlying documents to be amended to effect "Benchmark Replacement Conforming Changes," which refer to technical, administrative or operational changes that may be needed to implement the transition to a benchmark replacement. These changes may include changes to the definition of "Interest Period," the timing and frequency of determining rates and making payments of interest. These changes may be effected unilaterally by the administrative agent or the lender in the fallback provisions for loans, by the issuer (or its designee) in the fallback provisions for FRNs or by the Designated Transaction Representative in the fallback provisions for securitizations.

Pre-cessation trigger

As noted above, all the ARRC recommendations include a pre-cessation trigger in addition to the two index cessation triggers currently recommended by ISDA. As noted elsewhere in this paper, ISDA has launched a consultation on whether to include this pre-cessation trigger in the contemplated amendments to the 2006 ISDA Definitions. The ARRC recognizes that the results of ISDA's consultation on the inclusion of a pre-cessation trigger are not known at this time, and that it is not certain that ISDA will ultimately include a pre-cessation trigger in its standard definitions. The ARRC cautions that, if ISDA does not include such a trigger, a party seeking to effectively hedge its LIBOR-based exposure may need to take additional steps to cause its LIBOR-linked hedges to reference the benchmark replacement.

Adoption of ARRC recommended fallbacks

The ARRC recommended fallbacks are voluntary and adoption will depend on parties agreeing to include them in transactions. It remains to be seen how well they will be adopted or whether the markets will explore other alternatives. However, soon after the ARRC published its recommended fallback provisions for FRNs, JPMorgan included them in documentation for an FRN offering.[54] Similarly, soon after the ARRC published its recommended fallback provisions for securitizations, Ford Motor Credit Company included them in documentation for a securitization.[55] We have seen several syndicated loans include the ARRC's amendment approach.

In the syndicated loan markets to date, most LIBOR fallbacks have followed an amendment approach (although not necessarily the ARRC recommended provisions) as opposed to a hardwired approach. It is probably too early to tell whether the ARRC recommended provisions will be accepted by market participants.

[54] See here.
[55] See here.

Developments in the US

Forward-looking term rates

The replacement interest rate waterfalls in the ARRC fallback provisions for FRNs and securitizations, and in the hardwired approaches for syndicated loans and bilateral loans, all refer, as their first steps, to a Term SOFR, which refers to a forward-looking term rate based on SOFR that has been selected or recommended by the ARRC. As noted, above, this rate does not yet exist. While such a rate may be optimal for participants in the cash markets, the ARRC does not recommend that such participants wait until a Term SOFR exists to begin using SOFR in cash products.

The ARRC has stated that it intends to select a forward-looking term SOFR for use as a fallback rate in cash products, provided that a consensus can be reached among its members that an IOSCO-compliant benchmark exists and meets appropriate criteria set by the ARRC. However, it has also stated that it is not certain that such a forward-looking term benchmark will be produced prior to the discontinuation of LIBOR.

In April 2019, the ARRC published "A User's Guide to SOFR." In that guide, the ARRC described ongoing efforts to develop a forward-looking term rate based on SOFR. The ARRC has proposed that a private administrator might be able to construct an IOSCO-compliant forward-looking term rate based on SOFR derivatives markets after those markets develop enough liquidity. Under the ARRC's proposal, a forward-looking term rate would be based on some combination of SOFR futures and SOFR OIS transactions. The ARRC has not recommended a specific methodology for producing such rate.

The ARRC noted that "[b]ecause SOFR derivative markets have developed quickly and are expected to achieve a very high degree of liquidity, it is reasonable to expect that these markets will be sufficiently liquid and robust to construct a forward-looking term rate, but the timing cannot be guaranteed."

Other US developments

In July, the staff of the US Securities Exchange Commission (SEC) issued a Statement on LIBOR Transition.[54] Such statement discusses how the discontinuation of LIBOR may affect market participants (including registrants of US securities) and provides staff guidance on how market participants might respond to this risk.

The ARRC launched a consumer products working group, which includes the US Consumer Financial Protection Bureau (CFPB). The ARRC intends to consult on contractual LIBOR fallbacks for consumer products and examine the applications and uses of SOFR in consumer products. The ARRC Consultation regarding more robust LIBOR fallback contract language for new closed-end, residential adjustable rate mortgages was published on 12 July.[57] Relatedly, on 11 July, both Fannie Mae and Freddie Mac in the US announced plans to develop new adjustable rate mortgage products that will refer to SOFR instead of LIBOR.[58]

To date, there has been relatively limited demand (in terms of aggregate notional amount) for USD IRD in SOFR. For example, according to ISDA, the aggregate notional amount of SOFR IRD for YTD as of 31 May was $90.3 billion, while the aggregate notional of USD LIBOR IRD for the same period was $55 trillion. The aggregate notional amount of SONIA IRD for the same period was $2.8 trillion.

[56] See here. The statement was issued jointly by the SEC's Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets and Office of the Chief Accountant.
[57] Available here: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-ARM-consultation.pdf.
[58] See Statement on the Alternative Reference Rates Committee's Secured Overnight Financing Rate (SOFR) Adjustable-Rate Mortgage Framework from Nadine Bates, SVP and Treasurer, Fannie Mae and Freddie Mac Statement in Support of Transition to Secured Overnight Financing Rate for Single-Family Adjustable Rate Mortgages.

Developments in Asia Pacific

The Asia Pacific Loan Market Association (APLMA) formed a LIBOR Working Group and participated in the LIBOR Trade Association Working Party Meeting in March 2019. The APLMA noted that there has not been much progress in terms of new developments more widely as there is still no suitable alternative to LIBOR for the syndicated loan markets.

The APLMA published a note on LIBOR Reform in March 2019 and strongly encouraged financial institution members to consider including provisions in loan agreements that make it easier to transition to a new reference rate in the future. The note also reminds market participants that making amendments easier in future is not a solution in itself to the benchmark reform issue, since lender consent may be difficult to obtain and any amendment process can only be undertaken once there is clarity on the replacement benchmark (and any spread adjustment involved). It also strongly encourages financial institution members to be involved in the consultation processes and in engagement with local regulators given the significant implications of (L)IBOR transition.

APLMA template loan agreements currently contain an optional Replacement of Screen Rate provision that allows agreements to be amended by majority lender and borrower consent. This provision is triggered only when a Screen Rate is no longer available and only provides for amendments that provide for another benchmark rate to apply.

A footnote was added in August 2018 to the Replacement of Screen Rate provision with reference to the Recommended Revised Form of Replacement Screen Rate Clause and Users Guide published by the LMA. The APLMA suggests that if market participants would like to provide for a wider range of circumstances than the APLMA Replacement of Screen Rate provision, they can refer to the revised LMA Replacement Screen Rate clause.

Our colleagues in Asia observe that lenders are continuing to deliberate over the most appropriate form of screen rate replacement provision to include as a starting position for their facilities. This is not a surprise to us given that the market is yet to determine and universally adopt a rate deemed by the market as most optimal or appropriate to replace LIBOR for loans. Helpfully, the LMA Replacement Screen Rate clause serves as the most current and most widely adopted formulation that is designed to deal with the (L)IBOR transition and, accordingly, both law firms and banks have been framing their discussions on replacement of screen rate provisions by reference to the LMA's formulation. Of course, aspects of the LMA Replacement Screen Rate clause are negotiable and are (at present) best considered on a case-by-case basis – for instance, this would include whether the "all lender" provision should override the replacement of the screen rate regime where a replacement of the screen rate would result in a reduction of interest payable and also whether a replacement of screen rate-specific lender disenfranchisement mechanic should be included.

Banks have also been focused on the merits of including the optional language relating to Screen Rate Replacement Events, which require that at least one of a certain list of events must have occurred to enable the parties to use the replacement of screen rate regime. Given that an announcement of the phase-out of (L)IBOR is one of the enumerated Screen Rate Replacement Events, the view taken by our colleagues in Singapore is that such optional language does not have much utility, as a Screen Rate Replacement Event would have already taken to have occurred at the point of entry into the new loan documentation.

The Australian Securities and Investments Commission (ASIC) have issued their own Dear CEO letter in May 2019 to gauge the level of preparation for the transition.[59.]

ASIC expects significant financial institutions to undertake what it describes as a comprehensive, yet proportionate risk assessment of the potential impact.

Regulators in Australia have adopted a multi-rate approach. Market participants are encouraged to adopt an RFR, the overnight cash rate, for certain products. However, the methodology of the existing IBOR, the Bank Bill Swap Rate (BBSW), has been revised to make it more transaction based. It is expected that BBSW will continue to be used – in particular for derivatives and corporate loans.

On 29 July, the EU issued decisions recognizing the Australian[60.] and Singaporean[61.] regulatory regimes applicable to financial benchmarks as equivalent to the requirements under the BMR. This means that benchmarks such as BBSW and SOR subject to those regimes can continue to be used in the EU after 1 January 2022.

Reserve Bank of Australia Deputy Governor Guy Debelle gave a Keynote speech[62.] at the ISDA annual general meeting in April 2019, in which he noted that both BBSW and the overnight cash rate are supported by underlying markets with enough transactions to calculate robust benchmarks, and will co-exist in Australia under the multi-rate approach. However as other markets transition from referencing LIBOR to RFRs, there may be some corresponding migration away from BBSW towards the cash rate. This will depend on how international markets for products such as cross-currency basis swaps end up transitioning away from LIBOR.

[59.] ASIC Announcement dated 9 May 2019.
[60.] See here.
[61.] See here.
[62.] Available here.

Developments in Japan

The Bank of Japan established the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks (BOJ Committee) in 2018. The BOJ Committee has subgroups for loans, bonds and the development of term reference rates.

ISDA Japan also has a JPY Benchmark Working Group, which is discussing fallbacks for derivatives in line with the discussion under the recent consultation paper announced by ISDA globally.

In July, the BOJ Committee commenced its "Public Consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks."[63] The deadline for submissions is 30 September 2019. Based on the responses to this consultation, the BOJ Committee plans to publish the outcome of the consultation around fall 2019. This consultation seeks input from market participants on alternative benchmarks to JPY LIBOR and on contractual fallbacks.

One special issue in Japan is that the Bank of Japan and the FSA confirmed that TIBOR (which had been reformed in 2017) would survive even after 2021. The consultation also seeks input on the appropriate use of interest rate benchmarks in Japan's multiple interest rate benchmark environment.

Currently, TIBOR's administrator (JBA TIBOR Administration) is publishing Japanese Yen TIBOR and Euroyen TIBOR. However, JBA TIBOR Administration announced that it is considering the integration of Japanese Yen TIBOR and Euroyen TIBOR by retaining Japanese Yen TIBOR and discontinuing Euroyen TIBOR. Accordingly, market participants should consider contractual fallbacks for Euroyen TIBOR in addition to Yen LIBOR.

At a meeting of the Accounting Standards Board of Japan in March 2019, the Chair of the Standards Advisory Council proposed to address accounting issues arising from interest rate benchmark reform as a new agenda item.

[63] Available here. Appendix 5-a to the consultation, available here, contains the specific questions on which input is being sought.

Remaining challenges

Many challenges remain in connection with the probable discontinuation of LIBOR and the transition to replacement rates. It remains to be seen how the cash markets will adapt to a world without LIBOR, although there are some signs of certain cash products being priced in RFRs in some markets.

Contractual fallbacks continue to be developed. Market participants will need to be mindful of inconsistencies that may occur in fallback language, in particular when determining the alignment of fallbacks in transactions involving different asset classes. The expected publication by ISDA later this year of supplements to the 2006 ISDA Definitions to incorporate fallback triggers and term/spread adjustments is likely to act as a strong catalyst for market participants to finalize their own internal benchmark transition plans.

Market participants should also monitor how impediments to LIBOR transition—whether regulatory, tax, accounting or other—are identified and dealt with.

Perhaps most importantly, market participants should continue to watch how liquidity builds in the various RFRs and in forward curves in such RFRs.

Cross-market and cross-currency coordination among the official sector, working groups and market participants remains critically important. Baker McKenzie will continue to monitor and provide updates on the many separate workstreams addressing LIBOR transition now under way.

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