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LIBOR: when the going gets tough, the tough legacy contracts get going

In brief

In May 2020, the Tough Legacy Taskforce (the **Taskforce**) of the Working Group on Sterling Risk-Free Reference Rates (the **RFRWG**) published a paper entitled "*Statement on the identification of 'tough legacy' contracts across asset classes*" (the **Statement**)[1] making a case for action in relation to tough legacy contracts (i.e., those in which the transition away from LIBOR is particularly difficult using market solutions) across a number of different asset classes.

While highlighting the increasingly urgent need for action (a need that has been heightened by the shift of focus and resources away from LIBOR transition as a result of the COVID-19 pandemic), the Taskforce has set out the key considerations on tough legacy contracts and recommendations for market participants.

These considerations provide useful guidance to market participants in assessing the nature of their exposure to tough legacy contracts. The Taskforce also expresses a preference for the UK Government to adopt a legislative solution to the tough legacy problem.

The Taskforce cautions that its preferred legislative solution may not materialise, and recommends that other solutions be pursued in parallel. In addition, even if a legislative solution were to be implemented, that solution may not serve market participants as well as amending their own contracts. The RFRWG's overall view remains that market participants should proactively address the transition away from LIBOR in their contracts before the end of 2021 (the date on which LIBOR is expected to be discontinued).

[1] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/paper-on-the-identification-of-tough-legacy-issues.pdf?la=en&hash=0E8CA18F27F75352B0A0573DCBBC93D903077B6E

The Statement notes that any legislative solution may have unintended or undesirable consequences, including that such a solution may not be economically neutral. The Taskforce recommends that market participants should only rely on a legislative solution (assuming one is in fact enacted) for contracts that are "genuinely stranded."

In the absence of legislative or other external solutions to the difficulties that may arise as a result of the discontinuation of LIBOR, parties should review all contracts for potential impact resulting from the discontinuation of LIBOR and, whenever possible, amend contracts to refer to an alternative rate or to introduce fallbacks enabling conversion to an alternative rate.

Recommended actions

- Market participants should:
  - proactively identify contracts that may be tough legacy contracts even before specific legislative and regulatory guidance on how to deal with them is made available;
  - consider how to address barriers to active transition in respect of any contracts that are identified in order to reduce the number of actual tough legacy contracts;
  - keep up-to-date with any developments in relation to LIBOR transition and consider potential workable alternatives (even if these do not include a compounded risk free rate) along with identifying the ideal timeframe in which to implement these;
  - engage in active transition away from LIBOR to the extent possible (on the basis that it is the approach offering the highest degree of control over the terms of such a transition); and
  - make it as easy as possible to amend contracts, for instance by reducing consent levels or agreeing to "protocol" style approaches where the same parties need to amend multiple contracts simultaneously. Additionally, it should be noted that the earlier a contract is transitioned away from LIBOR to a risk-free reference rate, the more likely further changes will be required to reflect changes in market practice around the use of these new rates.
- Further considerations:
  - Despite some LIBOR interim deadlines shifting (please refer to our previous alert, available here), market participants should avoid entering into agreements or arrangements that refer to LIBOR or, in product classes in which the use of an alternative reference rate is not yet practically feasible, ensure that such contracts may be easily amended;
  - Market participants should consider the impact of potential unavailability or inadequacy of hedging in relation to exposures referring to LIBOR (including potential accounting issues) and the challenges of coordinating transition away from LIBOR in transactions where related contracts across product classes exist, as the markets for different products may be at different stages of transition and/or may favour different rate-setting approaches; and
  - Companies should implement a LIBOR transition plan as a tool for prudent and sound management, as this may be viewed in the market as a proxy for good governance and compliance.

In depth

What are tough legacy contracts?

Tough legacy contracts come in many forms but they all share a common denominator: they are particularly difficult to convert or amend to include fallback provisions in the transition from LIBOR.

The Taskforce identified certain common characteristics of tough legacy contracts across asset classes:

- complex or structured transactions or arrangements with LIBOR references in one or all constituent elements (for example the underlying financial contracts or collateral, derivatives and/or the main financing itself), where reliance on fallback provisions in individual constituent elements would potentially introduce instability into the structure;
- a broad distribution of the debt instrument / contract leading to challenges with obtaining consent;
- very high volumes of outstanding contracts (even if no other tough legacy features exist);
- the nature of customers (e.g. retail holders of mortgages or bonds).

The Taskforce recognised that a "one size fits all" remedy is not desirable and that careful consideration needs to be given to the tax, regulatory and accounting consequences of any market solution.

Tough legacy contracts are generally perceived to be a particularly relevant source of potential LIBOR-related litigation, in particular if the changes required to transition away from LIBOR cause the economic structure of the contracts to change.

What is the focus of the Statement?

The Taskforce is primarily focused on Sterling LIBOR, but it recognises the exposure of UK and non-UK market participants to LIBOR settings in other currencies under English law governed contracts. In fact, according to the Taskforce, exposures to US Dollar LIBOR exceed the exposures to Sterling LIBOR for UK market participants. Because English law is used extensively to govern financial contracts denominated in different LIBOR currencies, the Taskforce concluded that there would be significant benefits to adopting a consistent approach across legacy exposures to different LIBOR currencies, although this may not be achievable.

What would the best solution be?

The Taskforce proposed that the UK Government consider legislation to address tough legacy exposures in contracts governed by English law that refer to Sterling LIBOR, and would ideally include other LIBOR currencies.

In a statement to the House of Commons[2], the Chancellor of the Exchequer stated that, since the UK has an existing regulatory framework for critical benchmarks such as LIBOR, the Government intends to legislate to amend and strengthen the existing regulatory framework, rather than to impose direct legal changes on LIBOR-referencing contracts governed by UK law. In the forthcoming Financial Services Bill, the Government intends to:

- amend the existing UK regulatory benchmark framework to ensure that is can be used by the Financial Conduct Authority (the **FCA**) to manage an orderly transition from LIBOR;

[2] https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2020-06-23/HCWS307/

- enable the FCA to direct a methodology change for a critical benchmark, in circumstances where the benchmark's representativeness will not be restored and where action is necessary to protect consumers and/or to ensure market integrity; and
- prohibit the use of an individual critical benchmark where its representativeness will not be restored while ensuring that the FCA has the ability to specify limited continued use in legacy contracts.

The FCA has issued a statement[3] welcoming the Chancellor of the Exchequer's announcement and clarifying that the changes to the methodology used to compile LIBOR would possibly entail a move towards an alternative more robust methodology not based on panel bank submissions (it is anticipated that the FCA will seek market input on the methodology for this "synthetic" version of LIBOR). Although it is not intended that LIBOR will be representative again, these methodology changes could allow the FCA to stabilise certain LIBOR rates during a wind-down period enabling limited use of LIBOR in tough legacy contracts.

This legislative approach deviates from the legislative proposal under New York law[4] put forward by the Alternative Reference Rates Committee (**ARRC**) convened by the US Federal Reserve Board and the New York Federal Reserve Bank, which intends to minimise litigation by introducing measures that promote legal certainty for contracts referencing USD LIBOR that are governed by New York law, including:

- a prohibition on any party being able to refuse performance of a contract or declaring a breach of contract as a result of LIBOR discontinuation or the use of the benchmark replacement recommended by the ARRC;
- the establishment of a recommended benchmark replacement as a commercially reasonable substitute for LIBOR; and
- a safe harbour from litigation for the use of the recommended benchmark replacement.

The ARRC proposal would effect the above by requiring the use of the recommended benchmark replacement where the contract language is silent or the fallback provisions prescribe the use of LIBOR.

However, one notable exception from the ARRC proposal relates to contracts with existing fallback provisions - if fallback provisions are already included in the contract for a non-LIBOR replacement rate (such as the prime rate or a rate based on SOFR) the ARRC proposal would not affect those contracts. The ARRC proposal would also permit parties to a transaction to agree to opt out of the statute either before or after the occurrence of a statutory trigger.

While the Taskforce's preference is for a legislative solution, it recommends that market participants focus primarily on active transition and that other solutions to the tough legacy problem should be pursued in parallel (for instance resorting to a temporary 'synthetic' formula-based methodology to be applied as a substitute for LIBOR following its discontinuation).

In line with the proposed amendments to the existing benchmarks regulatory framework (which would enable the FCA to stabilise certain LIBOR rates during a wind-down period to allow its limited use in legacy contracts), if a synthetic version of LIBOR were to be adopted, it might only be workable if the synthetic LIBOR rate is included on the same screen page (of Reuters) where LIBOR is currently displayed or referred to as 'LIBOR' (for example in the Financial Times, which may often be the source for such rates in non-financial contracts). However, this would not ameliorate litigation risk in cases where parties misunderstand how the economics of the synthetic rate differ from the originally agreed position.

[3] https://www.fca.org.uk/news/statements/fca-statement-planned-amendments-benchmarks-regulation

[4] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Proposed-Legislative-Solution.pdf

Additionally, synthetic LIBOR would simply be a temporary "fix" and would eventually need to be discontinued. Therefore, while synthetic LIBOR may appear to be an attractive short term solution to address some pressing issues, it should not be considered a permanent solution to the problems posed by tough legacy contracts.

Syndicated and bilateral loans

In the syndicated loan market, most loan agreements contain a range of fallbacks that will apply if LIBOR is unavailable. The less recent of these were largely intended to address short-term unavailability issues and not the cessation of LIBOR and would be unsuitable for LIBOR transition.

More recent facility agreements commonly include a "replacement of screen rate" provision that allows necessary amendments to be made without requiring the consent of all lenders upon a trigger event (which, in theory means that it should be easier to make amendments). However, some older legacy loan transactions require all lender and borrower consent to amend the facility agreement to transition to an alternative rate. If the required consents are not obtained, the ultimate fallback in many syndicated lending agreements is to an individual lender's cost of funds, a position that will not be welcomed by a number of market participants.

Failure to proactively manage the process (and reliance on the fallbacks) may have undesirable and unintended consequences. For example, under older agreements, a fallback to historic LIBOR may result in a floating rate loan becoming a fixed rate loan or a fallback to lenders' costs of funds may be impracticable to calculate and collate on anything other than a very short-term basis.

In the bilateral loan market, there is less standardisation of terms. A small number of sophisticated borrowers have already amended their bilateral loan documentation to adopt a risk free reference rate. However, for the majority of the bilateral loan market, there is a wide variety of fallback language across a high volume of individual loans, and many of these include the lender's cost of funds as the ultimate fallback or contain no fallback at all (therefore requiring consent of both borrower and lender to amend them).

In order to avoid having to rely on existing fallback provisions, each existing LIBOR-referencing loan must be individually amended to provide for a replacement interest rate when LIBOR is discontinued or becomes unrepresentative of underlying financial reality.

The Taskforce expressed the view that a case for action exists to address tough legacy exposures in the loan market.

Additionally, the Taskforce identified certain issues for loan market participants in making a timely transition from LIBOR:

- a very large number of loan contracts;
- the diverse nature of the borrowers with varying degrees of sophistication and engagement in LIBOR transition;
- cost and resource availability; and
- procedural challenges to transition affecting the parties.

In a post-COVID-19 environment, additional challenges are anticipated in relation to cost and resource availability, and many market participants may be subject to procedures such as creditor standstills, financial restructurings or insolvency proceedings.

Bonds

In the bond market, the main cause for concern is the existing fallback language in many legacy bonds, which was not drafted in contemplation of the permanent discontinuation of the relevant reference rate. In many cases the ultimate fallback is for the rate to be fixed at the rate that applied at the last determination date - effectively turning a floating rate instrument into a fixed rate instrument overnight (and making the applicable fixed rate a matter of pure chance). The Taskforce also noted that other fallback provisions involved the exercise of discretion within certain parameters, which may not be straightforward. Moreover, in a small number of cases there are no fallback provisions at all.

Amendments to the interest rate provisions in legacy bonds require bondholder approval (in the US transactions, often 100%). Any consent solicitation process takes time to agree, in addition to complying with any meeting timeline set out in the terms and conditions of the bonds. Moreover, any consent solicitation process requires a decision maker, or a party willing and contractually able to assume the costs of amendment. While this may be used to transition some legacy bond contracts to alternative rates, this is often not a viable option since it is not always possible to obtain the requisite consent from bondholders. In more complex arrangements, the necessary consenting parties may no longer exist.

In some floating rate note transactions, benchmark replacement depends on the input of third parties that may be unwilling or unable to select an alternative rate for the remaining life of the bonds. This exercise of discretion within certain parameters may lead clients to assume that the responsibility for amending transactions lies with the security trustee or other transaction parties, though this is not the case for most transactions.

Refinancing floating rate bonds by reference to an alternative base rate (SONIA or SOFR) is a potential alternative to be considered.While the prepayment of bonds is an alternative available in certain circumstances, it may not be workable for very large issuances where the issuer is unable to raise the necessary finance to facilitate the prepayment or in situations where there are significant costs associated with doing so.

As a result, whilethe Taskforce advises that transactions should consider using consent solicitation to transition those legacy bond contracts where that is an option, it recognises that there is a case for action to address tough legacy bond exposures.

Derivatives

Although many derivatives will not be tough legacy contracts, the Taskforce considered that there are cases where a derivative could be considered a tough legacy contract. The Statement suggests that this may be the case where a derivative is used to hedge an exposure which is itself considered tough legacy or where the derivative forms part of a more complex structure such that the derivative is subject to the same or similar constraints as the instrument it is used to hedge.

Parties to derivatives contracts may transition away from LIBOR by either proactively amending and renegotiating these transactions or by relying on fallback trigger solutions. The Taskforce considers that proactive approaches are a better means for LIBOR transition than the use of a trigger to activate a fallback rate (particularly so for non-linear products), although both approaches can coexist.

For example, parties to uncleared derivatives can proactively negotiate to amend or replace contracts or embed new fallbacks either via adoption of the expected ISDA IBOR Fallback documents (i.e. amendments to the 2006 ISDA Definitions and a multilateral protocol, as set out in our previous alert available here) or by means of bilateral negotiation (some prominent central clearing counterparties announced their intention to incorporate fallbacks comparable to ISDA). For non-linear products, fallbacks are possible but may require additional amendments to supplement the amendments made by the ISDA IBOR Fallback Protocol.

Generally, the Taskforce advised parties to derivatives to, whenever possible, proactively convert LIBOR exposures into risk free rate exposures through the use of methods such as basis swaps and compression methods.

Commercial Contracts

While the Taskforce notes that there are cases where LIBOR is referenced in commercial contracts with terms beyond end-2021, it also states that in some cases firms may not have a mechanism for identifying them. The Taskforce is working to provide particular recommendations for transactions where no fallback was envisaged in the original contract but parties cannot agree to an appropriate alternative. Businesses should consider preparing their own strategies for identifying contracts with LIBOR references and work with their lawyers to proactively amend the contracts.

LIBOR transition in the context of commercial contracts will require cooperation across jurisdictions - local differences across products must be taken into account in any solution. Therefore, the Taskforce notes that an additional wind down period beginning after the end of 2021 may be beneficial for commercial contracts, as the jurisdiction variance means that a "one size fits all" solution may not be desirable.

Mortgages

The Taskforce comments that tough legacy issues in the mortgage market are "*contained and well understood*". However, just because they are understood does not mean a solution is readily available. In particular, the terms in some sterling LIBOR mortgage contracts fail to anticipate a discontinuation of LIBOR and/or have no fallback provisions.

This is particularly problematic as any attempt to vary a mortgage contract by agreement could result in the creation of a new mortgage contract, requiring appropriate regulatory permissions which many parties do not have.

As a result, the Taskforce concluded that there is a case for action in relation to tough legacy mortgages, given the potential difficulty of agreeing a variation with all affected mortgage customers (often unsophisticated) and the potential for harm if the transition is not achieved.

Structured finance and securitisation transactions

Although not specifically identified by the Taskforce as an area of particular concern, structured finance and securitisation transactions will have additional layers of complexity, and will often aggregate many of the issues identified in the Statement in relation to the various asset classes (particularly in relation to noteholder meetings highlighted above in the context of bonds and the issues around mortgages in respect of mortgage backed securities).

At the outset, securitisation transactions are structured to ensure that the cash-flow generated from the underlying assets matches the anticipated payments to noteholders (with derivatives typically used to ensure there is no mismatch of currency or interest rate risk). This creates additional complexities in the context of LIBOR transition, given any amendment to the reference rate on the assets, the notes or the hedging will inevitably have knock-on effects on the cashflows. Market participants need to carefully balance each of these components of a transaction when determining how to transition the transaction away from a LIBOR rate.

Furthermore, the transaction documents may impose restrictions to the variation of the rate on the underlying assets requiring extensive amendments and/or waivers and consents - which will further complicate any noteholder consent solicitation process. As noted in the context of bonds above, it will not be the

responsibility of a trustee to manage the transition process but will need to be led by the originator (if the originator is still involved in the transaction) or corporate service providers on behalf of the SPV issuers that they manage.

Please contact us if you would like to discuss any particular issues in more detail.

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