New and legacy loan transactions referencing Sterling LIBOR

The Working Group on Sterling Risk-Free Reference Rates

The overall objective of the Working Group on Sterling Risk-Free Reference Rates (the 'Working Group') is to catalyse a broad-based transition to SONIA (the Working Group's recommended risk free reference rate for sterling LIBOR) by end-2021 across sterling bond, loan and derivative markets, in order to reduce the financial stability risks arising from widespread reliance on sterling Libor. While this note principally discusses sterling LIBOR, the considerations in this paper are likely to have relevance for syndicated loans in any currencies for which LIBOR is quoted.[1]

This paper is addressed to loan market participants who continue to reference Libor in new and legacy loan transactions, in particular where those loans mature beyond the end of 2021 when Libor may cease to be available.

The Working Group believes that it is important that end users continue to have uninterrupted access to financing and risk management products. Over the near term, Libor usage might continue whilst firms take steps to mitigate the risks of a discontinuation and reduce their dependency on Libor.

This paper is intended to raise market awareness regarding potential considerations for loan market participants in relation to new and legacy loan agreements which reference Libor. Its aim is to help market participants increase their level of preparedness and forward planning.

The Working Group believes, as highlighted in this paper, that the most effective way of avoiding risks related to Libor discontinuation is to transition to alternative benchmarks, in particular SONIA. Where Libor continues to be referenced in Sterling loans in the interim period before market conventions and infrastructure for referencing alternatives to Libor are fully developed, there are certain steps market participants could take to mitigate some of the risks highlighted in the paper. One such step is the inclusion in documentation of provisions giving flexibility for changes relating to benchmark rate(s) to be made with a lower lender consent threshold. A key milestone for the Working Group in this respect was the wider publication of the revised LMA "Replacement of Screen Rate" clause in October 2018. Another key milestone for the Working Group will be communicating best practice for referencing SONIA in loan markets, planned for later this year.

The Working Group is particularly grateful to its Loan Market Sub-Group (the 'Sub-Group'), chaired by Clare Dawson of the LMA, for having developed this paper. The paper was discussed at the Working Group's meeting on 29 November at which it was agreed to publish the paper, and delegate the final steps to the Working Group Chair and Vice-Chairs as well as the Sub-Group Chair.

[1] For more information on the Working Group, see https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor

The Bank of England and the FCA are each ex-officio members of the Working Group. Market participants should note that the views and considerations set out in this paper do not constitute guidance or legal advice from the Bank of England (including the PRA), the FCA or the Working Group. Further, the views and considerations set out in this paper are not necessarily endorsed by the Bank of England (including the PRA) or the FCA. This paper has been prepared for the purpose of highlighting to market participants some of the potential considerations in relation to participation in legacy and new loan transactions referencing Libor. This paper does not constitute a comprehensive outline of all relevant considerations in this regard. Market participants should seek their own advice in relation to their legal, regulatory and other obligations and as to any other considerations or risk that may arise or be relevant in this regard

Summary

1. Given the work underway to transition away from Libor and towards risk free rates in the financial markets, there are a number of considerations to be borne in mind in relation to new and legacy loan agreements which reference Libor and are due to terminate after 2021. This paper outlines some of those potential considerations and steps that market participants could take in relation to those considerations. It is important to be mindful of these considerations and market participants are encouraged to take the actions that they can to promote awareness of the transition and contribute to consultations and other discussions.

Background

2. In a speech in July 2017[1] the Chief Executive of the FCA said that the FCA did not intend to use its powers to persuade or compel banks to submit contributions for Libor after the end of 2021; and would not in any case be in a position to compel banks to submit contributions indefinitely under the EU Benchmark Regulation. Work is therefore underway to transition away from Libor and towards risk-free rates across financial markets globally.

3. In the UK, the Working Group on Sterling Risk Free Rates convened by the Bank of England (the "**Working Group**") has chosen SONIA as the preferred alternative risk- free rate for Sterling.[2] On 17 July 2018, the Working Group published its Consultation Paper on Term SONIA Reference Rates[3] (the "**Term Rate Consultation**"). The Working Group has found that there is a use case for term SONIA reference rates in the corporate lending (including syndicated loans) markets. The Working Group is also considering proposed conventions for using SONIA compounded over the interest period which it expects to be published before the end of the year.

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1 https://www.fca.org.uk/news/speeches/the-future-of-libor

2 In addition, SOFR has been identified as the preferred alternative risk-free rate for US Dollar markets, SARON as the preferred alternative risk-free rate for Swiss Franc markets, TONAR as the preferred alternative risk-free rate for Japanese Yen markets and ESTER as the preferred risk-free rate for Euro markets.

3 https://www.bankofengland.co.uk/paper/2018/consultation-paper-on-term-sonia-reference-rates

4. In advance of a term SONIA reference rate or other SONIA based market conventions being determined and infrastructure being developed, there are a number of considerations for market participants when participating in loan transactions referencing Libor, given the uncertainty surrounding the discontinuation of Libor. It is the position of the Working Group that market participants should make themselves fully aware of these considerations and should form an understanding of them, to ensure that the market operates on an informed basis and in compliance with legal and regulatory obligations.

5. This paper sets out some potential considerations for market participants in relation to their participation in legacy and new loan transactions referencing Libor on the basis of current market documentation, based on the recommended forms of the Loan Market Association (the "**LMA**"). In highlighting the relevant considerations, this paper suggests a number of steps market participants may wish to consider taking in mitigation (although some market participants may conclude that it is premature to take certain of those steps at this stage). However, this paper does not set out all potential issues for all market participants.[4] Market participants should take their own advice and form their own views on the issues applicable to them.

6. It should be noted that developments in this area are many and frequent, with statements being issued by benchmark administrators, regulators in each of the relevant jurisdictions for the main currencies for which Libor is quoted, and industry bodies, as well as the development of new futures markets in the risk-free rates. Therefore, the steps suggested in this paper should be considered, and an assessment as to their appropriateness be undertaken, in light of any new developments as and when they occur. Market participants are encouraged to consider the issues highlighted in this paper now, rather than waiting for market solutions to develop over time. Market participants are also encouraged to contribute wherever possible to relevant consultations and other ongoing discussions and get involved in relevant working groups

7. Market participants are reminded of their obligations under competition law and that they should be mindful of such obligations when considering any of the steps set out in this paper. Market participants are responsible for taking their own legal advice in relation to competition law.

Considerations associated with legacy or new loan agreements referencing Libor

8. Set out below are some examples of the potential considerations for market participants in relation to loan agreements referencing Libor. Many of these considerations would apply equally to both legacy transactions and new transactions which reference Libor and are due to terminate after the end of 2021. However, a potential advantage of loan transactions compared to certain other products such as certain bonds[5] is that the parties are more likely to be known and thus it may be a simpler exercise to contact all the relevant parties to enter into discussions on Libor related matters. In

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[4] Neither does this paper reference broader issues relating to credit ratings, accounting or tax, all of which may be impacted by a switch to alternatives to Libor.

[5] See "New issuance of Sterling bonds referencing Libor " (July 2018) published by the Working Group.

9. most cases, the parties may at any time agree to make such amendments to their documents as may be agreed by the requisite majority.

An amendment exercise may be required if Libor is discontinued

10. If Libor is discontinued or if Libor is no longer an acceptable benchmark rate to reference, then the terms of loan agreements referencing Libor are likely to need to be amended to provide for alternative benchmark rate(s).

11. Depending on the terms of the particular agreements, this may be an all lender decision). There is no guarantee that any proposed amendments will be accepted by all parties. However, the process of amendment may be made easier if the documentation contains a provision which gives the flexibility for changes relating to benchmark rate(s) to be made with a lower lender consent threshold (such as the revised "Replacement of Screen Rate" clause published by the Working Group and the LMA (the "**Replacement of Screen Rate Clause**")).[6]

Hedging arrangements may be impacted

12. If a borrower enters or has entered into swaps associated with its loan transactions (e.g. interest rate swaps but also potentially cross-currency swaps or other hedging arrangements), in the context of Libor discontinuation, the fallbacks for swaps and loans may operate differently or may be triggered at different times. This may result in mismatches on payments which may have an impact on a borrower's funding arrangements. Lenders may also enter into related swaps on an individual or portfolio basis. A mismatch in the operation of loan and swap fallbacks may also have an impact upon the investment strategy of the relevant lender and may impact expected returns. There may also be implications for lenders that have offered hedges to borrowers through swaps if a hedge fails to provide the expected protection.

Market participants may be subject to increased risk of disputes

13. To the extent that changes to the benchmark rate(s) can be made with less than all lender agreement, it is possible that minority lenders may be unhappy with the decision of the majority. Any such risk may be exacerbated to the extent that a change to an alternative benchmark rate results in a transfer of economic value.

14. It is also possible that the borrower and lenders may fail to agree on a replacement benchmark rate(s) which may lead to the current fallbacks, ultimately participating lender cost of funds, being relied on. These fallbacks may not be practical and may only work in the short term.

[6] This clause was originally published as an option in LMA documentation in 2014 and was revised and published as a standalone rider by the LMA in May 2018. In October 2018, this clause was made available to a wider audience through publication by the Working Group and a corresponding version (with minor revisions to the May 2018 version) was re-published on the LMA website

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Libor may continue to be published but may be based on submissions from fewer panel banks or a different methodology

15. It is possible that the market might move to referencing a new benchmark rate, while some form of Libor might continue to be published by its administrator, for example based on submissions from fewer panel banks or a different methodology. If this were the case, Libor would be likely to continue to be applicable to interest calculations in loan agreements which do not have alternative fallback provisions enabling a transition to an alternative rate in these circumstances. This would be the case for transactions documented on the LMA's recommended forms where fallbacks would only usually apply where the "Screen Rate" (i.e. Libor) was unavailable. Again, this may not be agreeable to borrowers or lenders. However, the parties could agree to amend the documentation to refer to another agreed benchmark rate.

Libor replacement may impact on the regulatory obligations of certain market participants

16. Credit institutions and other financial institutions that are regulated in the UK by the FCA will also need to ensure compliance with FCA Principles which require them to pay due regard to the interests of their customers and treat them fairly and to pay due regard to the information needs of their clients and communicate information to them in a way which is clear, fair and not misleading. These principles will apply in relation to contracts that they are entering into or products they are selling and will be relevant in the context of introducing new fallback provisions and ensuring there is adequate disclosure and communication of pay-out profiles. Similar regulatory obligations in other jurisdictions are likely also to be relevant.

What steps can be taken to mitigate these considerations for new transactions?

17. The most effective way of avoiding issues related to Libor discontinuation in relation to new loan agreements would be for new loan agreements to reference alternative benchmarks.

18. There is still work to be done to align the recommended risk free rates, such as SONIA[7], to the requirements of the loan markets as evidenced by the Term Rate Consultation in relation to sterling loans and work on how SONIA compounded over the interest period could be referenced in loan agreements. Market participants may further wish to consider the timing of any move to an alternative reference rate in light of the development of infrastructure and conventions for such a rate. Parties would also need to consider the implications of alternatives carefully in the context of hedging liabilities where alignment with the underlying loan agreements is important.

19. The Term Rate Consultation confirms that there is a use case for forward-looking term rates in the syndicated loan market, citing operational challenges and genuine risk management needs such as cash flow forecasting or managing interest rate risk. Prior to there being further clarity on the availability of Term Rates, some market participants may consider it premature to consider alternative rates.

[7] We are not aware of any loan agreements that currently reference SONIA. In the bond market, public entities and financial institutions have issued bonds referencing SONIA.

20. Where Libor continues to be referenced in new loan agreements entered into in the interim period before market conventions and infrastructure for referencing alternatives to Libor are fully developed, there are certain steps market participants could take to mitigate some of the issues highlighted above. Some suggested steps are set out below although market participants should note that the option to amend the relevant documentation at the appropriate time always remains open to them.

<u>Increased transparency/awareness</u>

21. Given the uncertainty around the future of Libor, market participants should make themselves fully aware of these uncertainties and understand how any loan agreement referencing Libor may operate post 2021 (or whenever Libor ceases to exist or ceases to be an appropriate benchmark rate to reference). It may be appropriate to add disclaimers into any marketing information such as an information memorandum or any other marketing information relating to the sale of loans.

22. Market participants should be mindful of developments surrounding benchmark reform and the risk-free rates which could become the basis of benchmark rates that may be appropriate for the loan markets. It is hoped that parties have responded to the Term Rate Consultation and will respond to any further consultations issued by any of the different currency working groups which may be of relevance in order to assist in facilitating creation of and transition to benchmark rate(s) most appropriate for the syndicated loan markets.

23. Market participants should also endeavour to raise awareness of and discuss the issues with their counterparties and within their institutions with a view to being as prepared as possible to reference any appropriate replacement benchmark rate(s) and make consequential documentary amendments once market conventions and infrastructure for alternative rates are fully developed.

<u>Incorporating alternative fallbacks which attempt to provide the means by which a future alternative rate might be identified</u>

24. Loan agreements referencing Libor which terminate after 2021 could include an alternative fallback to specifically address discontinuation (or the market generally moving away from use) of a benchmark rate and attempt to provide the means by which a future replacement rate could be applied in specific circumstances. This would not require consent of the parties save at the outset of the transaction as application of the replacement rate would be contemplated within the terms of the loan agreement itself. However, the efficacy of these provisions will depend upon it being possible to select and apply an alternative rate, calculate any necessary adjustment spread and provide for any other related changes at the relevant time in accordance with the relevant provisions of the loan agreement. Given the current uncertainty surrounding each of these aspects, alternative fallback provisions may not operate as expected in the event of Libor discontinuation (for example, if provisions referred to a method of calculating a rate or spread but the use of another method became market practice). Market participants may find that the return on a loan might be significantly different to what they expected once any new rate is applied.

Amending terms of loan agreement to facilitate easier future amendment of terms

25. Parties could consider including provisions in loan agreements which may make it easier for such amendments to be made in the future. The Replacement of Screen Rate Clause may be incorporated into documentation where the parties would like to include the flexibility to make changes to the documentation to include replacement benchmark rate(s) and related changes with a lower consent threshold than may otherwise be required. This may make the process of amending loan agreements to incorporate any new benchmark rate(s) and related changes easier than may otherwise be the case if a higher consent threshold were required.

Senior managers should be mindful of their regulatory obligations

26. Senior managers within UK credit institutions (as well as other financial institutions to which the UK senior managers and certification regime applies) may also wish to consider the statutory duty of responsibility requiring them to take reasonable steps to prevent regulatory breaches from occurring, or continuing to occur, in their area of responsibility. It may also be advisable for regulated entities to document the reasons for concluding that the entry into a loan transaction was acceptable for regulatory purposes, at the time of its execution.

Costs of changes

27. It may be appropriate for market participants to consider at the outset who will bear the responsibility for any costs of amendments to documents as a result of changes to the benchmark rate.

Related transactions

28. To the extent that loan and other transactions are interlinked, market participants should ensure that those transactions are compatible. For example, where the loan is part of a wider transaction or is subject to hedging, it may be important that interest rate provisions match appropriately.

29. In particular, ensuring that there is flexibility within the fallbacks to a benchmark rate set out in ISDA documentation to match the provisions of a related loan agreement may be important.

What measures can be taken to mitigate these considerations for legacy transactions?

30. Where Libor is referenced in legacy loan agreements, there are certain steps market participants could take to address some of the issues highlighted above. Some suggested steps are set out below.

Amending the terms of loan agreements

31. Legacy loan agreements could be amended to include many of the suggestions referred to above in the context of new transactions. However, market participants may determine that the practicalities of making Libor-related amendments at this stage, particularly for multi-currency loans, may be premature and such amendments may be more appropriate once market conventions and infrastructure for referencing alternatives to Libor are fully developed.

32. Where, however, a loan agreement is being amended in any event for reasons other than Libor (including, in particular, amendments that would extend the termination date to after the end of 2021), market participants should give consideration to including provisions which may make it easier for such amendments to be made in the future such as the Replacement of Screen Rate Clause.

Diligence

33. Market participants should be aware of which of their loan transactions are due to terminate after 2021 and reference Libor. It may also be worth looking at the consent for amendments provisions of such transactions and interdependencies with other products (such as hedging, securitisations etc.).

34. Borrowers may further wish to consider diligencing the repayment provisions of their loan agreements. This may be helpful in circumstances where it would be appropriate or feasible to repay or prepay any of their loans, for example, where agreement cannot be reached with their current lenders on provisions relating to alternative benchmark rate(s) in due course.

Increased awareness

35. The steps set out in paragraphs 20, 21 and 22 above in relation to new transactions are equally applicable to legacy transactions which reference Libor.