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Transitioning From LIBOR from a UK Perspective

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Introduction

In an announcement made on 5 March 2021, the FCA confirmed that "all LIBOR settings will either cease to be provided by any administrator or no longer be representative immediately after 31 December 2021 in the case of sterling, euro, Swiss franc and Japanese yen and 1-week and 2-month US dollar settings; and immediately after 30 June 2023 in the case of the remaining US dollar settings". The FCA went on to say that "based on undertakings received from the panel banks, the FCA does not expect that any LIBOR settings will become unrepresentative before these dates". This announcement therefore provides final clarification to the market as to when LIBOR will cease; market participants (and, on a wider basis, everyone who uses LIBOR references in their contracts) must therefore adapt to the new interest rate regime prior to the relevant date.

Background to the changes

Way back in July 2017, Andrew Bailey, the then Chief Executive of the UK Financial Conduct Authority (FCA), announced the transition from LIBOR to a more robust benchmark rate by the end of 2021. The reasons cited by Mr Bailey for the need for the transition included the lack of an active underlying market made LIBOR unsustainable and unsuitable for the widespread reliance that had been placed upon it.

The immediate reaction by UK market participants was: how will this change things? Indeed, one question that was raised at a London Loan Market Association (LMA) seminar shortly after the announcement, was whether loan agreements could merely reflect the change by amending the "LIBOR" definition in syndicated loan agreements to read "SONIA" and we could all move on. Unfortunately, things were not quite that simple.

As time has progressed, the mist started to clear and not only have alternative risk-free rates (RFRs) been developed, the new rates have been readily adopted in some markets (such as the derivatives market and capital markets) in good time for the phasing out of LIBOR. The loan market however, being a cash based market, has not reacted quite so quickly and only now is taking steps to adapt to the implementation of the RFRs.

Current status of the UK Loan Market

It is fair to say that there has been a reasonable amount of delay in beginning the transition to RFRs in the loan markets around the world. The common approach advocated until recently by committees and working groups established by central banks such as the Bank of England and the US Federal Reserve to oversee the transition, was to promote a "soft-wired" approach in loan documentation by which the parties agreed to agree to amend the loan once the RFR had been properly established and LIBOR was no longer being used by market participants. This of course meant that loans were being made with terms extending beyond the 2021 LIBOR end-date which would need to be amended in due course to reflect the new interest rate regime.

In the summer of 2020, the US Alternative Reference Rates Committee (ARRC – the committee established by the US Federal Reserve to deal with the RFR transition in the US) updated its guidance so as to promote a "hard-wired" approach (rather than, as previously, a "soft-wired" approach). Under the new guidance, updated fallback language released by ARRC was recommended to be included in new loan documentation from Q3 of 2020. The drafting provided by ARRC

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included slot-in provisions and definitions which upon certain transition events occurring for the relevant loan to move to the RFR. Moreover, it also provided for the lender or administrative agent to make conforming changes to the loan documentation as may be required (such as the timing and frequency of determining rates and making interest payments) as may be appropriate in a manner consistent with market practice.

By contrast, the LMA in London, previously only advocated a "soft-wired approach" (using an agreement to agree to amend loan documentation as and when) in its template loan documentation which is widely used in the London loan market, although the provisions and guidance given to members were far more granular and detailed. Following the recommendation of the UK Working Group in Sterling Risk-Free Rates (RFRWG – the working group established by the Bank of England) that by the end of Q3 2020 all new and refinanced LIBOR-referencing loans maturing beyond end-2021 should include clear contractual arrangements to facilitate conversion to SONIA (the sterling RFR) or other alternatives, the LMA published an exposure draft of its rate switch multicurrency term and revolving facilities agreement in September 2020. This agreement provided a draft template loan agreement incorporating the necessary rate switching provisions (being a lookback with/without observation switch) by which the facilities automatically switch to the RFR (being SONIA, SOFR etc.) on a specified date or following the occurrence of a specified trigger event. As the LMA draft is stated to be an "exposure draft", a number of commercial points remain to be addressed by the parties. For example, matters such as the lag time on the lookback period, whether a credit adjustment spread is to be included in the total applicable interest rate, the applicability of zero floors, and the applicability of break costs still need to be agreed between the parties to the deal.

Since the initial rate switch agreement, the LMA has also published (in late January 2021) an exposure draft of a multicurrency compounded rate/term rate facilities agreement (again a lookback with/without observation shift) to deal with new transactions which will use the RFR from day one (rather than switch from a LIBOR rate during the term of the facility). Assuming that this document is widely adopted in the London loan market (which is likely to be the case) this will provide a good foundation for RFR-based loans to be documented going forward and upon which market norms can be established.

Legacy Transactions

Whereas it is still relatively early days for the new RFRs to be fully adopted by the loan markets in respect of new transactions, the recent publications of ARRC and the LMA are a welcome step in the right direction. Clearly differences of approach still remain – for example, ARRC recommends a Term (i.e. forward looking) SOFR rate as the first in its waterfall of applicable rates whereas the LMA adopts a backward looking SONIA rate only (following a statement of the RFRWG earlier in 2020 that said that a term SONIA should not generally be used for loan transactions even if one were to be developed); ARRC recommends a daily simple SOFR rate as second in its waterfall whereas the LMA's template uses a compounded SONIA rate, but at least guidance is available.

The elephant in the room however is the wall of legacy loan deals which will mature after the 2021 end-date and currently only include the soft-wired agreement to agree approach; these will need to be moved to the new RFR regime. This can only happen once the loan market has started to write new transactions incorporating the hard-wired transition language and market practice has been developed so as to provide a road-map on issues which are still subject to debate (for example, the inclusion of break cost language).

The RFRWG published further guidance to all participants in the loan market in its paper "Active transition of GBP LIBOR referencing loans" (Sept. 2020) (the Legacy Transactions Paper), in which it referenced its updated target milestones applicable in the UK so that by the end of Q2/3 2021 active conversion of legacy LIBOR products should for the most part have been undertaken leaving only tough legacy contracts to be dealt with by way of fallback arrangements.

The Legacy Transactions Paper sets out five practical steps to be undertaken by market participants in the London loan market as part of the transition process:

- *Step 1: Reviewing outstanding GBP LIBOR referencing loans*
- *Step 2: Identifying alternative reference rates to be used for each loan*
- *Step 3: Familiarisation on how the alternative reference rate will be calculated*
- *Step 4: Considering whether systems and operations are ready to accommodate alternative reference systems*
- *Step 5: Documenting the transition of loans (including due diligence on any changes that are proposed)*

Whilst it is likely that lenders will have undertaken a number of these steps already, clearly there needs to be buy-in from borrowers who will need to play an active role in the transition and amendment process. In this regard the RFRWG points out that "*the time required for, and considerations around, amending existing GBP LIBOR referencing loans should not be underestimated. Early action should therefore be taken to transition now*".

Besides amendment of the operational provisions dealing with how the new interest rates will work, other terms of the loan documentation will also need to be updated – for example interest cover financial covenants may need to be revised. Consideration must also be given to amending hedging arrangements, accounting issues which may arise (in this regard the International Accounting Standards Board (IASB) has considered the potential effects of the transition on financial reporting under IFRS) and so on. The Legacy Transactions Paper also points out in this regard "*that there may be other elements to consider as part of the documentation process, for example, the requirement to obtain legal opinions, hold board meetings satisfy condition precedents*", and that "*security documentation guarantees and other documentation related to the loan*"; these will also need to be considered and reviewed. Clearly all of this will take time. Where a transaction involves multiple jurisdictions as well as the UK, the amount of time and the issues which may arise will likely be greater.

Turning to the tough legacy contracts which are recognised to be particularly difficult to amend ahead of the LIBOR ceasing, it should be noted that in its 5 March 2021 announcement the FCA said that it "is taking steps to help reduce disruption in these cases. The FCA will consult in Q2 on using proposed new powers that the government is legislating to grant to it under the Benchmarks Regulation (BMR) to require continued publication on a 'synthetic' basis for some sterling LIBOR settings and, for 1 additional year, some Japanese yen LIBOR settings. It will also continue to consider the case for using these powers for some US dollar LIBOR settings." This provides some welcome assistance for these difficult contracts although the FCA also made clear that "any 'synthetic' LIBOR will no longer be representative for the purposes of the BMR and is not for use in new contracts. It is intended for use in tough legacy contracts only. The FCA will also consult in Q2 on which legacy contracts will be permitted to use any 'synthetic' LIBOR rate".

Conclusion

As the countdown clock on the LMA website reminds us and the FCA in their announcement of 5 March 2021 made clear, time to finalise the transition to the RFRs is getting shorter by the day. The recent updates from the LMA and ARRC are welcome steps towards the finalization of the transition to the new RFRs but heavy lifting remains to be undertaken both in respect of new loans (where the new provisions have to be adopted and market customs finalized) and legacy loans. Legacy loans which mature after the 2021 end-date and currently only include the soft-wired agreement to agree approach can only really be dealt with once the RFRs have been firmly established and new transactions have been entered into so that market participants are comfortable with the new regime; time for this however is running out. It is important that adequate planning is undertaken and resources allocated by all market participants if the target milestones, and the end-dates now confirmed by the FCA, are to be met.

If you have any questions regarding the topics discussed in this article, please contact **Trevor Wood** at +44 (0)20 3667 2944 or any Vedder Price attorney with whom you have worked.

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