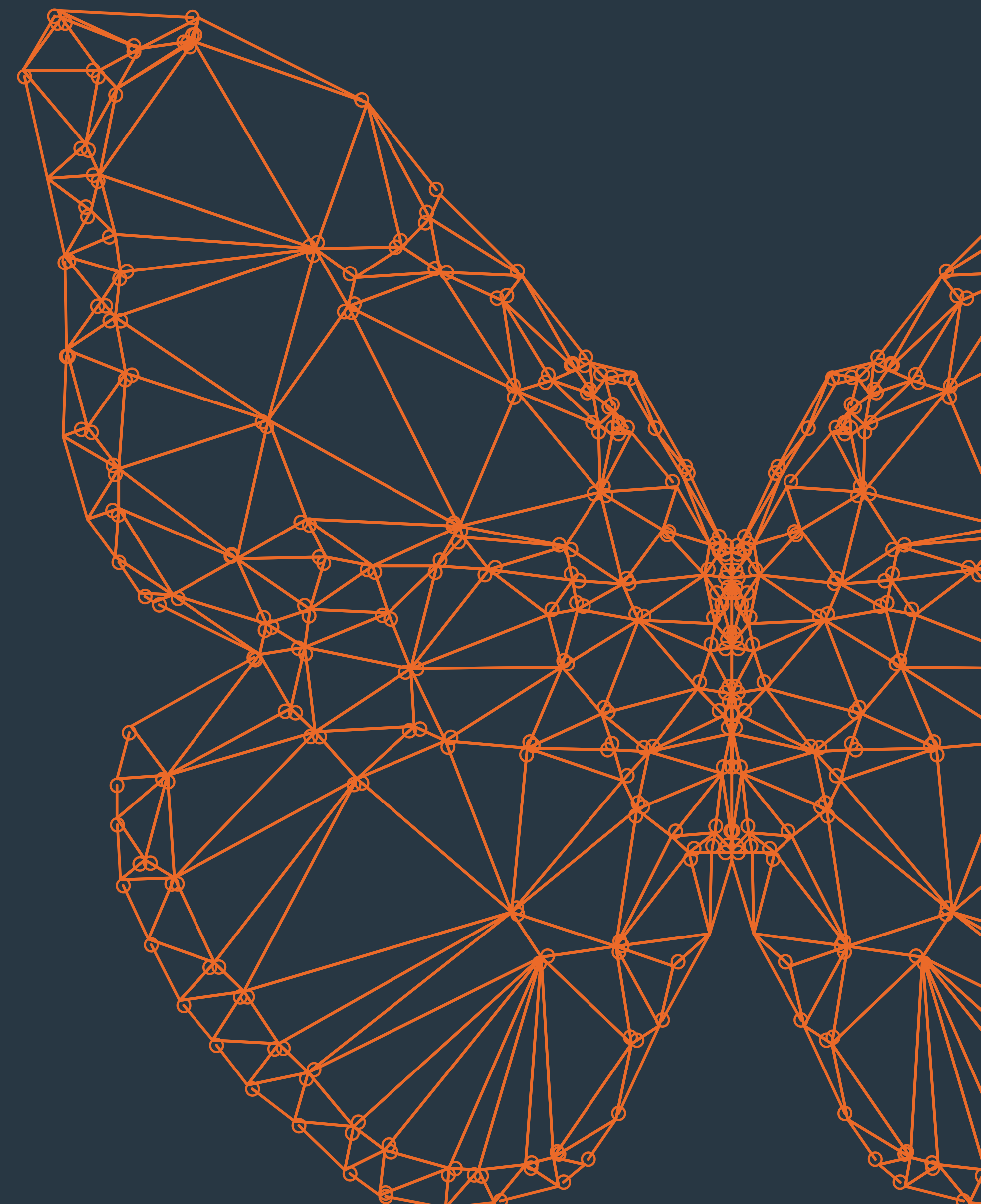
SLAUGHTER AND MAY/

ACT TREASURY EXCELLENCE AS STANDARD

A PRACTICAL GUIDE TO LIBOR TRANSITION

Produced for the Association of Corporate Treasurers
by Slaughter and May



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1. INTRODUCTION

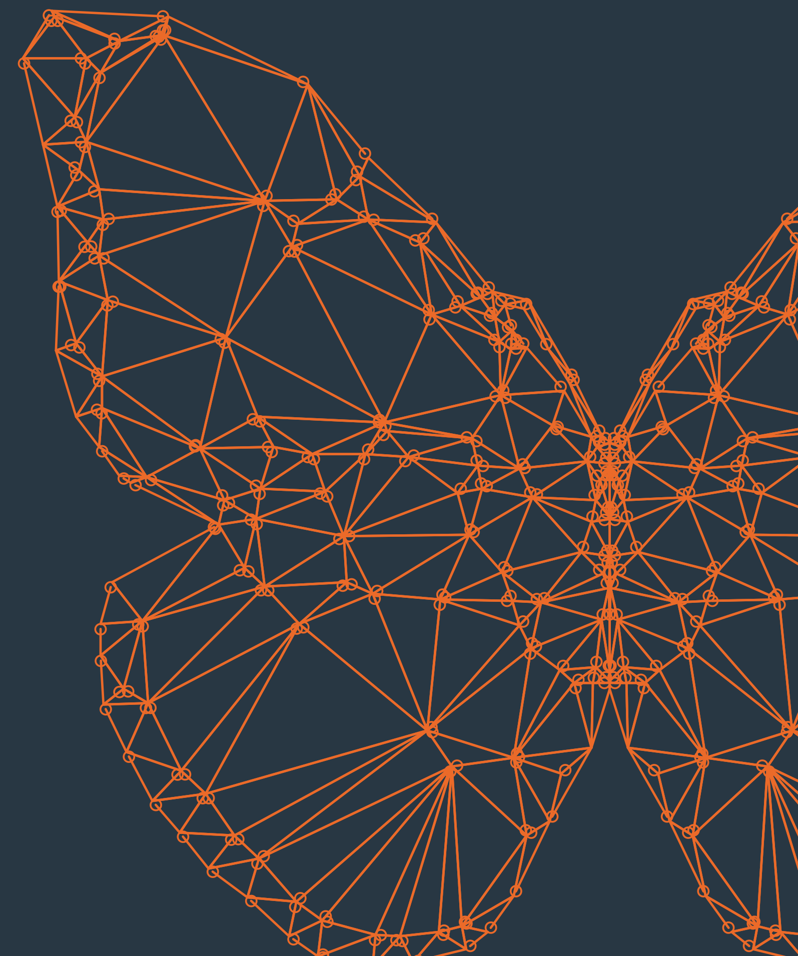
1.1 LIBOR transition is imminent

Most treasurers will be aware that the availability of LIBOR cannot be relied on beyond the end of 2021 and that LIBOR rates will be replaced, in most instances, by risk-free rates (**RFRs**). RFRs are available in all five LIBOR currencies (as well as a number of others), but relatively few businesses have taken steps towards using them. This will change in the very near future.

Determining how RFRs and other alternatives to LIBOR can be adopted and used in financial products has been an enormous challenge for all market participants. Replacing LIBOR involves the unravelling of market conventions that have been used for more than thirty years, in favour of a range of new product-specific and currency-specific conventions. As the final touches are put to the conventions and documentation that will enable the financial markets to dispense with LIBOR on a widespread basis, the focus has shifted to implementation.

The scale of the task facing the financial sector (especially in light of COVID-related delays) requires the implementation of the adjustments to systems, infrastructure and documentation required to facilitate transition from LIBOR, as far in advance of the end of 2021 as possible. International authorities, national regulators and industry working groups are stepping up their efforts to raise awareness of the work that remains and the need for businesses to have plans in place. To use their phrase, the time has come to "turbo-charge" LIBOR transition plans.

This is particularly apparent in the UK loan market. The Working Group for Sterling Risk Free Rates (**UK RFRWG**) recommended in April that from the end of Q3 2020, all new sterling LIBOR-referencing loans should contain provisions that enable the replacement of LIBOR with RFRs. Sterling LIBOR referencing loans must be phased out altogether by the end of Q1 2021. These targets require businesses raising new debt or refinancing to engage with alternatives to LIBOR somewhat earlier than they might have anticipated.



1.2 Aims and scope of this guide

Much of the information on LIBOR transition is detailed, technical and not available from a single source. The aim of this guide is to provide a starting point for finance and treasury teams transitioning LIBOR-referencing financial products to alternative rates.

The guide contains an overview of the key issues for users of loans, derivatives and other products - replacement rate options, calculation conventions and market documentation - alongside links to sources of further information. It also aims to give a practical steer on how treasurers might approach some of the open issues that will need to be determined on a case-by-case basis. It is structured as follows:

- **Section 2** is a checklist of action points for treasurers
- **Section 3** contains a timeline highlighting the key milestones to be aware of between now and the end of 2021
- **Section 4** summarises "LIBOR transition essentials" – background information about the LIBOR transition project, alternative rates and key concepts
- **Sections 5-8** outline the approach to replacement rates and documentation for loans (Section 5), derivatives (Section 6), bonds (Section 7) and non-financial products (Section 8) and some of the key discussion points
- **Section 9** contains links to further information and resources and **Section 10**, key contacts at the Association of Corporate Treasurers (**ACT**) and Slaughter and May.

The guide highlights the solutions that have developed for certain LIBOR products from a legal and documentation perspective. Treasurers will also need to consider broader operational issues relating to LIBOR transition; the updating of systems and market infrastructure to accommodate replacement rates as well as the accounting and tax implications of a move from LIBOR to alternative rates.

We are conscious that businesses operate cross-border in multiple currencies. The discussion in this guide is not limited to sterling products. Its main focus is rather on English law, which is frequently used as the governing law of cross-border products involving multiple currencies. Treasurers should be aware that products governed by the laws of other jurisdictions (for example, New York) may take a slightly different approach to replacement rates, conventions and related drafting. The guide touches on some of the key differences in the context of cash products and the approach to "tough legacy" contracts, but local advice is likely to be required.

While the bulk of the commentary in this guide relates to financial contracts, many readers will be aware that LIBOR is also used in a range of non-financial contracts. Experience with LIBOR transition in a financial context may mean that finance and treasury teams also have a role to play in raising awareness of the need to consider LIBOR usage, and how to manage transition, across their organisation. Possible approaches to replacing LIBOR references in non-financial contracts are discussed in Section 8.

Slaughter and May
30 September 2020

2. A TREASURER'S LIBOR TRANSITION CHECKLIST

- **Identify outstanding LIBOR exposures**: Review existing contracts (financial and non-financial) to determine the extent of outstanding LIBOR exposures. Assess the number of counterparties involved, the amount and currency of the exposure, the maturity of such exposures and any fallback provisions. Consider hedging and linkages between products. Review provisions specifying the process for amendment, if any.

- **Understand alternative rates**: Familiarise yourself with RFRs (as well as other alternative rates), how they differ from LIBOR and calculation conventions.

- **Monitor market developments**: Monitor how relevant product markets, jurisdictions and other corporates are approaching LIBOR transition. Draw on information/guidance from industry bodies, trade associations and your advisers.

- **Engage with counterparties**: Proactively engage with lenders and other counterparties to better understand their transition plans, their post-LIBOR product offering and what this means for your business.

- **Engage internally**: Implement a communication/education strategy for internal stakeholders (including business leadership) to increase understanding/awareness where relevant throughout the business.

- **Create a project plan and timeline**: Consider what steps you and your counterparty need to take to be ready and able, operationally and otherwise, to transition away from LIBOR. Form a view on the extent to which active transition (in advance of cessation) is feasible and if so, when it should take place.

- **Consider systems/infrastructure updates**: Consider the updates required to your treasury management system (**TMS**) to accommodate alternative rates. Proactively engage with your TMS provider to understand what it is doing to accommodate alternative rates and expected timeframes for, and costs of, implementation.

- **Consider accounting/tax implications**: Understand the tax and accounting implications of LIBOR transition. Engage with your tax advisers/accountants where necessary.

3. LIBOR TRANSITION TIMELINE

Currency | Q3 2020 | Q4 2020 | Q1 2021 | Q2 2021 | Q3 2021 | Q4 2021 | Q1 2022

Currency

- **October 2020:** Expected publication of ISDA Supplement and Protocol
- **End 2020 / Early 2021:** ISDA Supplement and Protocol to become effective (3-4 months after publication)
- **End 2021:** End of FCA support for LIBOR (assumed cessation)

GBP

- **End Q3 2020:** Lenders to offer non-LIBOR alternatives from end Q3 2020
- **After end Q3 2020:** all new and refinanced GBP LIBOR-linked loans to include clear contractual arrangements to facilitate conversion to SONIA or other alternatives
- **By end 2020:** SONIA term reference rate anticipated to be available
- **End Q1 2021:**
  - New issuance of GBP LIBOR-linked linear derivatives and cash products maturing after 2021 to cease
  - Acceleration of active conversion of cash products where viable
- **Q2/3 2021:**
  - New issuance of GBP LIBOR-linked non-linear and cross-currency derivatives maturing after 2021 to cease
  - Active conversion of LIBOR-linked linear derivatives where viable
  - Completion of active conversion of cash products where viable

USD

- **From end Q3 2020:** new syndicated loans to include hardwired fallback language
- **After end 2020:** issuance of USD LIBOR-linked FRNs maturing after 2021 to cease
- **After end Q2 2021:**
  - issuance of USD LIBOR-linked loans maturing after 2021 to cease
  - SOFR term reference rate should be available
  - issuance of new USD LIBOR derivatives to cease

EUR

- **Early 2021:** Final recommendations for fallbacks from EURIBOR expected
- **3 January 2022:** EONIA to be discontinued

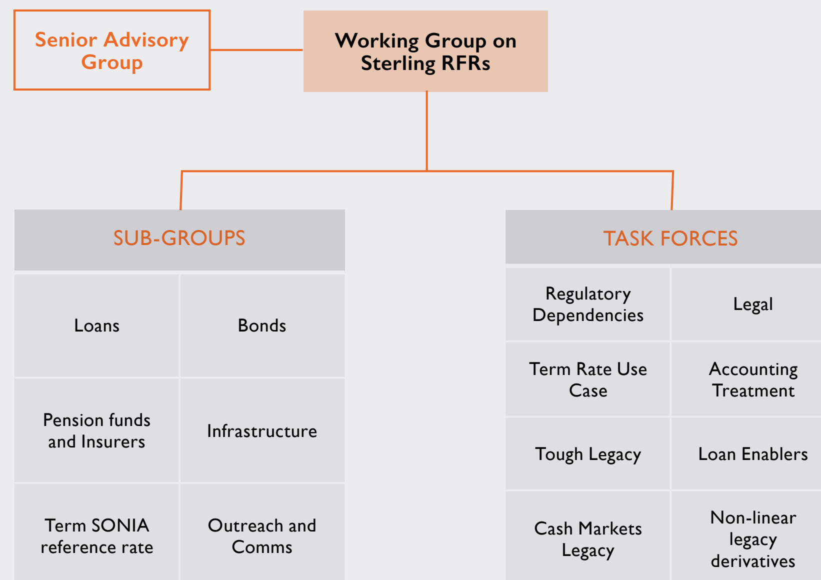
4. LIBOR TRANSITION ESSENTIALS

4.1 Role of the Working Groups

The official sector has encouraged an industry-led approach to LIBOR transition. The Financial Stability Board (**FSB**) recommended in 2014 that the focus should be on RFRs as alternatives to LIBOR. Following that recommendation, national regulators convened Working Groups in each LIBOR currency (the **Working Groups**) to catalyse market-led transition from LIBOR. These Working Groups are made up of banks, financial institutions, trade associations, advisers and other market participants, including a number of treasurers.

The Working Groups have taken the lead in recommending replacement rates and related calculation conventions for a range of products in the relevant currency. Each main Working Group has a network of sub-committees and task forces made up of specialists with a remit to focus on particular products or particular aspects of the transition project (such as systems and infrastructure). The diagram illustrates the structure of the UK RFRWG by way of example.

UK RFRWG



The ACT is a member of the UK RFRWG and also sits on a number of the sub-committees. The ACT and other trade associations have been heavily involved in outreach and education projects relating to LIBOR transition. Their websites are an important source of information on this project. Some of the key resources are listed in Section 9.

The Working Groups do not have regulatory powers. Their recommendations with regard to replacement rates, conventions and timelines are, however, expected to guide market practice to a large extent. This is partly because their recommendations are the result of consultation, but also because global and national financial sector regulators have emphasised their support for market-led transition efforts. The Bank of England and the Financial Conduct Authority (**FCA**), for example, have made clear to regulated firms that they expect them to adhere to industry and working group transition targets. The FCA has also stated that firms are more likely to be able to demonstrate that they have complied with their regulatory obligations to treat customers fairly in this context if they adopt solutions recognised by relevant working groups.

It is important that treasurers are aware of the Working Group and other industry recommendations that are relevant to the floating rate products used in their business and the timeframes to which they should be working. The Working Groups have set slightly different interim milestones on the path to end 2021. The key dates to be aware of in relation to sterling, euro and US dollars are set out in the timeline in Section 3.

4.2 Cross-currency co-ordination

The impetus to improve the robustness of interest rate benchmarks such as LIBOR is co-ordinated on a global level by the FSB, at the instigation of the G20. The FSB's communications emphasise the need for cross-jurisdictional co-operation, but acknowledge that complete homogeneity in terms of the approach to replacement rates will not be possible in a multi-rate environment.

National Working Groups are making efforts to co-ordinate their approach to LIBOR transition across products and currencies. The desire for the recommendations of each Working Group on LIBOR replacements for particular products to take a consistent approach is a continuing feature of consultation feedback. Some issues have been ironed out. However, the fact that a benchmark with a single consistent methodology is being replaced with a menu of single currency rates with differing characteristics will inevitably result in some level of variation.

This steepens the learning curve somewhat for users of multiple currencies, who will need to understand the approach taken to each currency. This is why multi-currency loans, going forward will require the rate sources and conventions applicable to each relevant reference rate to be documented individually. The international nature of the financial markets also means that there may be variations between the approach to rates and calculation conventions for certain currencies in domestic and cross-border deals. Cross-currency variations are discussed further in Section 5 (Loans), Section 6 (Derivatives) and Section 7 (Bonds).

4.3 Risk-free rates

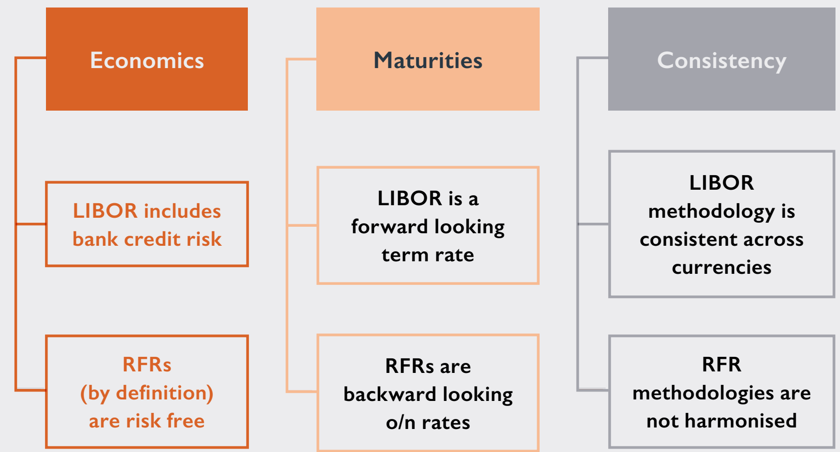
There are different options to replace LIBOR, but in most instances, the alternative will be a RFR or a rate derived from a RFR.

Some RFRs, like SONIA (the sterling RFR), are well-established rates that have been reformed more recently. Others, such as SOFR (the US dollar RFR) and €STR (the euro RFR), are brand new. Their common characteristic is that they are all backward-looking overnight rates on a pool of virtually risk-free investments. Otherwise, they have differing characteristics that reflect their underlying local market.

The RFRs are therefore quite different from LIBOR. LIBOR includes a measure of bank credit risk and as a term rate available over a range of maturities, a term liquidity premium. It is calculated on a consistent basis across all five currencies. None of these elements are present in the RFRs.

The RFR for each LIBOR currency is set out in the table on the next page, together with the current IBOR options, details of the national working group and links to sources of further information on the composition and operation of the relevant rate.

LIBOR vs. RFRs



RISK FREE RATES

LIBOR Currency	IBOR/ Administrator	RFR	RFR Administrator	Working Group
	LIBOR IBA	Sterling Overnight Index Average (SONIA)	Bank of England	Working Group on Sterling Risk-free Reference Rates
	LIBOR IBA	Secured Overnight Financing Rate (SOFR)	Federal Reserve Bank of New York (NY FED)	Alternative Reference Rates Committee (ARRC)
	LIBOR IBA EURIBOR EMMI	Euro Short-term Rate (€STR)	European Central Bank (ECB)	Working Group on Euro Risk-free Rates
	LIBOR IBA	Swiss Average Rate Overnight (SARON)	SIX Swiss Exchange	National Working Group (NWG) on Swiss Franc Reference Rates
	LIBOR IBA TIBOR Euroyen TIBOR JBATA	Tokyo Overnight Average Rate (TONAR)	Bank of Japan	Cross-industry Committee on Japanese Yen Interest Rate Benchmarks

4.4 Term rates

Focus on backward-looking rates

Moving cash products from LIBOR, a forward-looking term rate available over a range of maturities, to a backward-looking RFR prompted much concern in the early stages of the transition project. To calculate a RFR over a period (for example in the context of a loan or bond), it is necessary to calculate interest daily, meaning the results of the calculation will not be known until the end of the interest period. Corporates were concerned about the impact of using a backward-looking rate on their ability to manage cash effectively and there was a strong desire for forward-looking term RFRs.

The priority of the Working Groups has, however, been to promote the use of compounded (or averaged) RFRs, to align the cash markets with the derivatives market. SONIA compounded in arrears, for example, has been used in the sterling overnight interest rate swap (**OIS**) market for over 20 years, so conventions are well established. The slower transition to RFRs in the loan market reflects the time it has taken to overcome the operational hurdles to using backward-looking rates in the context of a product built around LIBOR.

The UK RFRWG has repeatedly emphasised their expectation that the bulk of the cash markets should transition to backward-looking RFRs and should not wait for term rates. The report of the UK RFRWG Use Case Task Force concluded:

"overnight SONIA, compounded in arrears, will and should become the norm in most derivatives, bonds, and bilateral and syndicated loan markets given the benefits of the consistent use of benchmarks across markets and the robust nature of overnight SONIA. The future use of a forward-looking term rate in cash markets should be more limited than the current use of LIBOR. So, where possible, counterparties are encouraged to transition to overnight SONIA compounded in arrears."

Forward-looking term rates

The UK RFRWG believes term SONIA is likely to be appropriate only in limited instances where operational necessity precludes the use of a compounded in arrears RFR or another alternative rate. Transactions for smaller corporate, wealth and retail clients for whom simplicity and/or payment certainty is a key factor are an example. In addition, there are some products where the use of SONIA compounded in arrears will likely create operational difficulty regardless of the sophistication of the borrower. These include trade and working capital products such as supply chain finance and receivable facilities, export finance and emerging market loans, and Islamic facilities. In such cases, although fixed rates or the Bank of England's Bank Rate are likely to be preferred, there may be instances where a forward-looking term rate is the most appropriate alternative to LIBOR.

A Term SONIA Reference Rate (**TSRR**) is being developed for this limited use case. The TSRR is available in beta form but is not yet available for use. Publication is anticipated to commence by Q1 2021.

The position on term rates is slightly different for each LIBOR currency:

- **Dollars:** Term SOFR is anticipated to be made available during 2021. Term SOFR is potentially likely to be adopted more widely than term SONIA, not least because the ARRC has recommended term SOFR as the primary fallback from LIBOR for syndicated and bilateral loans (see paragraph 5.11 of Section 5). Recommendations from the ARRC on the scope of use for a term rate derived from SOFR are expected in the coming months.
- **Euro:** The Euro Working Group is progressing term €STR rates with administrators and considering use cases.
- **CHF:** The Swiss Working Group has concluded it is not possible to produce a SARON term rate as the underlying data required to produce such a rate is not available.
- **Japanese Yen:** A prototype term TONAR commenced publication in May 2020.

Please refer to the national Working Group webpages listed in Section 9 for further information on the availability and use case for term RFRs.

What if forward-looking term rates are not available?

Even where national Working Groups have concluded that use cases are limited, it is clear that for certain products, the availability of forward-looking term RFRs is very important. While the timing and availability of such rates remains uncertain, parties using products such as trade and supply chain finance, may become concerned about whether there is a contingency plan.

Alternative approaches could include the use of fixed or central bank rates (see paragraph 4.5 below). Another option may be to use the RFR compounded in advance. This involves calculating the compounded RFR over a period of time equal in length to the current interest period, but occurring prior to the start of the interest period. In other words, for a 3 month interest period that ends at the end of Q1 2021, the daily RFR would be observed and compounded over the three month period of Q4 2020. This achieves the objective of providing borrowers certainty at the beginning of an interest period, of the amount of interest payable at the end. However, it does not, of course, reflect what actually happens to interest rates over the given interest period, the implications of which will need to be considered.

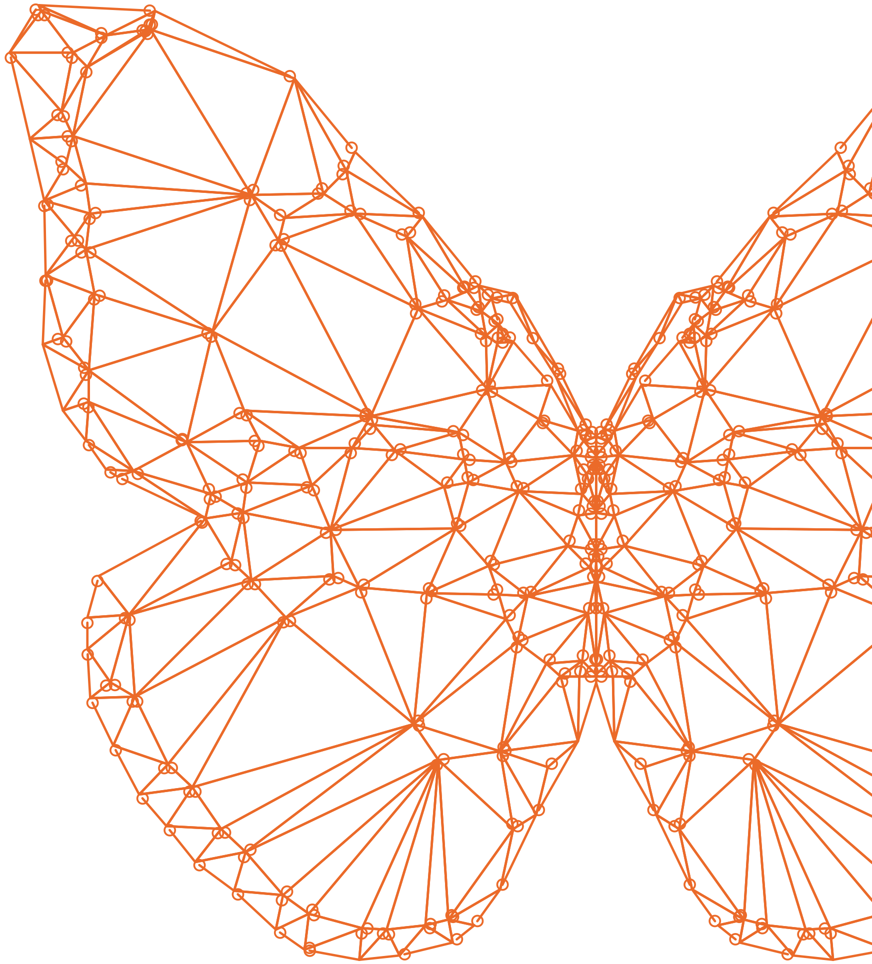
A detailed discussion of trade finance and working capital products identified as within the use case for term rates (supply chain finance and receivable facilities, export finance and emerging market loans, and Islamic facilities) is outside the scope of this guide. Treasurers using those products are urged to discuss their options with relevant counterparties.

4.5 Other alternatives

RFRs (whether forward-looking or backward-looking) are not the only alternative to LIBOR. Central bank rates and fixed rates, for example, have the advantage of being simpler to understand and administer so may be preferred for certain products. This is recognised by the Working Groups. Alternatives to RFRs may be more appropriate for products highlighted as unsuited to RFRs compounded in arrears, such as smaller business lending, trade finance and Islamic finance, for example.

These rates may also be appropriate to consider in the context of many non-financial contracts that would previously have referenced LIBOR (see Section 8).

Central bank rates and fixed rates have always been used in some categories of debt product so increasing their usage should not require significant innovation. For example, in the UK, banks are generally familiar with documenting and pricing SME-sized loans that reference the Bank of England Bank Rate. For this reason, these options for financial products are not considered further in this guide.



4.6 Compounded RFRs – rate conventions

The focus of the UK RFRWG has been on the use of SONIA compounded in arrears. Treasurers should be aware that the compounding methodology and conventions adopted may differ by product. The key concepts that are relevant to the products discussed in this guide are outlined below.

Compounding conventions

Compounding recognises that the borrower does not pay back interest owed on a daily basis and more accurately reflects the time value of money by keeping track of the accumulated interest owed but not yet paid.

There are different approaches to the compounding calculation. The additional amount of interest owed each day can be calculated either by applying the daily RFR to the balance or the rate:

- **Compounding the balance:** The daily RFR is multiplied by the outstanding principal and unpaid accrued interest (collectively, the balance).
- **Compounding the rate:** The rate itself is compounded and multiplied by the outstanding principal.

If the second option is chosen, there are two approaches to compounding the rate:

- **Cumulative compounded rate:** The compounded rate is calculated at the end of the interest period and that rate is then applied to the whole period. This method allows calculation of interest for the whole period using a single compounded rate. This is the method which has been adopted by ISDA for the purposes of fallbacks in derivatives and in capital markets products.
- **Non-cumulative compounded rate:** This rate is derived from the cumulative compounded rate. The non-cumulative compounded rate for a given day is the cumulative compounded rate for that day minus the cumulative compounded rate for the previous day. This generates a daily compounded rate which allows the calculation of a daily interest amount, enabling accurate calculation of accrued interest at any point in time.

The UK RFRWG recommends the non-cumulative compounded rate method for loans, because it better supports intra-period events such as prepayments and trading (see paragraph 5.7 of Section 5).

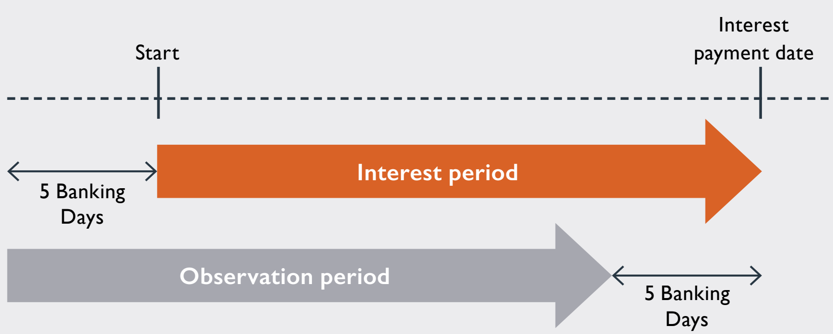
It is worth noting that the ARRC has put more focus on simple interest as an option for the US loan market, whereby the daily SOFR rate is multiplied by the outstanding principal of the loans. This appears to be largely on the basis that it is considered operationally easier to implement. See further paragraph 5.11 of Section 5.

Lookback

As RFRs are backward-looking overnight rates, the daily RFR will be available only at the end of the day to which it relates or the beginning of the next day. Where the daily RFRs used to calculate the interest payable for a given interest period are those observed over that interest period, the total interest payable will only be fully known at the end of that interest period or just after.

In the cash markets, this presents a challenge in that the parties will need to determine the amount of interest payable some period in advance of the end of the interest period to enable them to mobilise payments within the required settlement time. The solution that has been developed to deal with this is known as the "lookback".

Interest is calculated over an "observation period" which starts and ends a certain number of days prior to the start and end of the interest period.



The loan market is using a 5 Banking Day lookback period for transactions referencing SONIA compounded in arrears. The same period is also being used for sterling bonds. See further paragraph 5.7 of Section 5 (Loans) and Section 7 (Bonds).

Observation shift

When compounding a RFR over a period, the rate to be used for non-business days on which the RFR is not published will be the rate for the preceding business day. This means that the RFR for a business day may be weighted more than once – the RFR for a Friday, for example, when the next business day is the following Monday, will have a weighting of three days to account for the fact that it is used for the Friday, Saturday and Sunday.

If the lookback convention is adopted such that interest is calculated over an observation period that is different from the interest period, the question is how the weighting is derived - namely, whether to adopt the "observation shift" convention or not.

The observation shift convention ("**shift**" or "**lookback with observation shift**") weights the rate according to the number of days in the observation period rather than the interest period. The lookback convention ("**lag**" or "**lookback without observation shift**") weights the rate according to the number of days in the interest period to which the calculation is relevant.

The concept of an observation shift is used in the SONIA Compounded Index (see paragraph 4.7 below) and in the sterling derivatives market. The use of a 5 Banking Day lookback without observation shift is the recommended approach for the sterling loan market. For further information and some worked examples, see the UK RFRWG's Recommendations for SONIA Loan Market Conventions and Supporting Slides.

4.7 Compounded RFRs – data sources

No screen rates

The accessibility of RFRs has been a concern for many treasurers. There is no definitive "screen rate" source of compounded RFRs. In most RFR-linked products, rather than identifying the rate by reference to a screen page, the rate calculation formulae and conventions will need to be documented and calculations effected based on the agreement.

Indices

The production of a screen rate is challenging because the calculation of a RFR compounded in arrears requires a SONIA rate for each day in the period. The Bank of England has developed a SONIA Compounded Index to assist with calculations. This is a series of daily data that represents the returns from a rolling unit of investment earning compounded interest at the SONIA rate each day.

The New York Fed has similarly developed an Index for Compounded SOFR. While there are no current plans to discontinue EURIBOR, the European Central Bank is consulting on the publication of compounded €STR data.

These indices enable the user to calculate the RFR over a period by identifying the change in the index data between the two relevant dates. They will be helpful for certain transactions, but will not be useful universally as they are not consistent with certain conventions. For example the SONIA Compounded Index adopts the observation shift convention; if that is not adopted it will not be suitable. Similarly, the use of benchmark floors, which are common in the loan market, inhibit the use of the indices if rates are negative.

Rate calculators

Banks are developing rate calculators for use in conjunction with their RFR-linked products. This is the basis on which many of the RFR-linked loans completed to date have accessed relevant rates. Independent systems providers may yet develop a tool to assist borrowers with calculations, but it is not clear whether or when this might happen.

4.8 Managing legacy contracts

Active transition

Existing contracts referencing LIBOR may not include fallback provisions that cater satisfactorily or at all for the continuation of the contract upon LIBOR being permanently discontinued. As LIBOR-linked products are phased out, pre-existing LIBOR-linked contracts that extend beyond 2021 will need to be amended to incorporate replacement rates.

There are two options for actively managing legacy LIBOR contracts:

- **Conversion:** The contract can be amended such that LIBOR is replaced with an alternative rate and the contract proceeds on that basis.
- **Fallback approach:** The contract can be amended to insert fallback provisions that enable the conversion to alternative rates upon the occurrence of specified triggers.

The options will depend, among other things, on whether the parties are operationally ready to adopt alternative rates.

Fallback triggers

If the fallback approach is selected, the triggers for the application of the fallback rates must be clear:

- **Cessation:** A "cessation" trigger is essential. Replacement rates will need to be implemented when LIBOR ceases to be available.
- **Pre-cessation:** Market participants have also been strongly encouraged by the authorities and working groups across all asset classes to provide for the adoption of replacement rates if the FCA announces, earlier than the expected cessation date of the end of December 2021, that LIBOR has become non-representative of the underlying market it seeks to measure. This is the so-called "pre-cessation" or "non-representativeness" trigger.
- **Early opt-in:** Parties may also choose to include an early-opt in trigger so fallback rates can be applied if the parties are ready to transition at an earlier date.

The fallback triggers applicable in the context of particular financial products are discussed in Section 5 (Loans), Section 6 (Derivatives) and Section 7 (Bonds).

Credit spread adjustments

Whichever approach is adopted, the parties will need to determine the appropriate replacement rate, adjusted to accommodate the economic difference between LIBOR and the relevant RFR.

Spread adjustments for derivatives

The use of RFRs as fallbacks for LIBOR in financial products was initially examined in the context of fallbacks for LIBOR derivatives. Following extensive consultation, the derivatives market concluded to use RFRs compounded over the required tenor plus a spread adjustment to approximate the bank credit risk premium.

The conclusion of ISDA's consultations on the credit spread to be applied to the compounded in arrears RFR was to base the spread adjustment on the median over a five-year period of the historical differences between (i) LIBOR for the relevant tenor and (ii) the relevant RFR compounded in arrears over the corresponding period.

The "all-in" fallback rate for LIBOR derivatives (the compounded RFR plus the spread for the equivalent tenor) will be published by Bloomberg. As the rate is a backward-looking rather than a forward-looking rate, the fallback rate will be published on a date that is around the end of the relevant period (rather than the beginning of the period, as is the case in relation to LIBOR). Each published all-in fallback rate will be labelled with the date the original LIBOR rate would have been published, for ease of reference[1].

Spread adjustments for cash products

Consultations in the UK have found broad consensus for a credit spread adjustment for fallbacks in cash products based on the historic median between LIBOR and the relevant RFR over a five-year lookback period, in line with the approach adopted by ISDA. Similar conclusions have been reached in the US.

The UK RFRWG released a statement on 10 September, formally recommending the use of the "historical five-year median spread adjustment methodology" when calculating the credit adjustment spread to be applied to any relevant SONIA rate that replaces sterling LIBOR.

Access to this credit spread methodology remains unclear. The Bloomberg data published for derivatives will be of limited value to the loan market as the compounding calculation that this used for the purposes of the "all in" rate reflects conventions that are different to those used in the loan market e.g. it does not assume a 5 Banking Day lookback. The statement notes that the UK RFRWG will monitor the availability of data sources to support use of this spread adjustment methodology for use in cash products and consider whether any further work is needed in this area in due course.

How credit spread adjustments are being approached in practice in loans, derivatives and bonds is discussed in Section 5 (Loans), Section 6 (Derivatives) and Section 7 (Bonds).

[1] See further https://data.bloomberglp.com/professional/sites/10/IBOR-Fallbacks-Fact-Sheet.pdf

4.9 "Tough legacy" contracts

There are certain categories of contract that contain inadequate fallbacks but are impossible or very difficult to amend in advance of the end 2021 deadline. These contracts, known as "tough legacy" contracts, include products denominated in every LIBOR currency and may include:

- certain bonds (because the use of consent solicitations to transition legacy LIBOR bonds is costly, time-consuming and may require the consent of all of the bondholders);
- certain bilateral and syndicated loans (due to the diverse nature of borrowers, questions of cost and resource availability and other challenges); and
- certain derivatives (particularly where these are used to hedge an exposure which is itself considered tough legacy or forms part of a more complex structure).

In the absence of action by policy-makers, there is a risk that these tough legacy contracts would pose a risk to consumers or financial stability once LIBOR is no longer available.

The UK Government announced on 23 June that the UK will take legislative action to confer powers on the FCA to protect the continuity of certain tough legacy contracts. The FCA will be empowered to direct a change in the methodology of a critical benchmark - like LIBOR - that has become permanently unrepresentative, such that the benchmark can continue to be used in those contracts. This legislation will take the form of amendments to the UK's post-Brexit Benchmark Regulation, which is expected to form part of the upcoming Financial Services Bill.

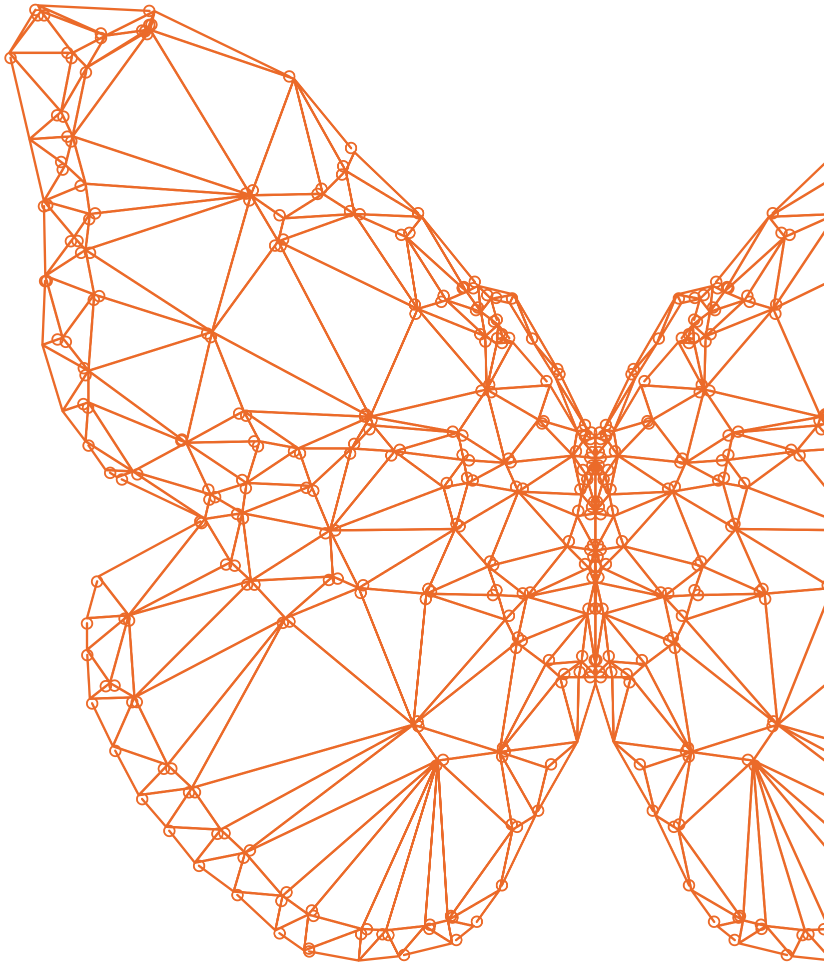
It is important, however to emphasise that this legislation should not be viewed as a substitute for negotiated amendments to legacy LIBOR contracts:

- The FCA's powers to support the continuation of tough legacy contracts might not be exercised in all circumstances or for all LIBOR currencies.
- The proposed legislation is aimed at a narrow pool of contracts which "genuinely have no or only inappropriate alternatives and no realistic means of being renegotiated or amended ahead of end 2021".

As a result, taking proactive steps to amend the terms of legacy LIBOR contracts is the only way the parties can have certainty that legacy LIBOR contracts will continue and have control over the terms on which they will continue when LIBOR ceases. This point was emphasised by the UK RFRWG Tough Legacy Task Force in its most recent paper and by the Bank of England in its August Financial Stability Report.

The ARRC and the European Commission are also taking steps to manage tough legacy contracts. The ARRC has put forward some draft New York legislation which is aimed at US dollar LIBOR contracts in the tough legacy category, which are governed by New York law. The European Commission is proposing to amend the EU Benchmarks Regulation, seemingly to enable the continuity of tough legacy LIBOR contracts in any currency that are governed by the law of an EU member state.

At the time of writing, the scope of these legislative solutions remains unclear, including whether they are likely to be helpful or a hindrance from the corporate perspective. Nonetheless, the key message remains that to have control over the economic outcome of the cessation of LIBOR, treasurers are best advised to take proactive steps to agree amendments to their LIBOR contracts with their counterparties rather than relying on a legislative solution.



5. LOANS

5.1 UK RFRWG recommendations for sterling loans

In April 2020, the UK RFRWG issued a statement containing the following recommendations for the sterling loan market:

- Lenders should be in a position to offer non-LIBOR linked products to customers by the end of Q3 2020.
- After the end of Q3 2020, all new and refinanced sterling LIBOR-referencing loans should include "clear contractual arrangements" to facilitate conversion ahead of end-2021 to SONIA or other alternatives, through "pre-agreed conversion terms" or an "agreed process for renegotiation".
- All new issuance of sterling LIBOR-referencing loan products that expire after the end of 2021 should cease by the end of Q1 2021.

The UK RFRWG recommendations mean that borrowers looking to finance or refinance in the sterling market currently have the option of continuing to reference LIBOR, provided that the agreement includes either "pre-agreed conversion terms" or an "agreed process for renegotiation", or alternatively using a "non-LIBOR" linked product.

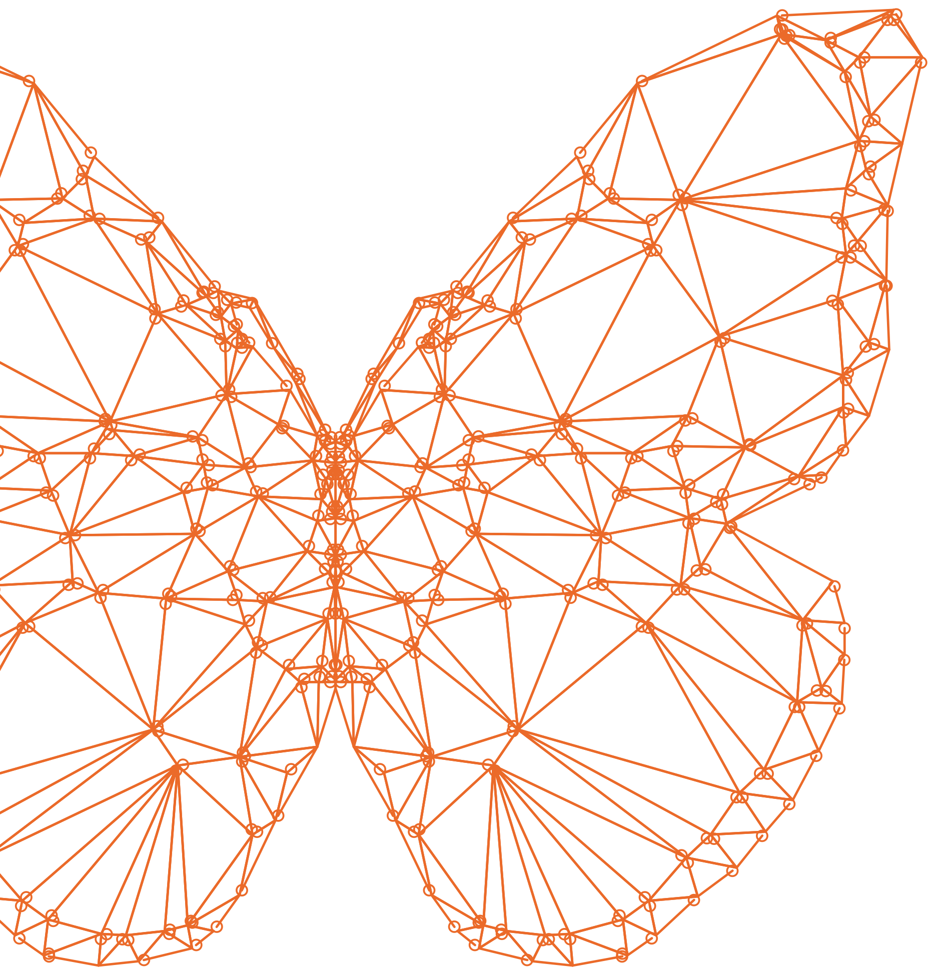
From April 2021, the only option available to borrowers will be to enter into "non-LIBOR" linked loans.

TRANSITIONING LIBOR LOANS

Current options:

- "Non-LIBOR" linked loan
- LIBOR loan including "pre-agreed conversion terms" (the "rate switch")
- LIBOR loan including "agreed process for renegotiation"

From April 2021, only "non-LIBOR" linked loans will be available.



5.2 Non-LIBOR-linked loans

As discussed in Section 2, in the vast majority of cases, the "non-LIBOR" product will be a RFR-linked loan.

A relatively limited number of RFR-linked loans have been completed so far, with most lenders running only pilot projects, using exposure draft RFR-linked documentation produced by the Loan Market Association (**LMA**) as a reference point (see paragraph 5.5 below).

The main hurdle to the widespread adoption of RFRs in the loan market has been the need to settle conventions for the use of RFRs in loans. More recently, however, significant progress has been made, including, in September 2020, the UK RFRWG publishing Recommendations for SONIA Loan Market Conventions (the **UK RFRWG Recommended Conventions**).

These recommendations should enable the documentation and market infrastructure that will facilitate the adoption of RFRs on a market-wide basis to be finalised. Volumes of RFR-linked loans are anticipated to increase significantly in the coming months.

5.3 LIBOR loans including "pre-agreed conversion terms"

"Pre-agreed conversion terms", otherwise known as "rate switch" provisions, provide that on a specified future date or following the occurrence of specified triggers, LIBOR will automatically be replaced by the relevant RFR.

This approach has been used in a number of large syndicated facilities to date, including for British American Tobacco and Shell. The LMA recently published a multicurrency term and revolving facilities agreement incorporating rate switch provisions in exposure draft form, which reflects the learning from these pioneer transactions and aims to assist the market with documenting this approach.

The UK RFRWG and UK regulators have given a strong steer that where possible, "pre-agreed conversion terms" are to be preferred over an "agreed process for renegotiation". Where conversion terms are pre-agreed, no further amendments are needed to transition the loan from LIBOR to RFRs, meaning the stock of legacy LIBOR deals that will require re-papering ahead of end-2021 is reduced by the transaction, rather than increased. Pre-agreeing conversion terms also provides the greatest certainty for borrowers and lenders.

The advantage of the rate switch approach is therefore that the loan is future-proofed. The parties can continue to use LIBOR until the time at which they have agreed the loan will switch to RFRs (either by reference to a specified date or the occurrence of specified triggers). This gives lenders and borrowers time to build/update the systems and processes required to accommodate RFRs, while having dealt with the contractual aspects of transition.

In order to deal with the contractual aspects of transition, however, parties need to make decisions now about how they reference RFRs following the switch. While progress has been made on the recommended conventions for referencing SONIA (and SOFR) in loans, there remain certain points on which parties must take a view.

The LMA's draft documentation and the key points for borrowers to consider in relation to rate switch facilities are considered at paragraph 5.9 below.

5.4 LIBOR loans including an "agreed process for negotiation"

LIBOR loans including an "agreed process for renegotiation" include just that. In a number of recent transactions, banks have put forward provisions that require the borrower, upon the occurrence of specified triggers, to engage with the lender(s) to negotiate amendments to the agreement that take effect in advance of the end of 2021.

Many LMA syndicated facilities contain the so-called "Replacement of Screen Rate" clause that provides for the replacement of LIBOR (or any other benchmark rate) by agreement between a specified majority of lenders and the borrower. This clause was developed initially to avoid the need to get consent from all lenders to make the changes required to implement transition from LIBOR.

The UK RFRWG indicated in a Q&A document published in July 2020 that the LMA Replacement of Screen Rate clause did not constitute an "agreed process for renegotiation" for the purposes of its recommendation. In response, the LMA published a revised version designed to meet the UK RFRWG recommendation. The updated clause provides (in summary) that if LIBOR is still being referenced at a specified date prior to 31 December 2021, the parties will enter into negotiations at that time to replace LIBOR.

The revised clause is set out in the schedule to the LMA's "Note on the Revised Replacement of Screen Rate Clause and documentary recommendations published by the Working Group on Sterling Risk-Free Reference Rates" (available to LMA members on the LMA's LIBOR microsite).

While the renegotiation route remains an option for parties currently looking to finance or refinance in the sterling market, the principal disadvantage is that it does not entirely de-risk the facility from being disrupted when LIBOR ceases. What happens if the parties do not reach agreement, or disagree on the solution? The risk of that happening is minimised if the market moves towards a clear consensus on replacement rates as is likely to be the case in the syndicated sterling market. More generally, lenders are constrained by their regulatory obligations from departing far from working group and industry recommendations[2].

Some banks are seeking to remove the risk that amendments are not completed efficiently in bilateral transactions by including a default resolution mechanism which enables the lender to implement the required amendments to replace LIBOR unilaterally if agreement cannot be reached with the borrower. To the extent such a provision is deemed necessary, borrowers will wish to build in safeguards such as the right to object and a requirement that the bank implements amendments in line with market consensus or, perhaps, its treatment of other similar borrowers.

As discussed above, the emphasis of the UK RFRWG and UK regulators is firmly on the inclusion of "pre-agreed conversion terms" over an "agreed process for renegotiation". The LMA's revised Replacement of Screen Rate clause reflects this by including a placeholder for those wishing to include an "agreed process for renegotiation" but at the same time able to pre-agree at least some conversion terms.

[2] See the FCA's Q&As Conduct risk during LIBOR transition (November 2019).

5.5 LMA documentation referencing RFRs

LMA publications to date

To support the transition of the syndicated loan market from LIBOR to RFRs, the LMA has produced a number of templates, supplementary drafting and guidance material. The LMA facility agreement templates for RFR-linked loans (together, the **LMA Templates**) currently comprise the following:

- Single currency term and revolving facilities agreement referencing SONIA (the **SONIA STR**)
- Single currency term and revolving facilities agreement referencing SOFR (the **SOFR STR**, and together with the SONIA STR, the **Single Currency Templates**)
- Multicurrency term and revolving facilities agreement incorporating rate switch provisions (lookback without observation shift) (the **Rate Switch Template**)

The templates are available to LMA members on the LMA's LIBOR microsite. At the time of writing, all of these templates remain in exposure draft form.

Single Currency Templates

The Single Currency Templates, which reference compounded SONIA and SOFR respectively, were originally published in September 2019, together with an accompanying commentary. Their primary purpose was to act as a focal point for consideration by market participants of the key issues and to facilitate awareness and consideration of those issues by framing them in their documentary context. As a result, they include a large number of blank placeholders and optional provisions, which are discussed at length in the commentary.

Rate Switch Template

The Rate Switch Template was published in September 2020, also in exposure draft form, together with an accompanying commentary. It is based on the LMA recommended form multicurrency term and revolving facilities agreement and has been drafted to accommodate loans in sterling, US dollars, euros and Swiss francs.

The Rate Switch Template provides a framework for "pre-agreed conversion terms" in LIBOR-referencing loans. On signing, the facilities reference LIBOR/EURIBOR. On a specified date or following the occurrence of specified trigger events, the facilities switch, on a currency-by-currency basis, to the relevant RFR (see paragraph 5.9 for more detail on the triggers for the rate switch).

Once the rate switch date has occurred in respect of a given currency, all new advances in that currency will reference the relevant RFR. All existing LIBOR advances will run their course to the end of the interest period and switch to the relevant RFR thereafter.

The Rate Switch Template incorporates RFR provisions which apply following the rate switch. These are set out by currency in a schedule to the agreement. The RFR provisions are based on the RFR provisions in the Single Currency Templates, updated to reflect the UK RFRWG Recommended Conventions, as well as feedback from market participants and the multicurrency nature of the template.

The LMA Rate Switch Template contains the most recent LMA drafting for RFR-linked loans and should be considered the current "state of the art". The discussion below relates to the RFR provisions in the Rate Switch Template, which are referred to in the remainder of this Section as the "LMA RFR Terms".

It is expected that the LMA Single Currency Templates will be updated in due course to reflect the LMA RFR Terms in the Rate Switch template.

Future LMA documentation

Further RFR-linked facility agreements are expected to be published by the LMA in the coming months, including:

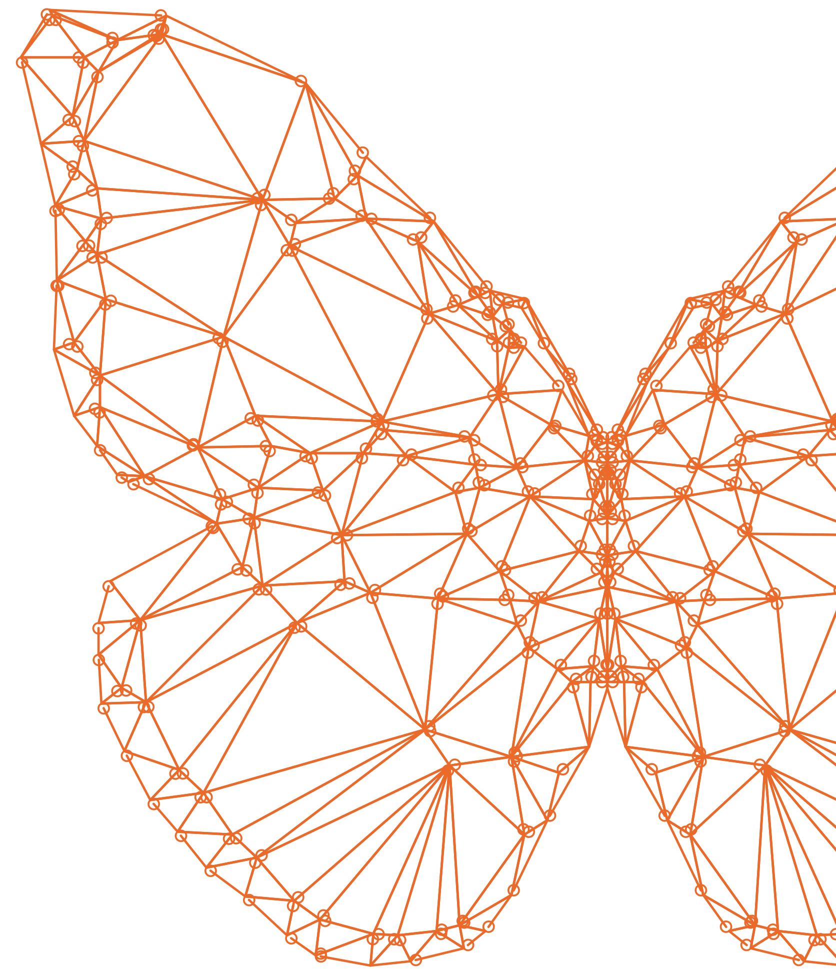
- A compounded rate/term rate multicurrency term and revolving facilities agreement, for loans in sterling, US dollars, euros and Swiss francs, providing for the use of compounded SONIA, SOFR and SARON for loans in sterling, US dollars and Swiss francs respectively, and for the continued use of EURIBOR for loans in euros.
- A multicurrency term and revolving facilities agreement incorporating rate switch provisions (lookback with observation shift).

These templates, and the Single Currency Templates and Rate Switch Template will be made available as LMA recommended forms when the feedback process is complete. The whole LMA documentation library will eventually need to be updated to reflect RFRs instead of LIBOR, a significant undertaking of itself in the timeframe.

5.6 RFR loans – key points for borrowers

The LMA RFR Terms are technical and unavoidably quite complicated, particularly in the context of multicurrency agreements. The most important issue from the borrower's perspective is to understand the rate calculation conventions that are adopted and the pricing structure – and that those are reflected properly in the agreement.

Key points on the rate calculation conventions and pricing of RFR-linked facilities, or facilities that switch to RFRs are summarised at paragraph 5.7. Secondary issues relating to RFR-linked facilities are noted at paragraph 5.8. Paragraph 5.9 outlines some additional points for borrowers that apply to "rate switch" transactions and the Rate Switch Template.



5.7 RFR loans – calculation conventions

Compounding methodology

The UK RFRWG Recommended Conventions recognise that several methods exist to calculate SONIA compounded in arrears and leave the choice to individual market participants. (See paragraph 4.6 of Section 4 for the different compounding methodologies available.)

The LMA Templates reference the relevant RFR compounded in arrears. The Rate Switch Template specifies a mathematical formula in the relevant schedule, which is intended to reflect the non-cumulative compounding methodology set out in the UK RFRWG Recommended Conventions.

The LMA has settled on this approach because daily non-cumulative compounding (pursuant to which interest varies on a daily basis rather than being a static average rate determined by reference to the entire interest period) is helpful to support the distribution of interest impacted by intra-period activity such as prepayments and secondary trading.

The compounded RFR is calculated daily as the percentage rate per annum which is the aggregate of the "Daily Non-Cumulative Compounded RFR Rate" for that day and the applicable credit adjustment spread (if any).

The "Daily Non-Cumulative Compounded RFR Rate" is to be determined by the Agent (or any other Finance Party which agrees to determine that rate in place of the Agent) in accordance with the specified calculation methodology.

If the parties wish to adopt a different compounding methodology, including where the preference is to rely on the official compounded SONIA/SOFR indices (discussed in paragraph 4.7 of Section 4), the LMA RFR Terms will require adaptation.

Whatever compounding methodology is used, especially where it is defined by reference to a specified mathematical formula, it will be important for borrowers to be able to verify interest rate calculations. Reconciliation tools, such as rate calculators, that enable borrowers to freely and independently verify interest rate calculations carried out by Agents/lenders are available from certain banks. The availability of rate calculators is a key point to discuss with lending banks.

Observation shift or not?

The mathematical formula in the Rate Switch Template for calculating the "Daily Non-Cumulative Compounded RFR Rate" reflects the lookback without observation shift approach, in line with the UK RFRWG Recommended Conventions. (See paragraph 4.6 of Section 4 for the meaning of a lookback with/without observation shift.)

Whether to calculate the compounded RFR with or without an observation shift has been one of the most debated matters in the context of transitioning sterling LIBOR loans to compounded SONIA. The UK RFRWG has recommended the adoption of a lookback without observation shift, as the majority of respondents to its consultation were in favour of that approach (which is in line with the ARRC's recommendations for the US dollar market, see further paragraph 5.11 below).

There may, however, be instances where the preference is for a lookback with observation shift and the UK RFRWG has recognised that this can be a viable and robust alternative. For example, the Bank of England's Compounded SONIA Index (see paragraph 4.7 of Section 4) is compatible with the lookback with observation shift convention. An observation shift is therefore to be preferred if the parties wish to make use of the Index rather than working off a mathematical formula/rate calculator.

As discussed at paragraph 5.5 above, the LMA is expected to publish shortly a form of its rate switch agreement based on the lookback with observation shift approach. In the meantime, where a lookback with observation shift is adopted, the formula specified for the calculation of interest in the Rate Switch Template will require adjustment.

Length of lookback period

The LMA Templates adopt the "lookback" convention", discussed in paragraph 4.6 of Section 4. This means that the compounded RFR is calculated over a reference period which starts a certain number of days prior to the start of the interest period, and ends a certain number of days prior to the end of the interest period.

The LMA RFR Terms suggest a lookback period of five Banking Days (i.e. business days in the financial centre of the relevant currency), in line with the UK RFRWG Recommended Conventions. This is, however, presented as optional.

The UK RFRWG has recognised that the lookback period can vary based on borrower/lender needs. Parties will need to weigh up the extent of the advance notice of interest amounts required against how precisely they wish to track the relevant RFR over the period. For very short interest periods, for example, a 5 Banking Day lookback may mean that the reference period overlaps only minimally with the interest period or even (if the interest period is less than 5 Banking Days), not at all. The key for borrowers will be to ensure that the length of the lookback provides sufficient advance notice to mobilise interest payments efficiently.

Whatever the agreed length of the lookback, parties will need to reflect this in the length of the notice period for voluntary prepayments, which would ideally take into account the amount of notice needed by the parties of the amount of accrued interest payable on a given prepayment and the processes involved in calculating that amount of accrued interest. To achieve a similar length of notice that the lookback mechanic provides for interest payments, the notice period for such a voluntary prepayment should be no less than the lookback period.

Credit spread adjustment

The pricing of new RFR-linked loans, like any loan transaction, is to be agreed between the lender and the borrower. It scarcely needs to be pointed out, however, that lenders will most likely look to maintain the yields achieved in the days of LIBOR-linked pricing.

The economic difference between LIBOR and the RFR could be compensated simply by increasing the Margin. In other words, the credit risk premium inherent in LIBOR is absorbed into an increased Margin. The pricing of the majority of English law RFR-linked loans completed so far has been structured to include a "spread adjustment" component rather than increasing the Margin, such that the loan is priced at the compounded RFR + credit spread adjustment + Margin.

The adoption of a spread adjustment in new RFR-linked loans appears to reflect a desire for transparency, in light of the emphasis placed by UK regulators on treating customers fairly in the context of LIBOR transition. It may, however, be that the alternative approach of building the economic difference between LIBOR and the relevant RFR into the Margin becomes more prevalent once RFRs become more widespread and RFR-linked loans begin to be refinanced. This is not least because calculating the appropriate credit spread adjustment after LIBOR has been discontinued may become increasingly challenging.

The Single Currency Templates present the inclusion of a separate credit spread adjustment as optional, reflecting the alternative approaches that might be adopted. The Rate Switch Template assumes the inclusion of a separate credit spread adjustment and no change to the Margin. This reflects the fact that the Rate Switch Template documents a loan which starts off referencing LIBOR and switches to the relevant RFR and for which the use of a credit spread adjustment to account for the difference between LIBOR and the relevant RFR, therefore, makes most sense.

If the parties agree to include a separate credit spread adjustment, they will need to agree how that adjustment should be calculated. This is not specified in either the Single Currency Templates or the Rate Switch Template.

As discussed in paragraph 4.8 of Section 4, where legacy LIBOR loans are transitioned to RFRs, the recommendation of the UK RFRWG is that a spread adjustment, based on the historic median between LIBOR and the relevant RFR over a five-year lookback period, is added to the relevant RFR, in line with the approach being taken by ISDA to fallbacks for derivatives. A number of the RFR-linked loans completed so far use this method to calculate a credit spread adjustment which is fixed at the point the loan is entered into. This method has also been used in the publicised rate switch loans (see paragraph 5.8 below).

[3] See the FCA's Q&As Conduct risk during LIBOR transition (November 2019).

There are examples of alternatives approaches in some sterling deals, for example basing the spread adjustment on the forward-looking basis swap market. This involves calculating the spread as the linear interpolation between differing tenors of LIBOR and SONIA swaps.

The credit spread adjustment will be calculated and specified on a currency-by-currency basis. It may also vary according to the length of the interest period in question. .

No separate spread adjustment

If the parties choose to increase the Margin rather than incorporate a separate credit spread adjustment, it is necessary to consider the effect that might have on other provisions of the agreement. For example:

- **Commitment fees:** Does the formulation of any commitment fees, which are typically set at 30-40% of the Margin on LIBOR-referencing deals, require adjustment? Borrowers will wish to ensure that the increase in the Margin has no impact on the level of commitment fees.
- **Market disruption/fallback provisions:** These provisions (including whether to include them at all) should be reviewed as a result of any decision to account for the difference between LIBOR and the relevant RFR by way of a Margin increase rather than the inclusion of a separate credit spread adjustment (see paragraph 5.8 below).

Application of zero floors

It has become common practice in LIBOR-linked facilities to apply a zero floor to LIBOR, such that if LIBOR falls below zero, the Margin paid to lenders is not eroded.

In a RFR-linked facility that includes a separate spread adjustment, borrowers should ensure that any zero floor (if agreed), applies to the sum of the compounded RFR and the spread, rather than the compounded RFR alone. In this way, interest payable is floored at the Margin (rather than the Margin and spread). This aligns with how zero floors operate in relation to LIBOR and is consistent with the principle that the transition from LIBOR to RFRs should be economically neutral.

This is reflected in the LMA RFR Terms, which also reflect the UK RFRWG's recommendations in respect of zero floors.

The UK RFRWG has recommended that interest rate floors be calculated daily (rather than at the end of an interest period) because loans accrue interest daily. The floor can then be applied to the applicable daily RFR for the relevant interest period. This recommendation has been reflected in the LMA RFR Terms, which incorporate optional zero floor wording in the definition of "Daily Rate" used to calculate the Daily Non-Cumulative Compounded RFR Rate.

The zero floor provisions in the Rate Switch Template also reflect the UK RFRWG recommendation that for legacy contracts containing a floor, where the aggregate of SONIA plus the credit spread adjustment is less than the legacy floor value, the credit spread adjustment should remain unchanged, with SONIA adjusted to ensure that the aggregate of SONIA plus the credit spread adjustment is equal to the legacy floor value. It will be for parties to decide whether to also adopt this approach on new RFR-linked deals.

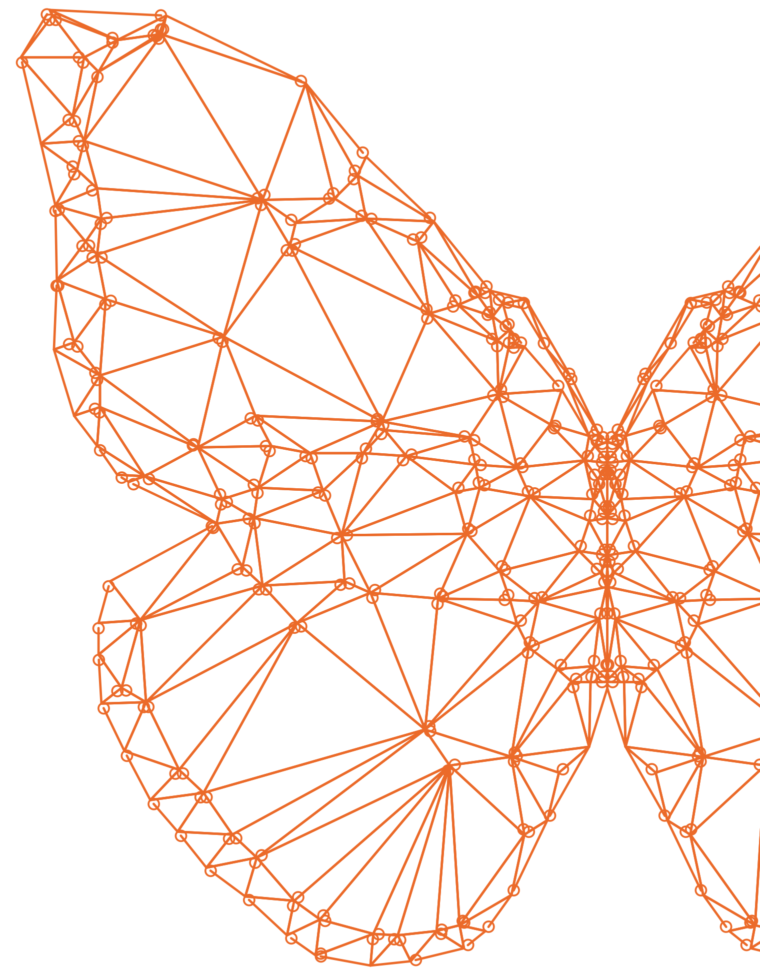
It should be noted that the compounded SONIA/SOFR indices in their current form are not compatible with the use of benchmark floors.

Multicurrency considerations

The Rate Switch Template is a multicurrency agreement and applies the UK RFRWG Recommended Conventions to each referenced currency and RFR which corresponds to that currency, rather than reflecting the recommendations of the different currency-specific working groups.

The LMA has done this for reasons of simplicity and ease of illustration. While there are similarities between the recommended conventions of the different currency-specific working groups (where available), there are also a number of differences.

When entering into a multicurrency facility, the parties should consider the extent to which the UK RFRWG Recommended Conventions, and the recommendations of other currency-specific working groups, are appropriate for use. The practical action point for treasurers is to make sure that all relevant lenders provide information on their preferred approach and the extent of any flexibility to work with other conventions. Any inconsistencies – or approaches that the company finds challenging - will need to be discussed and managed.



5.8 RFR loans - other issues

Break costs

Break costs compensate lenders for broken funding costs incurred if a loan is repaid in the middle of an interest period. The concept assumes that lenders are funding themselves on a matched term basis in the interbank market and is therefore difficult to reconcile in its traditional form with a RFR-linked loan.

The LMA RFR Terms include a blank, optional placeholder for break costs, leaving their inclusion and, if included, their calculation, to be determined by the parties on a case-by-case basis. Provision is made for their application to be determined on a currency-specific basis.

Where break costs continue to apply, consideration will need to be given as to how they are quantified. The difficulties of this are such that market practice in RFR-linked loans so far suggests that break costs will simply be omitted altogether. Lenders may, however, look for alternative protection in the form of a prepayment premium or an administrative fee for mid-interest period prepayments in some instances. They may also seek to impose a limit on the number of voluntary prepayments permitted in any given period. In most relationship facilities, however, we would expect the concept to be deleted.

Fallback rates

If the daily RFR is unavailable, the LMA RFR Terms substitute a specified central bank rate (plus an optional spread adjustment) for the daily RFR in the compounded RFR calculation formula. For sterling loans, for example, where daily SONIA is unavailable, the Bank of England Bank Rate (plus an optional spread adjustment) will be used instead.

If the specified central bank rate is unavailable, the most recently available central bank rate (plus an optional spread adjustment) will be used instead. An optional ultimate fallback is also provided, to cost of funds.

There is some debate as to whether an ultimate fallback to cost of funds is appropriate in a RFR-linked deal. RFRs are not a proxy for term funding costs in the way that LIBOR is. In addition, there has been ongoing debate around the inclusion of cost of funds as a fallback given the practical issues associated with its use.

In recognition of this, the LMA RFR Terms present cost of funds as an optional ultimate fallback, able to be applied on a currency-specific basis. The commentary accompanying the Single Currency Templates notes that cost of funds as a fallback is only suitable for inclusion where pricing is structured as compounded RFR + credit spread adjustment + Margin. In that instance, cost of funds, if applicable, will replace the sum of the spread adjustment (being an approximation of funding costs) and the Margin.

Parties might take the view that an ultimate fallback beyond a central bank rate is unnecessary, given the very remote possibility of it ever being triggered. The very fact that it is so unlikely to be triggered may, however, mean that borrowers are not too concerned should lenders believe it necessary.

Market disruption – obsolete?

Market disruption provisions are designed to protect lenders against disruption in the interbank funding market, by allowing lenders to recover their actual cost of funds in the event that they are unable to fund themselves at the relevant reference rate. In LIBOR syndicated loans, they provide that if a sufficient number of lenders notify the Agent that they are unable to fund themselves at LIBOR, LIBOR shall be replaced in the interest calculation lenders' cost of funds.

As discussed in the [ACT Borrower's Guide to the LMA's Investment Grade Agreements], the justification for market disruption provisions has long been questionable in LIBOR-referencing facilities, due to the fact that in many cases, lenders will not be funding themselves at LIBOR, meaning that the clause is capable of being triggered at any time. Like LIBOR itself, the provisions might be viewed as predicated on a funding model that does not reflect economic reality. As the loan market moves from LIBOR, which is intended as a proxy for term funding costs, to a pricing model built on RFRs, market disruption provisions might be viewed as finally obsolete.

The LMA Templates acknowledge this to an extent, by presenting the market disruption provisions as optional and capable of application in multi-currency facilities, on a currency-specific basis. The commentary to the Single Currency Templates suggests that such provisions are only suitable for inclusion where pricing includes an overt proxy for funding costs in the form of a credit spread adjustment. In other words, if the facility is priced at a compounded RFR + credit spread adjustment + Margin, if the market disruption provisions are triggered, cost of funds will replace the sum of the spread adjustment and the Margin.

In the financial markets generally, lenders tend to be reluctant to let go of protections rooted in years of precedent. However, these clauses will become increasingly difficult to frame if RFR-linked loans move away from spread adjustment pricing.

Market disruption in the LMA RFR Terms

If market disruption provisions continue to be included for the time being, there are a couple of points for borrowers to be aware of in relation to those provisions as presented in the LMA RFR Terms.

The market disruption provisions in the LMA RFR Terms are triggered by a specified percentage of lenders notifying funding costs in excess of the "Market Disruption Rate" (being the sum of the Cumulative Compounded RFR Rate for the relevant interest period and the credit spread adjustment (if any)). This results in the replacement of the compounded RFR plus credit spread adjustment (if any) with lenders' cost of funds.

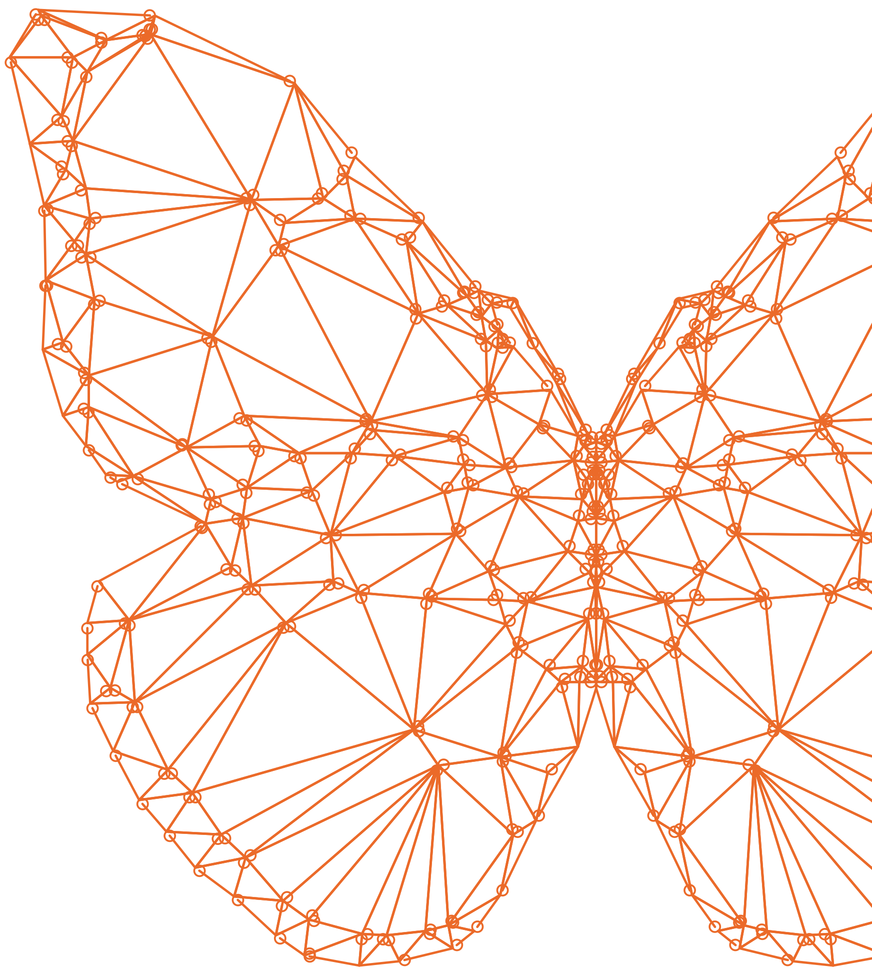
The calculation of the Market Disruption Rate in the LMA RFR Terms differs from the calculation of the compounded RFR for the purposes of determining the interest payable - the "Cumulative Compounded RFR Rate", rather than the Daily Non-Cumulative Compounded RFR Rate, is used. This reflects that market disruption is assessed by reference to the interest period as a whole, rather than on a daily basis. The Cumulative Compounded RFR Rate for an interest period is, however, intended to be economically identical to the combined effect of the application of each individual Daily Non-Cumulative Compounded RFR Rate.

In a LIBOR deal, the deadline for triggering the market disruption clause is the date on which the LIBOR rate is fixed i.e. the beginning of the interest period. Some documentation includes a negotiated right of the borrower to revoke a utilisation request, if the utilisation is to proceed on a cost of funds basis.

The LMA RFR Terms allow lenders to trigger the market disruption clause at any time before the end of the lookback period (the period over which the Compounded RFR is observed). This means that the borrower could find itself notified only a few days before an interest payment is due that it is payable on a cost of funds basis for the interest period just finished and giving it no option but to pay cost of funds. Borrowers may therefore wish to discuss with their lenders why the clause needs to operate in this way and suggest that the deadline for triggering the provision should occur earlier than provided for in the LMA RFR Terms.

Forward-looking financial covenants

Some loans may contain financial covenants that measure projected debt service or interest cover. These may also need to be updated to accommodate alternative rates, if presently crafted to accommodate LIBOR exposures.



5.9 Rate switch loans – discussion points

Trigger for rate switch

The Rate Switch Template provides for the switch from LIBOR to RFRs to occur on the earlier of:

- a specified date (with the possibility of specifying different dates for each currency);
- any date agreed between the parties in relation to the relevant currency;
- the date on which LIBOR is discontinued (known as the "cessation trigger"); and
- the date on which LIBOR ceases to be representative of the underlying market it is intended to measure (known as the "pre-cessation trigger").

The specified date is intended to be set prior to 31 December 2021, on a date when all parties anticipate they will be ready to switch to RFRs.

If that approach is adopted, borrowers may wish to reserve the right to unilaterally defer the switch date, for example by giving 30 days' notice. This right, sometimes referred to as an "operational readiness condition", is a feature of some of the rate switch deals publicised so far. It is a potentially important protection for practical purposes as it permits the borrower to delay the switch date if its systems (or indeed those of any of its lenders) are not yet ready to accommodate RFRs. This is noted by the LMA in the commentary accompanying the Rate Switch Template.

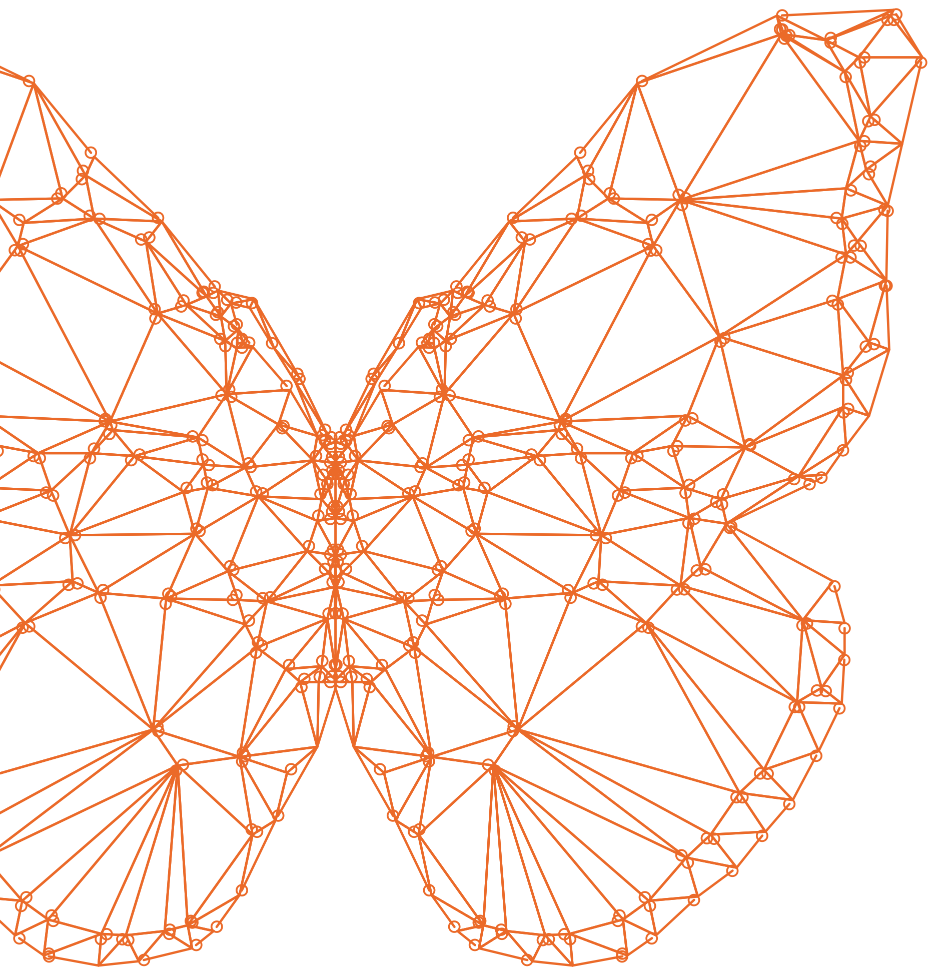
Where such a right is included, consideration will need to be given to the number of times it can be exercised. Borrowers would ideally wish to have the discretion to exercise it as many times as they wish.

Timing of calculation of credit spread adjustment

There is an ongoing debate about whether the credit spread adjustment should be fixed at the date of signing of a rate switch deal, or whether a calculation formula should be included which is then used to calculate the adjustment at the point of the switch.

Agreeing the adjustment at the point of signing provides certainty for the borrower and removes the need for future calculations. Calculating the adjustment at the point of the switch, however, takes into account potential basis volatility between the signing date and the rate switch date, and supports the rationale for including a credit spread adjustment in the first place (i.e. to ensure that transition is economically neutral).

The LMA Rate Switch Template is silent as to how and when the credit spread adjustment is calculated, leaving a blank placeholder for the parties to complete on a case-by-case basis.



5.10 RFR-linked bilaterals

The substance of the conventions and documentation changes applicable to RFR-linked bilateral loans are not anticipated to be significantly different to those applicable to RFR-linked syndicated loans. The UK RFRWG Recommended Conventions apply equally to bilateral loans and the LMA's RFR Terms are likely to be influential across the loan market in the normal way.

Borrowers with multiple bilateral loans will be familiar with the benefits of ensuring that their obligations are consistent across all of their facility agreements. It will be particularly important in the context of transitioning to RFRs that each lender agrees to the same methodology and conventions for calculating and using RFRs.

They key difference between new syndicated and bilateral deals in terms of points for borrowers is likely to be during the transitional period, where LIBOR loans need to incorporate "pre-agreed conversion terms" or an "agreed process for re-negotiation".

The scope of many lenders' bilateral books is such that there is some reluctance to add to the stock of deals that will require manual amendment. As a result, borrowers may find themselves under more pressure to agree a "rate switch" mechanism. If an "agreed process for re-negotiation" is included, borrowers might anticipate, as noted at paragraph 5.4 above, that the lender will wish to reserve the right to amend the agreements unilaterally, should the renegotiation not be completed in good time.

5.11 US dollar loans

The ARRC's Recommended Best Practices for Transitioning from LIBOR include interim milestones for the US dollar loan market similar to those set by the UK RFRWG for the sterling loan market:

- All new syndicated loans should now be including ARRC-recommended (or substantially similar) "hardwired" USD LIBOR fallback language - all bilateral loans completed after 31 October 2020 should include the same4.
- No new USD LIBOR loans to be issued after 30 June 2021. The US dollar loan market is being given slightly longer to transition new business, given SOFR is a new rate.

The ARRC has also issued final conventions for using SOFR in arrears in syndicated loans.

In terms of documentation for new RFR-linked loans, in September 2020, the Loan Syndications & Trading Association (**LSTA**) published a Daily Simple SOFR Concept Credit Agreement referencing daily simple/daily compounded SOFR.

The ARRC's and LSTA's drafting and conventions are slightly different to those that the UK RFRWG has recommended for the sterling market and which the LMA has reflected in its templates. This is not a material issue in terms of contractual provisions; there has always been a difference between New York law (LSTA) and English law (LMA) credit agreements. The areas of divergence in terms of replacement rates and calculation conventions are, however, likely to be an area of focus

In particular, as discussed in paragraph 5.6 above, the Rate Switch Template applies the UK RFRWG recommendations for SONIA to all currencies and associated RFRs, such that the facility operates to switch to RFRs (including SOFR for US dollar loans), compounded in arrears and calculated using the non-cumulative compounding methodology. In contrast, the ARRC's hardwired fallback language falls back first to a term SOFR rate (to the extent available) and then to daily simple SOFR. The LSTA's concept credit agreement references daily simple SOFR or compounded SOFR, but the latter using the compounding the balance convention[5] (see paragraph 4.6 of Section 4). It also includes optional language contemplating a transition to Term SOFR, if it exists.

For English law US dollar deals, parties have a choice of following the LMA drafting, applying the conventions and associated drafting recommended for SONIA to SOFR, or following the ARRC drafting for SOFR and/or the LSTA's concept credit agreement. For multicurrency loans which accommodate both sterling and US dollar loans, the latter approach will result in a bifurcated approach to the calculation of SONIA and SOFR.

It is not currently clear how practice will develop. Whether a syndicated deal in US dollars will follow the ARRC's or the LMA's approach to SOFR may simply come down to the governing law of the agreement – which often equates to where the loan is originated and the predominant nationality of the lenders. A London-led English law US dollar deal involving largely European banks might be expected to adopt the LMA drafting. A New York-led, New York law deal involving largely US banks might be expected to follow the approach reflected in the ARRC/LSTA drafting.

[4] See ARRC recommendations regarding more robust fallback language for new originations of LIBOR syndicated loans (June 2020) and ARRC recommendations regarding more robust fallback language for new originations of LIBOR bilateral business loans (August 2020).

[5] The LSTA has stated it plans to product a further concept credit agreement referencing compounded SOFR using the "compound the balance" approach, acknowledging the alternative option.

5.12 Euro loans

Treasurers will be aware that the European authorities have decided to reform rather than discontinue EURIBOR. There is currently therefore no need to transition euro loans from EURIBOR to €STR, although equally, it should be possible to price loans based on compounded €STR if preferred.

The current focus of the Euro RFRWG is on identifying €STR-based fallbacks for EURIBOR to cater for a future scenario in which EURIBOR may permanently cease. Both forward and backward-looking options are being considered.

The Euro RFRWG published a report with high-level recommendations for fallback provisions in contracts that reference EURIBOR in November 2019. These are expected to be complemented by additional recommendations planned for early 2021, to be drawn up following two upcoming public consultations on (i) the preferred EURIBOR fallback rate for each financial product and preferred spread adjustment and (ii) the trigger events for the application of the fallback rates.

It is anticipated that, once the final recommendations are made available, the LMA Templates which accommodate loans in euros will be updated to incorporate the recommended fallback provisions. Until then, parties will need to consider the most appropriate fallbacks from EURIBOR.

The LMA Rate Switch Template makes provision for the switch of euro loans from EURIBOR to €STR. Given that EURIBOR is not being replaced or discontinued at this time, parties will need to consider the application of the rate switch provisions to loans in euros. For example, where the intention is to continue referencing EURIBOR, it will be important to ensure that any specified rate switch date does not apply to loans in euros. The continued application of the rate switch provisions on "cessation" and "pre-cessation" may however be beneficial, to cater for a future scenario in which EURIBOR may permanently cease.

Whether to transition euro loans to €STR now or continue referencing EURIBOR will be a decision for parties to make on a case-by-case basis. As the loan market becomes more familiar with using RFRs, it may be that more market participants consider moving away from EURIBOR to €STR.

5.13 Legacy LIBOR loans

The focus in the sterling loan market is currently on transitioning new/refinanced loans. There is, however, a significant stock of legacy LIBOR loans that require re-papering ahead of end-2021. The existing fallbacks in these legacy loans are unlikely to be sufficiently robust to cater for a permanent cessation of LIBOR.

The UK RFRWG has set a target of Q2/3 2021 for the completion of the transition of legacy cash products to alternative rates, where viable. Given the sheer number of legacy LIBOR loans, this is no small task. The UK RFRWG and UK regulators are conscious of this, and are stepping up efforts to encourage and assist lenders and borrowers to take action now, where feasible, to transition legacy business.

Most legacy LIBOR loans will need to be amended individually. The method of amendment will depend on the type of deal. A single amendment agreement detailing all of the required amendments may be appropriate for bilateral loans and club deals. For syndicated loans, amendments will require the approval of the whole syndicate or the specified majority. Where this is likely to be difficult to achieve (for example, because of the size of the syndicate), a two-stage amendment process might be used, whereby all the parties (or the requisite majority) agree the key commercial terms and delegate authority to the Agent and borrower to determine and make the necessary changes to the agreement itself.

In September 2019, the LMA published a Reference Rate Selection Agreement (the **LMA RRSA**) in exposure draft form for use when transitioning syndicated loans based on this two-stage process. The LMA RRSA envisages the parties agreeing the basic commercial terms of transition in the LMA RRSA via a tick box checklist, and authorising the Agent and borrower to determine the necessary amendments to the relevant facility agreement to implement the commercial agreement. A formal amendment agreement would then be entered into by the Agent and borrower to incorporate the necessary detailed drafting into the facility agreement, bypassing the need for all lender/majority lender consent to the full set of changes. It is expected that the actual drafting changes would be based on the drafting of the relevant LMA Template.

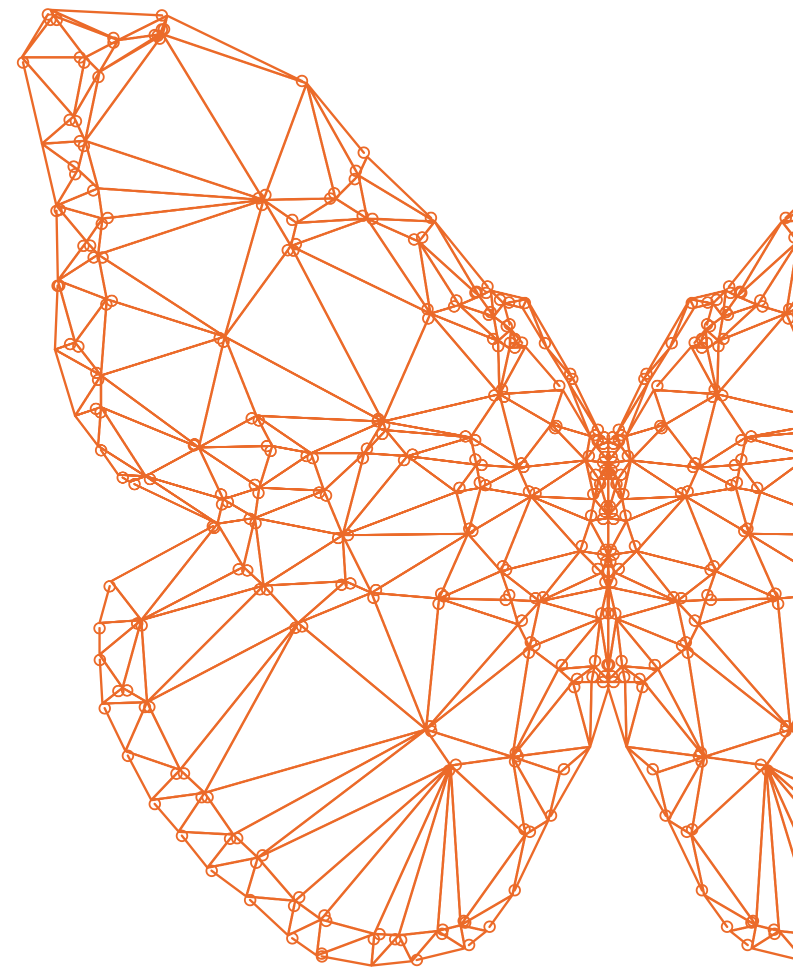
The LMA RRSA received a mixed response following its initial publication. It remains to be seen how the LMA responds to the feedback received. As noted, it is aimed at larger syndicated deals where one-stage amendments may not be practical, so to that extent is of limited application.

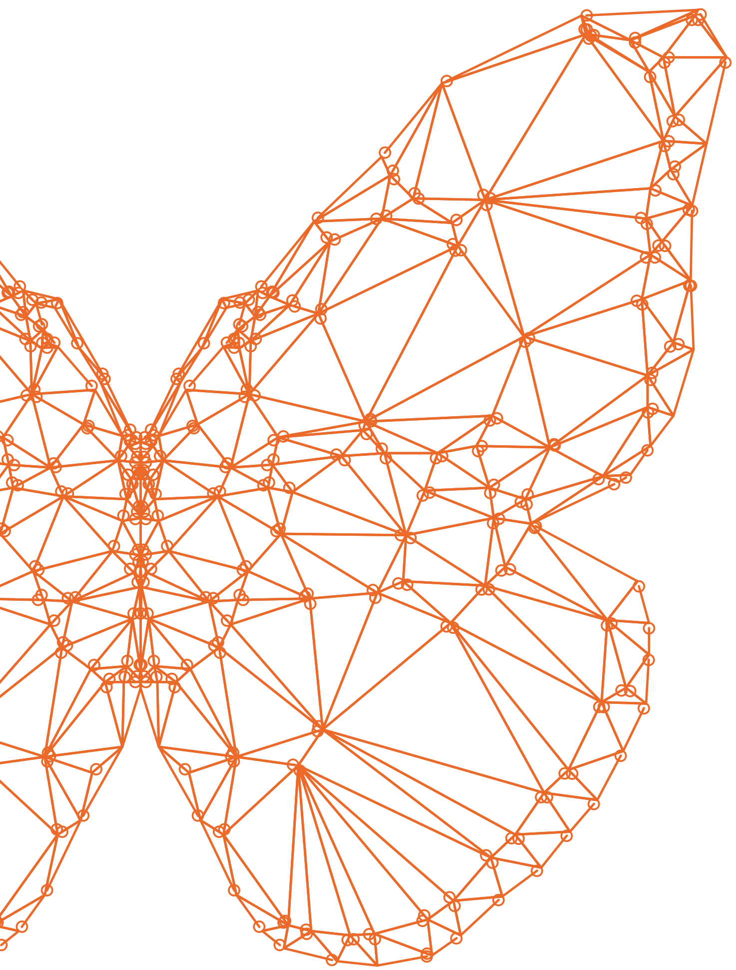
Some practical steps which borrowers can take to prepare for the transition of legacy loans are set out in the UK RFRWG's September 2020 paper Active transition of GBP LIBOR referencing loans. These steps, many of which will have already been addressed by borrowers in the context of new "non-LIBOR" business, include:

- Reviewing outstanding LIBOR-referencing loans.
- Identifying the alternative reference rate to be used for each loan i.e. RFRs or other alternative rates.
- Becoming familiar with how the alternative reference rate will be calculated, and how to calculate any economic difference between LIBOR and the selected alternative reference rate (i.e. any credit spread adjustment).
- Considering whether systems and operations are ready to accommodate alternative reference rates.

Most importantly, borrowers should seek to engage with their lending banks sooner rather than later to understand the preparations being made for LIBOR transition and the anticipated process for transitioning legacy business.

Some legacy LIBOR-referencing loans will be almost impossible to transition to alternative rates, either because their structure is such that they depend on a forward-looking term rate or because they are syndicated loans and a high or unanimous consent requirement means that obtaining consent to any necessary amendments will be near impossible to achieve. See paragraph 4.9 of Section 4 in relation to "tough legacy" contracts.





6. DERIVATIVES

6.1 UK RFRWG recommendations for sterling derivatives

The current UK RFRWG roadmap specifies the following priorities and milestones for LIBOR derivatives:

- **By end of Q4 2020 -** widespread adherence to the ISDA 2020 IBOR Fallbacks Protocol and operational readiness to support the development and market making of non-linear SONIA derivatives such as options.
- **By end of Q1 2021 -** ceasing initiation of new sterling LIBOR-linked linear derivatives maturing after 2021, except for risk management of existing positions.
- **By end of Q2/Q3 2021 -** assessing and actively converting LIBOR-linked linear derivatives where viable (e.g. auction/compression mechanisms) and to cease new issuance of sterling LIBOR-linked non-linear and cross currency derivatives with a sterling leg, that mature after 2021 (except for risk management of existing positions)

The key points to take from this for non-financial users of derivatives are that during the current transitional period, the focus, as in relation to cash products, is on reducing the stock of legacy LIBOR transactions as far as possible. Any new LIBOR-linked derivatives trades must incorporate updated fallbacks that cater for the replacement of LIBOR. After the end of Q1 2021, as in relation to cash products, new LIBOR-linked linear derivatives will cease to be available. Further, the parties will need to take steps to actively transition or update fallbacks in any legacy LIBOR derivatives exposures extending beyond the end of 2021.

6.2 ISDA documentation for LIBOR transition

The derivatives market is heavily reliant on standardised documentation. Current market standard IBOR fallback provisions were not designed to cater for the permanent cessation of an IBOR. They are generally reliant on reference bank rates. Even if quotations were available after a permanent discontinuation, it is unlikely that they would be available for each future reset date over the remaining tenor of long dated contracts. It is also likely that quotations could vary materially across the market.

ISDA has been working on documentation to effect market-wide transition from LIBOR for some time, which includes new and robust RFR-linked fallbacks. ISDA's IBOR documentation is anticipated to be very widely used for both new and legacy derivatives.

The key elements of ISDA's documentation package are the 2020 IBOR Fallback Supplement (the **Fallbacks Supplement**) and the 2020 IBOR Fallbacks Protocol (the **Fallbacks Protocol**), which enable the incorporation and adoption of updated fallbacks into LIBOR (and other IBOR) derivatives. This documentation has been finalised, but at the time of writing, ISDA is waiting for confirmation from the US Department of Justice and competition authorities before it can announce its official launch. The timetable is anticipated to proceed as follows:

- **Announcement:** ISDA to announce launch date for the Fallbacks Supplement and the Fallbacks Protocol – expected shortly.
- **Publication:** upon announcement of launch date, ISDA is expected to publish the Fallbacks Supplement, Fallbacks Protocol and associated bilateral template and amendment language.
- **Launch date:** expected to be approximately 2 weeks after ISDA's announcement.
- **Effective date:** the Fallbacks Supplement, as well as the amendments made by the Fallbacks Protocol, are expected to take effect 3-4 months after launch date (ISDA currently expects the effective date to be in mid- to late-January 2021).

As the documentation has not yet been published in final form, the commentary in this Section is based upon market expectation, draft documentation, results of market consultations and other communications relating to the soon-to-be published documents.

While it is not anticipated that ISDA's documentation will change materially, the discussion below is subject to any final provisions that may be amended or added to the documents when eventually published.

6.3 Current options for derivatives users

The options for derivatives users in terms of whether to choose non-LIBOR derivatives, or to continue with LIBOR derivatives with updated fallbacks (and if so, what those fallbacks are) depend on a number of considerations, including:

- whether the transaction is to be entered into before or after the ISDA documentation terms designed to effect LIBOR transition are published and become effective;
- whether the transaction is hedging a cash product such as a loan or bond and the extent to which it is important to match the options selected for the cash product;
- the pricing of the preferred option (more bespoke options are likely to attract different pricing) balanced against any potential basis risk exposure; and
- any preferences of the derivative user's counterparty, which may have a larger book of derivatives with other parties which it needs to take into account.

The options are discussed in detail below.

TRANSITIONING LIBOR DERIVATIVES

Current options for new derivatives:

- Non-LIBOR-linked derivatives
- LIBOR-linked derivatives with market standard (ISDA) fallbacks to RFRs
- LIBOR-linked derivatives with bespoke fallback provisions

6.4 Non-LIBOR-linked derivatives

As in relation to cash products, the preference of the official sector is that new transactions reference RFRs or other alternatives rather than LIBOR and the derivatives market has been swift to adapt. There is good liquidity in most of the RFR-linked markets, particularly in relation to SONIA. In the first half of 2020, traded notional of interest rate derivatives (IRD) referencing RFRs increased to $10.9 trillion (from $5.1 trillion in the second half of 2019) and accounted for 7.6% of total IRD traded notional (compared to 4.3% in the second half of 2019). IRD traded notional referencing SONIA represented 93.7% of total IRD traded notional referencing RFRs in the first half of 2020[6].

Documentation for RFR-linked derivatives is readily available. ISDA has already published supplements to its 2006 ISDA Definitions containing floating rate option definitions for compounded RFRs. These include GBP-SONIA-COMPOUND, USD-SOFR-COMPOUND, CHF-SARON-OIS-COMPOUND and EUR-EuroSTR-COMPOUND. The ISDA Collateral Agreement Interest Rate Definitions include definitions of SONIA (Collateral Rate), SOFR (Collateral Rate) and similar RFR-based rates for use in collateral agreements such as credit support annexes for variation margin.

Each RFR definition incorporates fallbacks and contingency measures which cater for the unavailability of or disruption to the RFR.

[6] ISDA Interest Rate Benchmark Review of first half of 2020

6.5 ISDA Fallbacks Supplement

New LIBOR-linked derivatives should contain fallbacks that contemplate transition to RFRs. This can be achieved by adopting ISDA's market standard fallback documentation, which as noted above, is expected to be published very soon.

The Fallbacks Supplement amends the 2006 ISDA Definitions to include new fallbacks for LIBOR and other IBORs. From the effective date of the Fallbacks Supplement (the **Supplement Effective Date**), any new transaction entered into pursuant to the 2006 Definitions will automatically incorporate the new fallbacks and related provisions set out in the Fallbacks Supplement.

Key features of the Fallbacks Supplement are as follows:

Scope

The Fallbacks Supplement is expected to apply to any new derivative transaction which incorporates the 2006 ISDA Definitions and which references one or more relevant IBOR rates.

Fallback Triggers

The new fallbacks in the Fallbacks Supplement will apply upon the temporary unavailability of or disruption to the relevant IBOR, but also upon the permanent cessation of an IBOR rate or (optionally), if a pre-cessation event occurs. As described in paragraph 4.8 of Section 4 in relation to LIBOR, a pre-cessation event is, in essence, where the regulatory supervisor determines that the IBOR rate is no longer representative of the underlying market and economic reality that the rate is intended to measure.

The parties will have the option as to whether to apply the pre-cessation trigger or not. The nature of the fallback triggers in related cash products may have a bearing on whether the parties choose to include the trigger.

Fallback Rates

The Fallbacks Supplement will specify fallback rates to apply when the relevant IBOR is temporarily unavailable or has been permanently discontinued (or following a pre-cessation event).

RFRs are structurally and economically different from IBORs, as discussed in Section 4. The ISDA fallbacks use RFRs compounded in arrears, to align with the applicable tenor, based on daily compounding of publicly available RFRs typically published by relevant central banks. A credit spread adjustment is added to the compounded RFR, which uses a median historical comparison, separately calculated for each tenor, between the IBOR for a particular tenor and the relevant compounded in arrears RFR, over a five year period prior to the announcement triggering a fallback (see paragraph 4.8 of Section 4).

The methodology for these adjustments was finalised after several market wide consultations incorporating feedback from market participants and regulators.

Published fallback rates – Bloomberg

The fallback rates will be implemented as set out in Bloomberg's IBOR Fallbacks Rate Adjustment Rule Book.

Prior to a permanent cessation or, if relevant, a pre-cessation event in respect of an IBOR, Bloomberg calculates the fallback rates on a 'what if' basis (i.e. what would the 'all in' fallback rate be on any given day if the trigger event occurred and the fallback rates were to take effect on that date or on a specified future discontinuation date).

Once the relevant fallback trigger has occurred, the spread adjustment will be fixed for each tenor of the relevant IBOR and thereafter Bloomberg will continue to publish the 'all-in' fallback rates, which will be the compounded in arrears adjusted RFR plus the fixed spread adjustment.

To help derivatives users get ready for the use of RFRs and understand the effect of the fallbacks, Bloomberg has started to publish the term adjusted RFRs (excluding the spread adjustment), the spread adjustments and the "all in" fallback rates (the combination of the term adjusted RFR and the spread adjustment) in the form of indicative data.

Fallbacks for the primary fallbacks

The Fallbacks Supplement will also include fallbacks for the adjusted fallback RFR rate.

For example, Fallback Rate (SONIA) will switch to SONIA plus a specified spread. The fallback rate for SONIA, upon a specified trigger, will be a rate recommended as a replacement for SONIA (with any spreads or adjustments) by certain specified organisations (labelled the 'GBP Recommended Rate') plus a specified spread. The fallback rate for the GBP Recommended Rate, upon a specified trigger, will be the Bank of England Bank Rate plus a specified spread.

6.6 Bespoke fallback provisions

In new derivatives transactions entered into from the Supplement Effective Date, if the parties want bespoke fallback provisions to apply instead of the new market standard, these will need to be incorporated specifically to override the new fallback provisions in the Fallbacks Supplement.

Bespoke fallback provisions might be considered for transactions which will be hedging a loan or other cash product, for example, where the fallbacks to LIBOR in those products (whether it be the fallback rate, the fallback trigger or related provisions) are different to the fallbacks in the Fallbacks Supplement. The waterfall of fallback rates and related triggers should also be considered for both the derivative and the product it is hedging to ensure as much consistency as possible, not just when rates switch from a LIBOR to an adjusted fallback RFR rate, but also if the rate were to switch from an RFR to an alternative reference rate at some point in the future.

Other potential mismatches between a derivative and a cash product it is hedging could be differences in adjustment and spread methodology, timing differences and differences in provisions dealing with market disruption. Another consideration is whether there could be any back to back hedge in place for the derivative and any potential mismatch of fallbacks there.

In all instances, the extent of any potential mismatch between the fallbacks in the cash and derivative product should be considered in order to assess the potential difference between the results that each may yield and how comfortable a party and its counterparty is with the potential basis risk exposure. The least risky approach would always be to align the fallbacks and related provisions wherever possible, but this will need to be balanced against practical considerations, not least, pricing.

ISDA has just published an RFR Conventions and IBOR Fallback Products Table summarising how the IBOR fallbacks in the Fallbacks Supplement apply to a variety of different derivative products, including non-linear products (e.g. swaps with stubs or non-standard accrual periods, caps and floors, swaptions). The table compares these outcomes to the standard conventions for the same products that reference IBORs and RFRs. This table aims to help counterparties understand how the fallbacks would function in their existing and new derivatives that reference IBORs. The table also includes suggested language that counterparties could use if they wish to alter the impact of the fallbacks for certain derivatives products by bilaterally negotiating modifications to the standard payment dates, business day conventions and/or fixing dates/observation dates/reference days. These amendments may be suitable for derivatives which hedge cash products so as to achieve better alignment with equivalent terms in such hedged products.

6.7 LIBOR-linked derivatives prior to the Supplement Effective Date

As noted above, the Supplement Effective Date is not anticipated to be until January 2021. Prior to the Supplement Effective Date, the existing fallbacks in the 2006 ISDA Definitions will apply to new transactions, unless the parties incorporate alternative fallback provisions.

Pending the Supplement Effective date, the parties will need to consider including bespoke fallback provisions in new LIBOR derivatives (see paragraph 6.6 above).

Alternatively, they can include acknowledgement wording that applies the terms of the Fallbacks Protocol (see paragraph 6.9 below), when it becomes effective. ISDA has produced draft template acknowledgement wording for inclusion in agreements entered into prior to the effective date of the protocol (the Protocol Effective Date), which enables parties to explicitly acknowledge whether or not the terms of the Fallbacks Protocol will apply to the relevant agreement.

6.8 Legacy LIBOR derivatives

The immediate amendment of legacy LIBOR transactions to RFR-linked or non-LIBOR-linked rates (i.e. a switch from a LIBOR-linked rate as the primary reference rate to an RFR-linked rate as the primary reference rate, by way of amendment) may be difficult to achieve. The economic differences between the original primary rate and the replacement primary rate means that an amendment to the reference rate in a derivative transaction would inevitably require the addition of a spread to the new reference rate or an adjustment payment between the parties to take account of the transfer of economic value. In many instances, parties may prefer to terminate the LIBOR transaction (with a mark-to-market close out payment) and enter into a new non-LIBOR transaction. The different pricing of the new transaction, compared to the old, would be expected to reflect the economic difference of the new transaction compared to the old.

The vast majority of legacy LIBOR derivatives are therefore anticipated to be transitioned by the incorporation of new fallbacks. Transition by way of fallback means the derivative will continue to reference an IBOR rate as the primary reference rate but upon a permanent cessation trigger event in respect of an IBOR rate or, perhaps, a pre-cessation trigger event, RFR-linked fallbacks will apply. The incorporation of new fallbacks can be achieved by adherence to the ISDA Protocol or by a bilateral amendment process. ISDA's IBOR transition suite will include various documents that enable parties to bilaterally agree amendments to the Fallbacks Protocol. Alternatively, the parties can agree their own bespoke provisions (as outlined at paragraph 6.6 above). Bilateral amendment might be the preferred option for parties seeking to align fallbacks in legacy derivatives with those in related cash products.

6.9 ISDA Fallbacks Protocol

The The Fallbacks Protocol will enable parties to a "protocol covered document" to include the new fallbacks in the Fallbacks Supplement into their IBOR derivative. It does this by effectively replacing references to the relevant IBOR with an IBOR rate option (which has new fallbacks and triggers) and related provisions.

The Fallbacks Protocol will apply to master agreements, credit support documents and confirmations covered by the protocol in respect of uncleared derivatives and entered into with a counterparty which has also adhered to the Fallbacks Protocol. It applies provided such document incorporates, or references, a rate as defined in a specified ISDA definitions booklet or otherwise references a relevant IBOR.

The Fallbacks Protocol will apply to documents which are entered into prior to the Protocol Effective Date or, if later, the date of adherence of the later of the two adhering parties. There is currently expected to be no cut-off date for adherence to the Fallbacks Protocol.[8]

The Fallbacks Protocol will not apply to any agreement in which parties expressly state that the terms of the Fallbacks Protocol will not apply.

To fall within the scope of the Fallbacks Protocol the relevant document must incorporate, or reference, a rate as defined in a specified ISDA definitions booklet or otherwise reference an IBOR. The ISDA definitions booklets specified for this purpose include the 2006 ISDA Definitions but extend to the 2000 ISDA Definitions and others. It is important for parties to be aware of this so that they understand which of their derivatives documents will be automatically amended if they adhere to the Fallbacks Protocol.

The Fallbacks Protocol will not only act as a transition tool for ISDA documents, but it will automatically extend to certain non-ISDA documents (those that include references to key IBOR rates) provided these documents are specified in a list of non-ISDA documents in the Fallbacks Protocol. If parties want to remove non-ISDA documents from or add non-ISDA documents to the scope of the Fallbacks Protocol they will need to do so bilaterally.

The date on which the amendments contemplated by the Fallbacks Protocol become effective will be the later of the Protocol Effective Date and the date on which the latest adherence letter sent by the two parties is accepted by ISDA. ISDA will publish a list of adherents to the Fallbacks Protocol, so it will be possible to check who has adhered and when.

ISDA will make available an FAQ document in relation to the Fallbacks Protocol which provides more detail in relation to its operation.

Corporates will wish to consider carefully whether it is worth their while to adhere to the Fallbacks Protocol or to adopt the terms of the Fallbacks Protocol on a bilateral basis with any bespoke amendments which may be required. This is most likely to depend on the extent of their derivatives exposures and how closely they need to align to hedged items.

Corporates should also consider any accounting and cash flow implications of the choice to IBOR transition. For example, the mark-to-market of an interest rate swap for the corporates (which are typically the fixed rate payer) is likely to decrease upon a transition in the absence of an adjustment spread or payment, as RFRs are historically lower than the IBORs they are intended to replace.

[7] The 1998 ISDA Euro Definitions, the 1998 Supplement to the 1991 ISDA Definitions, the 1991 ISDA Definitions.

[8] Non-ISDA documents included in the list include, for example the 2011 SIFMA/ICMA Global Master Repurchase Agreement (GMRA), various local law master agreements and energy and emissions specific master agreements and various non-ISDA collateral agreements.

7. BONDS

7.1 UK RFRWG recommendations for sterling bonds

The UK RFRWG's target milestones as updated in July 2020 include the following recommendations for the sterling bond market:

- During Q4 active conversion should be progressed where possible to reduce legacy volume.
- Active conversion should be completed where viable (as for loans) during Q2/3 2021.
- All new issuance of sterling LIBOR-referencing bonds that mature after the end of 2021 should cease by the end of Q1 2021.

The third of these targets is well on the way to being achieved. Active conversion is a key area of focus, although a challenge for bonds.

7.2 LIBOR transition in the international bond markets

International bond market participants have responded to the need to transition away from LIBOR by referencing the identified alternative RFRs, rather than LIBOR, in new issues of floating rate notes (**FRNs**) and securitisations. There have been significant volumes of new SOFR and SONIA-linked FRNs issued since mid-2019. So far, these have been issued primarily by sovereigns, supranationals and financial institutions. Public issuance of sterling LIBOR-linked FRNs and securitisations with a maturity beyond the end of 2021 has all but ceased. RFR-linked issuance by corporates is expected to pick up in the coming months alongside the broader transition of corporate debt products to RFRs.

7.3 RFR bond market conventions

New market conventions for bonds referencing RFRs are currently consolidating and a body of publicly available precedent is available.

SONIA bonds

The market conventions used in SONIA FRNs and securitisations have typically involved referencing SONIA compounded in arrears over an interest period, with a margin added, and a "lookback" (also known as a "lag"), in respect of each interest period. This operates in the same way as described in relation to loans in paragraph 5.7 of Section 5. The SONIA rate used to calculate a rate for each day in an interest period is based on the SONIA rate for a prior day (typically, five days' prior). In other words, the interest "observation period" starts a certain number of days (typically, five) prior to the first day of the relevant interest period and ends the same number of days prior to the end of such interest period. This allows the interest amount to be determined sufficiently in advance of the interest payment date so that issuers and agents can organise payment.

In more recent months there has been a trend towards the use of the "observation shift" convention in SONIA bonds, which is compatible with the use of the Bank of England's Compounded SONIA index (see paragraph 4.7 of Section 4).

SOFR bonds

The market conventions used in SOFR bonds vary, but typically involve referencing a simple average of SOFR over an interest period, with a margin added, and a "lockout" in respect of each interest period. The "lockout" operates such that one of the daily SOFR rates is "suspended" meaning that it is repeated for several (typically, four) days, usually at the end of an interest period. The realised rates for those four days are not used at all: i.e. they do not roll over and are therefore not used in the calculation of the rate for the next following interest period. However, some SOFR bonds have used market conventions that are similar to those used in SONIA bonds (see above). In addition, some SOFR bonds have used a "payment date delay" mechanism, where interest is paid several (typically, two) days after the end of the interest period (except for the final interest payment, which uses a two-day lockout mechanism that assumes the SOFR rate stays the same for those two days).

Since March 2020, the Federal Reserve Bank of New York, the administrator of SOFR, has published 30-, 90-, and 180-day SOFR Averages as well as a SOFR Index, in order to support a successful transition away from USD LIBOR. The SOFR Averages and Index employ daily compounding on business days, as determined by the SOFR publication calendar. This has given rise to an increase in issuance of SOFR bonds based on a compounding in arrears, observation shift convention (as described under SONIA bonds above).

€STR bonds

The market conventions used in €STR bonds issued to date are aligned with those typically used in the SONIA bond market, i.e. €STR compounded in arrears over an interest period, with a margin added and a "lookback" of five days.

7.4 Fallbacks in IBOR referencing bonds

From July 2017, issuers of English law-governed bonds referencing IBORs began to adjust fallback provisions to reflect the announcement that the future of LIBOR could not be guaranteed beyond the end of 2021. The adjusted provisions typically provide for a fallback on the permanent cessation of the relevant benchmark to an alternative or replacement rate and spread adjustment to be applied to such rate, as selected by an independent adviser on the basis of (a) any recommendations made by relevant official bodies or (b) if no such recommendations have been made, customary market practice. In some cases, an additional "pre-cessation trigger" (being a declaration by the FCA of non-representativeness of LIBOR) has been included as a trigger to the fallbacks. In the international bond market, where multi-currency issuance programmes are common, these adjusted fallback provisions generally apply across currencies and in respect of different benchmarks (not just LIBOR).

While fallbacks are helpful, as discussed in Section 4, the official sector has stressed in relation to all cash products that the better option is to avoid use of LIBOR altogether or convert contracts before fallbacks are triggered.

7.5 Legacy LIBOR bonds

As noted in paragraph 4.9 of Section 4, the UK Government intends to legislate to amend and strengthen the UK Benchmarks Regulation to address, among other products, "tough legacy" LIBOR bonds. However, the authorities consider that the best and smoothest transition from LIBOR will be one in which contracts that reference LIBOR (including legacy transactions) are replaced or amended before the fallback provisions are triggered or regulatory action takes place.

In relation to legacy bonds, active transition may be achieved via a consent solicitation, a market-based process which enables an issuer to amend bond conditions by way of bondholder consent. Under English law, amendments to interest rate provisions in bond terms and conditions typically require a quorum of two-thirds or 75% of holders of the outstanding principal amount of bonds, of which 75% of votes cast have to be in favour of the extraordinary resolution to amend the relevant terms and conditions. The process for contacting the bondholders and preparing the legal documentation can be time-consuming and may involve regulatory issues that require bespoke advice.

At the time of writing, a number of legacy bonds (including conventional floating rate notes, covered bonds and securitisations) have already been the subject of successful consent solicitation processes undertaken in order to transition the relevant Legacy Transactions from LIBOR to SONIA (plus a spread adjustment). These successful consent solicitations are useful precedents for other issuers seeking to undertake a similar exercise.

For New York law governed bonds, a consent solicitation process to change interest rate provisions typically requires consent from every bondholder. It is therefore unlikely to be workable for many bonds with a large number of holders. Therefore, unlike in the UK, the US authorities are not actively encouraging market participants to transition as many bond contracts as possible by way of consent solicitation.

8. NON-FINANCIAL CONTRACTS

Provisions referencing LIBOR are also found in non-financial contracts. It is important that businesses take steps to identify all instances of reliance on or references to LIBOR in their contractual arrangements. In addition, business will want to consider the appropriate interest rates to be used in new contracts where LIBOR would previously have been the preferred option.

Compounded or Term RFRs (if available) might be used in certain circumstances – possibly with the addition of a spread adjustment if economic parity to LIBOR is the desired result. In the context of many commercial contracts (and indeed some internal financial arrangements such as intra-group loans), the drafting and calculation exercise required for the use of a compounded RFR, in the absence of a screen rate, is simply too lengthy and complex. The simpler solution of a central bank rate or a fixed interest rate might be more appropriate.

A common place to find LIBOR references is in provisions specifying the consequences of late payment, which may reference LIBOR as the interest rate applicable to late payments. These are a feature of many commercial contracts.

An example of such a clause, adapted to reference the Bank of England Bank Rate in place of sterling LIBOR, is set out below:

"Any party which fails to pay any sum payable by it under this agreement on the due date for payment shall pay interest on that sum at the Default Rate for the period from and including the due date up to the date of actual payment (after as well as before judgment), accruing on a daily basis. Any default interest accruing under this Clause shall be immediately payable by the defaulting party on demand."

"Default Rate" means interest at the rate of [x]% per annum above the Bank of England's Bank Rate (the "Base Rate") prevailing at [10.00am] on the due date for payment and as adjusted by the Bank of England from time to time thereafter[, provided that if the applicable Base Rate is below zero, the rate of interest shall be [x]% per annum]."

The approach to replacing LIBOR in non-financial contracts will be fact specific. In existing contracts, businesses may need to take a view on the importance of the reference to LIBOR. It will be necessary to weigh up the benefit of amending the reference now (which will in turn depend on the function and importance of the LIBOR-referencing provision) against the potential risks associated with re-opening the contract.

In new contracts, if RFRs are the preferred option, forward-looking term RFRs where available, might be viewed more straightforward to reference and work with than compounded RFRs, on the expectation that they will be available for specific tenors on screen, in a similar manner to LIBOR. However, as noted in paragraph 4.4 of Section 4, term RFRs for the time being remain work in progress, and are not anticipated to be available for use until next year.

In the meantime, for new contracts where the floating rate benchmark is important to the operation of contracts but the appropriate replacement is not clear, a middle ground could be to include an "agreed process for re-negotiation", similar to that discussed in paragraph 5.4 of Section 5 for loan agreements.

9. FURTHER INFORMATION

Below is a selection of further resources on LIBOR transition, which readers may find useful as a supplement to this guide. Readers should note that there is a wealth of information and materials available on the transition project, and that the list below is not exhaustive.

GENERAL

Financial Stability Board

- FSB Financial Benchmarks webpage
- FSB Reforming major interest rate benchmarks: Progress report (December 2019)
- FSB User's Guide to Overnight Risk-Free Rates (June 2019)

FCA resources

- FCA Transition from LIBOR webpage
- FCA LIBOR transition: getting my firm ready webpage
- FCA statement and supporting Q&As on planned amendments to the Benchmarks Regulation (June 2020)
- FCA Q&As on conduct risk during LIBOR transition (November 2019)

Trade associations

- ACT LIBOR hub
- LMA LIBOR microsite
- UK Finance LIBOR transition hub
- ISDA Benchmark Reform and Transition from LIBOR webpage
- ICMA Benchmark reform and transition to risk-free rates webpage
- AFME IBOR Transition webpage

"Tough legacy" – legislative measures

- Written statement made by the Chancellor of the Exchequer on the UK government's intention to amend the Benchmarks Regulation to address "tough legacy" contracts (June 2020)
- UK RFRWG Paper on the identification of Tough Legacy issues (May 2020)
- ARRC proposed legislative solution to minimize legal uncertainty and adverse economic impact associated with LIBOR transition (March 2020)
- European Commission's proposal to amend EU rules on financial benchmarks (July 2020)

GBP

Useful webpages

- Bank of England Transition to sterling risk-free rates from LIBOR webpage
- Bank of England SONIA interest rate benchmark webpage

UK RFRWG statements/publications

- UK RFRWG Recommendations for SONIA Loan Market Conventions and supporting slides (September 2020)
- UK RFRWG Recommendation of Credit Adjustment Spread Methodology for fallbacks in cash market products referencing GBP LIBOR (September 2020)
- UK RFRWG papers on active transition of GBP LIBOR referencing loans and active transition of GBP LIBOR referencing bonds (September 2020)
- UK RFRWG latest priorities and roadmap for 2020-2021 (July 2020)
- UK RFRWG Q&A for end-Q3 2020 loans milestone (July 2020)
- Further statement from the UK RFRWG on the impact of Coronavirus on the timeline for firms' LIBOR transition plans (April 2020)
- UK RFRWG Statement on bond market conventions: Use of the SONIA Index and weighting approaches for observation periods (March 2020)
- UK RFRWG paper: Use cases of benchmark rates: compounded in arrears, term rate and further alternatives (January 2020)

USD

Useful webpages

- ARRC homepage
- ARRC Transition from LIBOR webpage
- ARRC Fallback Contract Language webpage
- Federal Reserve Bank of New York SOFR webpage

ARRC statements/publications

- ARRC recommended best practices for completing the transition from LIBOR (September 2020).
- ARRC recommendations regarding more robust fallback language for new originations of LIBOR syndicated loans (June 2020) and LIBOR bilateral business loans (August 2020).
- ARRC SOFR 'in arrears' conventions for syndicated business loans (July 2020)
- ARRC User's guide to SOFR (April 2019)

EUR

Useful webpages

- Euro RFRWG homepage
- Euro RFRWG €STR-based fallbacks for EURIBOR webpage
- ECB Euro short-term rate (€STR) webpage

Euro RFRWG statements/publications

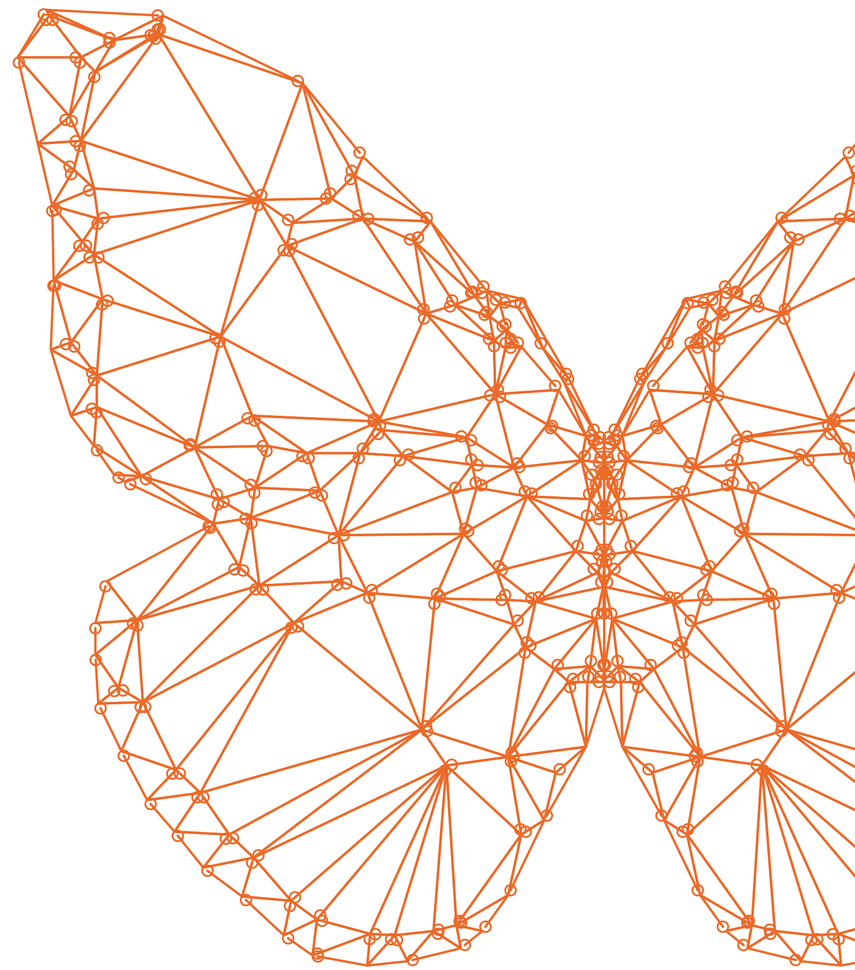
- Euro RFRWG High-level recommendations for fallback provisions in contracts for cash products and derivatives transactions referencing EURIBOR (November 2019)

CHF

- The National Working Group on Swiss Franc Reference Rates homepage
- Swiss Reference Rates (SARON) homepage

JPY

- Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks homepage



10. KEY CONTACTS

Association of Corporate Treasurers

The ACT is the chartered professional body for treasury. We work in the public and the profession's interest to influence policy and ensure decision makers understand the impact of proposed changes to regulation and market practice on non-financial corporates.

The ACT participates in many of the IBOR working groups and has been working closely with regulators, fellow trade associations and benchmark providers to ensure that the needs of the corporate sector and the real economy are not overlooked in the transition from LIBOR.

We welcome input from members on all aspects of LIBOR transition by e-mail to technical@treasurers.org

Further information about the ACT is available at www.treasurers.org

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Slaughter and May

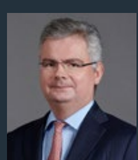
Slaughter and May is a leading international law firm that advises on a wide range of often ground-breaking transactions and has a varied client list that includes major corporations, financial institutions and governments.

Our team has been actively involved since inception in a number of the London-based regulatory and industry-led working groups looking at aspects of LIBOR transition. We have been involved in the development of much of the template documentation that has been prepared for the purposes of transitioning English law products from LIBOR.

We are advising many borrower and issuer clients on the current options for floating rate products. As long-standing advisers to the Association of Corporate Treasurers, we are supporting its work with corporate treasurers in this area, including its outreach and information gathering projects.

Further information about Slaughter and May is available at www.slaughterandmay.com

Slaughter and May Contacts



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Contact details for the full Slaughter and May LIBOR transition Working Group are available on our LIBOR transition webpage.

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