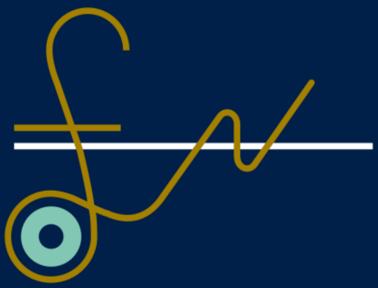
BRIEFING

TRAVERS SMITH

FCA announces cessation and pre-cessation triggers for LIBOR-linked loans and derivatives



5 March 2021

Of particular interest to many parties will be the cessation of 26 of the 35 LIBOR benchmark tenors immediately after 31 December 2021.

This briefing is relevant to Corporate Treasurers and Investment Professionals who deal with LIBOR-linked financing contracts and investment products. With these announcements the next milestone in the mandatory transition from LIBOR to SONIA has now been reached.

There are gaps between different markets and, in particular, between the loan market and related interest rate hedging products. The derivatives market is offering a universal approach to LIBOR replacement and the relevant fallback rates. However, the approach in the loan market will depend on the timing and the nature of agreement reached between borrowers and lenders. Parties who have not yet taken any steps to deal with LIBOR cessation may now have less than 9 months left to take the relevant steps.

Turn to *Implications for Derivatives Transactions* if your focus is on the developments in the derivatives market, and to *Implications for Loan Market Transactions for the loan market*. Both sections will be relevant for facility-linked hedging.

LIBOR CHECKLIST

Which of your finance contracts reference LIBOR (e.g. loans, derivatives, insurance contracts, investment policies, bonds)?

- Do you have derivatives contracts?
  - Are your derivatives contracts hedging LIBOR exposure in a different agreement? If so, consider whether the standard derivatives fallback is appropriate. What is the position under the main agreement? Is hedge accounting relevant? Discuss your position and options with your legal advisor.
  - If your derivatives are stand-alone, have you adhered to the ISDA 2020 IBOR Fallbacks Protocol? If not, discuss your position and options with your legal advisors.
- Do you have loan agreements which reference LIBOR?
  - Have you already entered into arrangements to deal with LIBOR cessation? If so, consider whether the latest announcements triggered a need to respond.

If you have not yet entered into arrangements to deal with LIBOR cessation, discuss your position and options with your legal advisors.

1 The Announcements - Why are they important?

On ***5 March 2021***, ICE Benchmark Administration ("IBA") the administrator of LIBOR, released the results of its consultation paper on potential cessation and notified the FCA that it intends to cease publishing the principal LIBOR tenors in 4 currencies (GBP, EUR, CHF and JPY) immediately after ***31 December 2021***.

On the ***same day***, IBA also notified the FCA that it intends to cease publishing the one week and two month tenors of USD LIBOR, immediately after ***31 December 2021***. Remaining USD LIBOR tenors will cease to be published immediately after ***30 June 2023***.

On ***5 March 2021,*** the Financial Conduct Authority ("FCA"), the supervisor of IBA, made its announcement on the future cessation and loss of representativeness of the LIBOR benchmarks stating that *"We make this statement in the awareness that it will engage certain contractual triggers for the calculation and future application of fallbacks that are activated by pre-cessation or cessation announcements made by the FCA (howsoever described) in contracts, and in accordance with out 11 March 2020 statement on LIBOR contractual triggers"*. The full text of the FCA announcement can be found *here*.

These announcements (the "Announcements") trigger important consequences for determining the rate which will replace the discontinued LIBOR setting in finance documentation.

The derivatives market has attempted a unified approach to replacement via the ISDA 2020 IBOR Fallbacks Protocol. This incorporates fallback rates into existing derivatives transactions. The main consequence of the Announcements is to fix the "Spread Adjustment" to be applied in calculating the relevant Fallback Rate. This is explained in more detail in "*Implications for Derivatives Transactions*".

In the primary loan markets, the consequence of the Announcements are less uniform. Since 2018, the Loan Market Association has encouraged parties to adopt a "Screen Rate Replacement Event" as a trigger for the re-negotiation of pricing with a lower level of lender consent required. The Announcements amount to such a Screen Rate Replacement Event. The loan market has since moved toward some level of hard-wiring of the consequences of a "Screen Rate Replacement Event" such as re-pricing linked to risk-free rates ("RFRs"). This is explained in more detail in "*Implications for Loan Market Transactions*".

2 Implications for Derivatives Transactions

The ISDA 2020 IBOR Fallbacks Protocol (the "Fallbacks Protocol"), for parties who signed up to the Fallbacks Protocol, and, more generally, the ISDA 2020 IBOR Fallbacks Supplement (the "Fallbacks Supplement") came into effect on 25 January 2021. The Fallbacks Supplement amends the 2006 ISDA Definitions to incorporate the new risk-free rates ("RFRs") fallbacks – therefore, where a derivatives transaction that references the 2006 ISDA Definitions is executed on or after the 25 January 2021, the changes to the fallback rate are applied automatically. The Fallbacks Protocol has the effect of incorporating the Fallbacks Supplement into contracts covered by the Protocol and entered into before 25 January 2021.

Under the Fallbacks Supplement, the FCA announcement is an "**Index-Cessation Event**" in respect of the relevant LIBOR rate. The "**Index Cessation Effective Date**" is the date that the "**Applicable Rate**" (e.g. Sterling LIBOR, US Dollar LIBOR etc) for that setting is no longer published or is no longer representative of the market it aims to represent. In the case of the affected non-USD LIBOR rates this will be immediately after ***31 December 2021***, and in the case of all the affected USD LIBOR tenors this will be immediately after ***30 June 2023*** (as US Dollar LIBOR settings continuing to that date can be used to interpolate discontinued tenors – see below).

Non-USD LIBOR tenors

- In the case of the FCA announcement in respect of the relevant LIBOR tenors in GBP, EUR, CHF and JPY (the "non-US tenors") an **Index Cessation Event** has occurred in respect of such LIBOR tenors.

- For in respect of the non-USD tenors falling after the **Index Cessation Effective Date**, each affected LIBOR setting will be replaced by a specific fallback floating-rate (the "**Fallback Rate**") based on the relevant term-adjusted "risk-free" rate (the "**Adjusted RFR**", see *Determining the Fallback Rate* section below), plus a "**Spread Adjustment**"(see *Determining the Fallback Rate* section below) applicable to LIBOR for the relevant currency. For example, for GBP LIBOR tenors, the applicable **Fallback Rate** will be a term-adjusted SONIA rate plus the **Spread Adjustment**.

- However, although the **Fallback Rate** applies to **Reset Dates** after the **Index Cessation Effective Date** (i.e. immediately after ***31 December 2021***), the calculation of the **Spread Adjustment** to be applied to the Adjusted RFR (e.g. SONIA) is driven by the date on which the **Index Cessation Event** This is because the **Spread Adjustment** is fixed for every **Reset Date** following the **Index Cessation Event**.

USD LIBOR tenors

- In the case of the IBA announcement in respect of the USD LIBOR tenors, an Index Cessation Event has occurred on 5 March 2021 in respect of all tenors. However what happens after the **Index Cessation Event** is different as only two USD LIBOR tenors are being discontinued immediately after 31 December 2021.

    - **One-week and two-month USD LIBOR tenors:** as there are remaining tenors for the terms either side of the tenors which are being discontinued immediately after 31 December 2021, under the **Fallbacks Supplement**, the one-week and two-month discontinued tenors (the "2021 discontinued US tenors") will fall within the provisions on **Discontinued Rates Maturities**. These provide that while there is a shorter and a longer tenor still being provided by the administrator, an interpolation mechanic (usually linear interpolation) will apply to determine the rate applicable for the tenors no longer being published.

    - **Overnight, one, three, six and 12 months USD LIBOR tenors:** These tenors will continue to be published beyond the end of 2021 but will cease immediately after

30 June 2023.

- This means that when the 2021 discontinued US tenors are switched off, the overnight and one-month tenors can be used to interpolate a replacement rate for the one-week rate, and the one-month and three-month rates can be used to interpolate a replacement rate for the two-month rate. This means that the **Fallback Rate** (i.e. an Adjusted RFR plus a Spread Adjustment) will not be used for the 2021 discontinued US tenors until the remaining USD LIBOR tenors are discontinued. The **Fallback Rate** will apply for Reset Dates immediately after 30 June 2023, when it will apply to all discontinued USD LIBOR tenors.

- Note however that the use of interpolation to determine a value for the discontinued rate does not change the **Spread Adjustment Fixing Date**, which remains immediately after 31 December 2021, as the date of the FCA announcement constitutes the **Index Cessation Event** in respect of all the affected LIBOR tenors, regardless of the date they are due to be discontinued.

All LIBOR tenors in all currencies

- The Spread Adjustment Fixing Date occurs on the first **Index Cessation Event** to occur in respect of the affected LIBOR setting. This means that if there were to be a second **Index Cessation Event** for that setting - for example if the FCA were to make a second announcement prior to cessation of LIBOR, stating that LIBOR or a particular tenor has become non-representative of the market it is intended to measure - this does not supersede the original Spread Adjustment Fixing Date. Once the Spread Adjustment is fixed, it is fixed for all future Reset Dates. We note that the IBA has stated that the FCA has indicated that it does not expect any of the relevant LIBOR tenors will become non-representative prior to the intended cessation dates for such LIBOR tenors. However, parties should continue to monitor this for further developments.

Synthetic LIBOR settings

- It should be noted that the FCA announcement, while constituting an Index Cessation Event in respect of all of the LIBOR tenors, included a proposal that the FCA consult on the publication of a "synthetic" LIBOR rate, based on different methodology from LIBOR, for the 1-month, 3-month and 6-month LIBOR settings in sterling and Japanese yen. The FCA also stated that it may also consult on publication of synthetic LIBOR rates for the 1-month, 3-month and 6-month USD settings following 30 June 2023. However the Index Cessation Effective Date for each of these settings remains the dates set out above as the FCA has confirmed that where synthetic LIBOR rates are published they will not represent the underlying markets they are intended to measure and representativeness will not be restored.

DETERMINING THE FALLBACK RATE – ADJUSTED RFR, RESET DATES AND SPREAD ADJUSTMENTS

Fallback Rate

The Adjusted RFR and the Spread Adjustment are summed to arrive at the 'all in' Fallback Rate published by Bloomberg. These terms, and other relevant concepts, are explained below.

Adjusted RFR

The Adjusted RFR aims to extrapolate from the overnight RFR a term RFR which reflects the tenor of the LIBOR setting it is replacing. While LIBOR term rates are forward-looking over the relevant tenor (e.g. one-month LIBOR reflects the cost of borrowing for the coming month), the Fallback Rates are backward-looking and are calculated on the basis of overnight RFRs (e.g. SONIA reflects the cost of borrowing over the previous night).

To determine the Adjusted RFR and replicate the characteristics of LIBOR tenors, Bloomberg therefore compounds the RFR (e.g. SONIA) each day over an "Accrual Period" the duration of which corresponds to the affected tenor of LIBOR. The compounded rate is then annualised, and the day-count convention is matched to that of LIBOR.

The Accrual Period will begin on or just prior to the Reset Date (e.g. for SONIA it will begin two days prior to the Reset Date, but RFRs in different currencies have different conventions), and it will finish the day which is the length of the affected LIBOR tenor from the Accrual Period start date.

As compounding is applied daily by Bloomberg during the Accrual Period, using the new SONIA overnight rate each day as an input to the compounding formula, the parties will not know the Adjusted RFR until it is published at the end of the Accrual Period.

Function of Reset Dates under Fallbacks Supplement

In existing LIBOR-based swaps, the "Reset Date" will be set to fall at or just before the start of the Calculation Period over which interest is calculated. As the LIBOR tenors are forward-looking, parties could simply read the screen rate on the Reset Date and apply that rate to the Calculation Period.

Under the Fallbacks Supplement, as the Adjusted RFR is not published until the end of the Accrual Period, which starts just prior to the Reset Date, the Reset Date itself is no longer the date on which the screen rate is observed. Instead, under the Fallbacks Supplement, the parties apply the screen rate for the Fallback Rate for that Reset Date on a "Fallback Observation Date", which is a date falling two days prior to the interest payment date.

Under the Fallbacks Supplement, the Reset Date therefore operates to reset the perimeters of the Accrual Period over which Bloomberg conducts the daily compounding of SONIA in order to publish the compounded "term" RFR rate on the Fallback Observation Date.

Spread Adjustment

Having calculated the Adjusted RFR, Bloomberg applies the Spread Adjustment to arrive at the Fallback Rate. The Spread Adjustment aims to capture the element of LIBOR which represents bank credit risk over and above RFRs.

Prior to the Announcements, Bloomberg was publishing a daily indicative Spread Adjustment calculated as the median spread between LIBOR and the Adjusted RFR over the preceding five-year period, ending on the day which falls on Reset Date minus the relevant tenor, minus two business days.

On 5 March 2021, Bloomberg published the fixed Spread Adjustments for all relevant LIBOR tenors. The announcement can be found *here*.

Our commentary

After some four years of preparation for the demise of LIBOR, the fix of the Spread Adjustment in respect of LIBOR tenors marks the point at which derivatives counterparties can look forward using real quantitative data. In a perfect world, the transition to a mechanic aimed at replicating the economics of LIBOR would do just that, and the efforts of ISDA and its partners in designing the Fallback Supplement and Protocol, as well as achieving adherence in large numbers, must be applauded.

But the loss of such a familiar feature of the financial markets as LIBOR is unlikely to be pain-free for all. Where there is anything less than a uniform fallback mechanic across derivative, loan, bond and repo markets, mismatches and gaps will inevitably appear. The mismatch risk is particularly acute where a party has entered into a derivatives transaction to hedge a risk arising under another financial arrangement, such as a loan. See "*Implications for Loan Market Transactions*" below for an overview of how the Announcements are likely to affect loans.

The Protocol and Fallback Supplement are not a one-size-fits-all solution. Each party needs to assess its own circumstances and consider the approach which is most suitable for it.

For more information about what entities should take into account when considering whether to adhere to the Protocol and make use of the fallback mechanics under the Fallback Supplement, see our *LIBOR Transition Toolkit*.

3 Implications for Loan Market Transactions

Loan market participants have not reached as uniform a consensus as the derivatives markets for LIBOR replacement. Despite this, since 2018 LIBOR cessation triggers have generally been included in loan agreements, whether in the conclusion of new facility documentation or in the course of agreements to "amend and extend" existing facilities.

Not all facilities will use the same definitions for LIBOR cessation triggers. Parties will have adopted different versions of the trigger event, depending on when the documentation was agreed (or subsequently amended) and whether the triggers were subject to further negotiation (including backstop dates).

- In May 2018, the Loan Market Association ("**LMA**") published a standard "Replacement of Screen Rate" clause, under which a "Screen Rate Replacement Event" triggers the possibility of agreeing new pricing with a reduced lender consent threshold.

- In April 2020, the FCA urged parties to include "pre-agreed conversion terms" or an "agreed process for renegotiation" in new loans from the end of Q3 2020. Since then, market participants have typically supplemented the "Replacement of Screen Rate" clause such that a trigger event would also set the clock running on the agreed process towards transition. In such cases, a "Screen Rate Replacement Event" (or similar) either (a) triggers a positive obligation to negotiate new terms; or (b) activates a pre-agreed pricing structure linked to a risk-free rate (the so-called "**hard-wired method**").

- The LMA has facilitated use of the hard-wired method by publishing a series of exposure drafts for rate switch loan templates (and other draft templates with pricing linked to RFRs). To further complicate the picture, the larger banks have each formulated different policies for transition and so the market has seen a range of approaches.

Parties now need to consider whether the Announcements amount to a "Screen Rate Replacement Event" or similar trigger under loan facility documents where the interest (or other provision such as early repayment costs) is linked to a LIBOR rate.

The effects of the Announcements for outstanding loans will therefore depend entirely on the context.

- It may simply trigger the possibility (but not the obligation) for the parties to agree RFR-linked pricing, subject to agreement between the Majority Lenders (usually 66.67%) and the borrower. The impact will depend on the current composition of the lender group, which may have changed since inception of the facility.

- The clock may start running for a short period of negotiation during which the parties must agree a new rate. In some cases lenders may have sought to include provisions whereby their proposed pricing will apply by default, if a borrower is unresponsive or no agreement is reached.

- In facilities that have adopted the "hard-wired approach", RFR-linked pricing is likely to apply from the start of a new interest period, for loans in affected currencies.

The answer will depend on the terms of the relevant facility documents.

Our commentary

In many cases, LIBOR discontinuation provisions in existing loan documents may not be entirely effective. Some amount to an "agreement to agree" and others allow the lender unilaterally to select a new benchmark rate. They may also conflict with fallback provisions elsewhere in the document, which point to historic LIBOR rates, reference bank rates and/or lenders' cost of funds.

Even the more sophisticated hard-wired facilities are likely to see some teething problems in terms of the practical implications of future events over the life of a facility. The market is only now coming to terms with the impact of RFR-linked pricing on other terms which are linked indirectly to pricing. These include debt service projections in financial covenant ratios, rules on prepayments and various event-driven fees that are based on the calculation of yield. There may also be existing intercreditor restrictions on the re-pricing of facilities which have not been adequately addressed.

A key issue with loan documents is that the calculation of the element of rate-switching that represents the credit spread adjustment (i.e. the element representing bank credit spreads versus the RFR) is currently a matter for negotiation – the only market consensus reached as to re-pricing is the compounded RFR element of the rate-switch set out in the LMA exposure drafts. While in the derivatives space the ISDA Fallback Supplement both compound SONIA over a term approximate to the discontinued tenor **and** apply a pre-agreed **Spread Adjustment** (see "*Implications for Derivatives Transactions*"), no equivalent Spread Adjustment is built into the LMA rate-switch exposure drafts as they stand at the time of writing. Parties are therefore free to negotiate their own credit spread adjustments into replacement pricing.

For many credits, the Announcements may expose mismatches between the pricing of a loan and related hedging arrangements.

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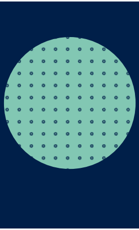

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