SLAUGHTER AND MAY

Transforming Interest Rate Benchmarks

July 2019

Are you ready for risk-free rates?

The move from LIBOR to risk-free rates (**RFRs**) is a complex and multi-faceted exercise. There are some over-arching workstreams (for example, in relation to accounting implications), but the project is proceeding largely on a currency by currency basis. Further, within each currency, transition to RFRs is being analysed product by product.

Attempts are being made by regulators and the trade associations to co-ordinate across currencies and products, but perhaps inevitably, neither the pace of transition planning nor outputs are consistent across the board. The result is a daunting (and mounting) pile of guidance notes, consultations and documentation provisions that might tempt some market participants to defer engagement until closer to the FCA's 2021 deadline.

Supervisory pressure on the financial sector to reduce LIBOR inventories as quickly as possible suggests that RFRs must be embraced across LIBOR portfolios sooner rather than later. In certain sectors of the market, the move to RFRs has begun. In others, where transition is more challenging and LIBOR continues to be used, various options for referencing RFRs are under review. Now is the time for market participants to weigh up their preferences – and weigh in on the debate.

How are RFRs (SONIA and SOFR) being used?

- Derivatives - increasing liquidity in SONIA/SOFR derivatives
- FRNs - predominantly financial sector issuers
- Securitisations – sterling market for consumer ABS has moved almost entirely to RFRs
- No reports yet of SONIA/SOFR referencing syndicated loans
- Bilateral loans referencing SONIA starting to emerge

This briefing outlines why the pace of transition to RFRs differs across products, and the contexts in which RFRs are starting to be used in mainstream financial products. It is primarily focussed on the sterling market, which is in many respects ahead of the other LIBOR currencies in terms of transition efforts. However, the techniques being used and issues being debated in London mostly apply equally to, and therefore may influence the approach to transition in relation to, other IBOR exposures. This includes EURIBOR, notwithstanding ESMA's recent announcement that the reformed EURIBOR is compliant with the EU Benchmarks Regulation. It is not currently anticipated that EURIBOR will be discontinued along the same timeline as LIBOR, but €STR, the new euro short term rate, may in time be used in place of EURIBOR in certain contexts (for example, derivatives). It is also anticipated that rates based on €STR will be adopted as fallback rates in EURIBOR-linked products.

Why is the pace of transition different across products?

RFRs have been identified for all 5 LIBOR currencies. Four of the five RFRs are in the market and capable of use. The exception is €STR, which is due to be published from 2 October 2019. Why then, are the available RFRs not being used across the board in place of LIBOR?

Lack of familiarity with RFRs is perhaps the key obstacle for certain market participants that have never used these types of rates. RFRs are currently being used in place of LIBOR by market participants who have worked with RFRs for many years and have systems in place that enable their use. This, broadly speaking, means the wholesale markets and the financial sector.

Where is SONIA being used in place of LIBOR?

SONIA was launched in 1997, and has been used in the sterling overnight interest swap (OIS) market for many years. The conventions for using SONIA are therefore well established and understood. The derivatives market has been swift to adapt to reformed SONIA and the volume of sterling LIBOR-linked derivatives has quickly reduced.

The use of RFRs in the derivatives market is important for various reasons. Firstly, LIBOR-linked derivatives form the bulk (in volume terms) of legacy LIBOR exposures, making it important to reduce as soon as possible the inventory that ultimately needs to be amended. In addition, liquidity in RFR-linked OIS trades and/or futures is crucial to the production and viability of any forward-looking term rate that might be derived from the RFR for the relevant currency in the future (discussed further below).

The financial institution (FI) and public sector issuer portion of the sterling FRN market has also adapted to SONIA. SONIA is now the norm in place of LIBOR for FRNs from FI and public sector issuers. While the initial challenges for adapting internal systems to use SONIA even for the financial sector should not be underestimated, the resources available as well as the size and diverse funding base for the sector have meant that once the market convention was established, the switch could occur rapidly.

In the first half of 2019, the sterling covered bond market moved to SONIA, which is now exclusively used for new issues, for the same reasons as in relation to FRNs. The sterling securitisation market has been slower to adopt SONIA, in part because of reduced issuance due to the challenges posed by the introduction of the EU's Securitisation Regulation in January, but also as a result of the difficulty of adapting many different internal and external reporting and modelling systems to reflect the change. However, some of these challenges have been overcome and in the second quarter of 2019 most new sterling consumer ABS issuance has been in SONIA. However, at the time of writing, this is almost entirely in the context of FI and/or public sector issuers and those businesses that are predominantly funded through securitisation.

Risk Free Rates
(LIBOR currencies)

- SONIA
- SOFR
- SARON
- €STR (from 2.10.19)
- TONAR

RFRs are a much more novel concept for non-financial corporates, in particular for cash products such as loans and bonds and it is this portion of the market that has been slowest to adapt. We are not aware that any corporate has yet issued a new RFR-linked FRN in sterling or indeed, any other currency (although Associated British Ports recently became the first issuer to convert a legacy LIBOR FRN to a rate based on SONIA). Similarly, we are not aware of any syndicated loans using RFRs in place of LIBOR, although the first bilaterals referencing SONIA have recently started to emerge.

What will speed up the transition of cash products to RFRs?

In practice, the loan and bond markets need to coalesce around a single methodology (or a small number of variants) for using RFRs in cash products to stimulate the broad adoption of RFRs.

As discussed further below, the issue at the top of the current agenda for those involved in LIBOR transition, is whether the conventions for referencing SONIA (or other RFRs) used in those products that have started to transition are workable more broadly – or whether it is necessary to adapt them and/or focus on alternative types of rate, such as term rates.

Once the conventions for using RFRs have been determined, the other key building blocks required to support the RFRs should fall into place:

- pricing adjustments can be determined (to address the economic differences between LIBOR and the RFRs);
- systems providers can be comprehensively briefed as to the features and requirements of the new rates;
- regulators can engage decisively with rate vendors to assess how the rates should be made available to the market (e.g. screen rates, rate calculator tools, indices); and
- documentation can be finalised.

What about term rates?

A key question is whether RFR-derived term rates (i.e. forward looking rates over a range of maturities) will be available in due course. The Bank of England's RFR Working Group is working with three administrators during 2019 to establish whether a robust SONIA term rate, compliant with international standards, can be produced in the time frame required. Whether and when term rates will be available for other LIBOR currencies is even less certain. In the US, the current intention is to produce a term SOFR rate in 2021. The CHF working group, however, has already confirmed that there are no current plans to produce a SARON-derived term rate.

Against that backdrop, the message from the official sector is that market participants must not rely on the availability of term rates. Even if available, the Bank of England's expectation is that the future use of forward risk-free term rates will be more limited than current LIBOR usage. Users may also conclude it desirable for FRNs and loans to follow the same approach to referencing RFRs as is used in the derivatives market, given the inter-linkages. The OIS market, as noted above, is referencing RFRs directly. Developing a liquid derivatives market in term RFRs presents a structural challenge, as it may divert liquidity away from the OIS market in the underlying RFRs upon which the very existence of a term RFR is likely to depend.

In the regulators' view, the focus should therefore be on determining how to reference RFRs directly in cash products rather than waiting for term rates.

What are the options for referencing RFRs directly in cash products?

The RFRs are overnight rates. The cash markets require the RFRs to be available over a period (e.g. 1 months, 3 months, etc.). In the absence of a term rate, this means that RFRs must be compounded or averaged over the required period.

If a daily RFR is compounded or averaged over a period, the precise amount of interest due on the interest payment date will not be known until the last day of the period. Some have suggested this may not be a material concern in practice, to the extent the RFRs are relatively stable over a period compared to LIBOR. However, the lack of certainty has prompted concerns that the use of compounded or averaged RFRs could lead to interest settlement times being delayed beyond current norms. To address this, a mechanism for calculating the amount of interest due sufficiently in advance of the end of the interest period is required for the loan and bond markets, to enable payments to be mobilised and any tax due to be calculated in good time.

The main possibilities under discussion are:

- Observing the RFR over a period that begins and ends on a date that falls 5 Business Days earlier than the start and end of the interest period.

  This "lag" mechanism has been used in the SONIA-referencing FRNs and covered bonds issued so far. It is also, reportedly, the mechanism used in the first publicly announced SONIA-referencing bilateral loan, entered into recently by NatWest and National Express.

- Observing the RFR over the interest period, but "stopping the clock" a few days (e.g. 4 days) prior to the end of the interest period, and using the RFR on the lock date as the interest rate for each of the last few days of the period.

  This "lock" mechanism has been used in a number of SOFR-referencing FRNs in the US.

There are pros and cons of each approach – and potentially differing views on the required length of any "lag" or "lock", which market participants are likely to be keen to minimise.

In an attempt to socialise the main techniques that the cash markets might adopt for referencing RFRs directly, the RFR Working Group in the UK published a "Discussion Paper for Referencing SONIA in new contracts". The intention is to prompt debate and feedback, with a view to determining whether the market is likely to settle on a single option, and if so, which. The Bank is currently reviewing feedback, and further information is anticipated shortly.

The US authorities have taken similar steps in the form of a "User's Guide to referencing SOFR". The Financial Stability Board has published a paper for the global audience: "Overnight risk-free rates: a user's guide".

These papers are recommended reading for users of IBOR-linked loans and bonds, both to illustrate the direction of travel and the implications and potential challenges of referencing RFRs directly in cash products. Users are strongly encouraged to give feedback and comment on the options put forward to advisers, trade associations and regulators.

What is happening in the interim?

Pending consensus on conventions for referencing RFRs across the full product spectrum, products including loans, FRNs and certain securitisations (and related derivatives) are still using LIBOR. To the extent current transactions extend beyond 2021, attempts are being made to anticipate the eventual transition to RFRs.

The focus in most cases is on making sure that when documentation comes to be amended to cater for RFRs, the amendment process is as efficient as possible. For example, for the syndicated loan market, the LMA has published a Replacement of Screen Rate clause, which broadly enables the adoption of a replacement benchmark and related amendments with Majority Lender consent, rather than the unanimous Lender consent that is typically required for changes to the applicable interest rate. In the FRN market, a variety of solutions are being adopted, many of which confer responsibility on the issuer, possibly with the help of an independent expert, to determine the replacement rate and effect appropriate amendments.

The nature of the contractual provisions being adopted varies by product, by currency/governing law and in some cases, by transaction. This is a topic that requires advice on the most practical solution in the circumstances.

What's next for fallbacks?

The approach to anticipating the demise of LIBOR will evolve as the market determines the most appropriate fallbacks for particular products. These are thought likely to fall into place as ISDA reaches firm conclusions on fallbacks for the derivatives market.

The development of fallbacks for derivatives referencing sterling LIBOR and certain other IBORs appears to be at a reasonably advanced stage. The proposal (following ISDA's initial consultation) is that swaps referencing the IBORs subject to that consultation (which include sterling LIBOR), will fall back to the relevant RFR compounded in arrear, plus a credit spread adjustment.

In response to its initial consultation on this topic, ISDA is currently working on finalising the parameters of the credit spread adjustment and is also engaging with rate vendors to determine how these rates will be made available to the market and by whom. It has also launched a second consultation on the same topic, in relation to a further group of IBORs, including USD LIBOR.

Once the fallback rates are finalised, ISDA will issue fallback drafting for transactions referencing the relevant IBORs in the form of updated definitions that can be adopted on a case by case basis. A protocol will also be made available which, if adhered to by both parties to the relevant transaction, will automatically incorporate the new fallbacks into existing transactions. ISDA's most recent timeline indicates that it hopes to make the new definitions available for the IBORs on which it has so far consulted towards the end of 2019 and open the related protocol for adherence in 2020.

The question then for the cash markets is whether to follow ISDA's approach to fallbacks, or whether it is or may be necessary to do something different (e.g. fallback to term rates). Much may depend on progress on the development of term rates, and the extent to which the cash markets determine to use those in preference to referencing RFRs directly e.g. by using compounded rates.

LIBOR is starting to disappear and in relation to certain products, this may well happen in advance of the 2021 deadline. Now is the time to get ready for RFRs.

Slaughter and May are monitoring closely developments in relation to transition from LIBOR, EURIBOR and other major benchmarks across all of the major financial products. For further information, please contact any of the lawyers listed below or your usual adviser at Slaughter and May.

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