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Eyes on IBOR- Update no. 6 – LIBOR’s Loan Problem.

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LIBOR's Loan Problem

Libor began as a convenient, consensus rate for the small club of mid 1970's Eurodollar lenders, rising to global fame on the coat tails of the then-new derivatives markets. It also continued with ever-wider adoption as a reference rate for loans- it is these more "simple" products that potentially present the more challenging LIBOR transition prospect. For derivatives, the ISDA IBOR Fallback protocol went "live" on 23 October 2020, as of today it has 756 adherents. Although already a success and covering an extensive range of documents, the Protocol is far from a silver bullet for the derivatives market, necessarily applying to only the most standardised products. There is no protocol mechanism for more bespoke markets such loans or bonds.

Regulatory Background

Following a failed attempt to reform its administration, the FCA focused on the need for LIBOR transition in July 2017; regulators have been increasingly insistent ever since. In April 2020 the Working Group on Sterling Risk-Free Reference Rates ("the Working Group") acknowledged that the transition would be affected by COVID-19, shifting its milestones six months down the 2020 road:

"After the end of Q3 2020 lenders, working with their borrowers, should include clear contractual arrangements in all new and re-financed LIBOR-referencing loan products to facilitate conversion ahead of end-2021, through pre-agreed conversion terms or an agreed process for renegotiation, to SONIA or other alternatives"

The opaque "clear contractual arrangements" was clarified to some extent in the Working Group's July 2020 Q&A. These constitute a spectrum from "pre-agreed conversion terms" to "an agreed process for renegotiation". 2020 is rapidly shaping up to be the new exemplar for legal resource bottleneck; excepting a handful of landmark new transactions e.g. BAT, Shell and ABP, the loan market has been staring at the oncoming headlights. Recent Working Group recommendations for SONIA loan conventions and new template documentation from the LMA should provide at least a starting point to start tackling the repapering mountain.

SONIA Conventions

In September 2020 the Working Group sought to break the logjam with the following recommendations:

1. Use SONIA compounded in arrears (unsurprisingly)
2. Use a Five Banking Days Lookback without Observation Shift. This aligns with the USD ARRC approach, though the Working Group acknowledges that an observation lag convention still constitutes a viable alternative
3. Where an interest rate floor is used, the Working Group recognises that it may be necessary to apply the floor to each daily interest rate before compounding
4. Prepayments- accrued interest should be paid at the time of principal prepayment

These are broad recommendations rather than detailed prescriptions, associated documents give examples of various calculation options.

LMA Rate Switch Agreement

The LMA has recently published an exposure draft agreement ("the Switch Agreement") aiming to standardise the "pre-agreed conversion terms" for the switch to an RFR following a LIBOR's pre-cease by the FCA or de-cease by a Regulator and/or Administrator. Although the LMA emphasise that users of the Switch Agreement will have to choose the conventions most suited to particular transactions; the Switch Agreement is problematically chimeric, potentially subjecting multiple currency RFRs to GBP Working Group conventions. The Switch Agreement is more framework than template; for instance, it would require substantial amendment to accommodate the US ARRC recommended fallbacks to a term SOFR rate (when one exists), then to daily unadjusted SOFR. This shouldn't be an issue, the loan market is long familiar with currency-specific conventions- the LMA have at least provided a point to depart from.

The Room Elephant

While the Switch Agreement is very welcome for new loan transactions (in GBP at least), the larger 2021 loan challenge is the transition of legacy transactions. The Working Group published a September 2020 paper intended to incentivise transition. The foreword advises that "Market participants should be looking to amend their legacy GBP LIBOR referencing loans now where feasible"- but the paper raises questions, rather than providing answers. It recommends that when discussing SONIA compounded in arrears, consideration should be given to: using SONIA at all, the length of the lookback period, and if back-looking, whether an observational shift should be applied. It similarly reviews various approaches to the calculation of the credit adjustment spread: forward approach referencing LIBOR-SONIA basis swaps, ISDA historical median, and "other"- the DIY method. The historical heterogeneity of the loan market precludes any quick fix, standard amendment solution- you are effectively on your own, unless there's a few of you. While the more informationally symmetric wholesale markets are perhaps less hamstrung by the spectre of litigation than their retail brethren, they face their own cat herding problems in respect of syndicated loans. In the structurally inevitable absence of market leadership, fundamental questions remain regarding agency discretion to amend facilities, process initiation and cost distribution.

Legislative Solution

Regulators and politicians acknowledge that there are a number of "tough legacy" contracts that "genuinely have no or inappropriate alternatives' to LIBOR and no realistic ability to be renegotiated or amended". The Working Group "Tough Legacy Taskforce" published a paper at the end of May, highlighting issues for particular asset classes, but providing little by way of solution. The paper recognises that legacy, both syndicated and bilateral, have been considered amongst the toughest category to transition, noting in particular:

- While recent syndicated loans include 'replacement of screen rate' wording, reducing the amendment consent threshold requirements, many legacy loans will require the consent of all lenders
- Syndicated and bilateral loans may fall back to individual lender cost of funds, raising difficulties in cost calculation
- Lack of awareness of LIBOR transition in the bilateral loan market may prove to be a problem for consent solicitation
- The large volumes of the market, the diverse nature of both contracts and borrowers, and resource constraints makes individual contract renegotiation challenging

The UK "solution", by way of amendment to the UK BMR, is to enable the FCA to create a new "Transition LIBOR", a temporary rate that may be used for tough legacy contracts in the event of Libor's decease. There is currently no definition as to what constitutes "toughness" in legacy contracts and therefore no certainty that loans will be covered, or indeed that any legislative solution will transpire prior to cessation. The US ARRC has taken a more direct approach to the tough legacy issue, recommending legislation

that would mandatorily amend NY law contracts to include a fallback to SOFR rates. The overall picture is that while disparate legislative solutions are envisaged, they are likely to be of severely limited, and potentially problematic application. Regulators have been at pains to emphasise that reliance should not be placed on a deus ex machina legislative solution – “The message remains clear: those who can transition away from LIBOR should do so on terms that they themselves agree with their counterparties”- Andrew Bailey “Libor: Entering the Endgame”

Tick...Tock

Although not technically a LIBOR, an IBOR cousin has already had the inevitable news with Refinitiv’s 12 November announcement that two CDOR tenors will no longer be published from 17 May 2021. In order to avoid (typically) falling back to cost of funds, the wider GBP LIBOR- loan market has at most 405 days to make amendments. These will be bilaterally-negotiated, largely transaction-specific and will require a degree of short-in-supply loan expertise. Many market participants have already analysed their loan portfolios: their fallback provisions, amendment provisions and consent requirements. Many have already looked at the cross-jurisdictional implications for multi-currency loans, matching all of the above with applicable hedges and considered amendment process costs and possible transition accounting IFRS effects. Many will have tested treasury management and loan systems to account for compounded in arrears SONIA and incorporated adjustments for individual credit spread agreements. In reality, not that many. Time is already short and effective external resources will be scarce.

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