Baker McKenzie.

Benchmark rate reform and the transition to risk free rates

Rafal Zakrzewski, Solicitor (England & Wales) | 25.10.2019

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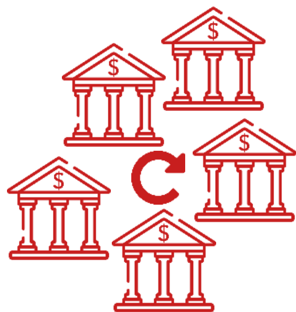
Agenda

1. Benchmark rates in syndicated loans
2. What went wrong?
3. LIBOR reform then replacement
4. Overview of RFRs
5. LIBOR->RFR transition status
6. Impact on loan documentation

Syndicated loans evolved on the basis of the matched funding principle



Bank finances itself in the interbank market

Assumption is that the bank borrows the relevant currency to onlend it to the borrower with the benchmark rate being the bank's cost of obtaining the funds in the interbank market

Lends money to a borrower with the margin representing the bank's profit

Profit margin is protected by market disruption, increased costs and tax indemnity clauses

What are benchmark rates?

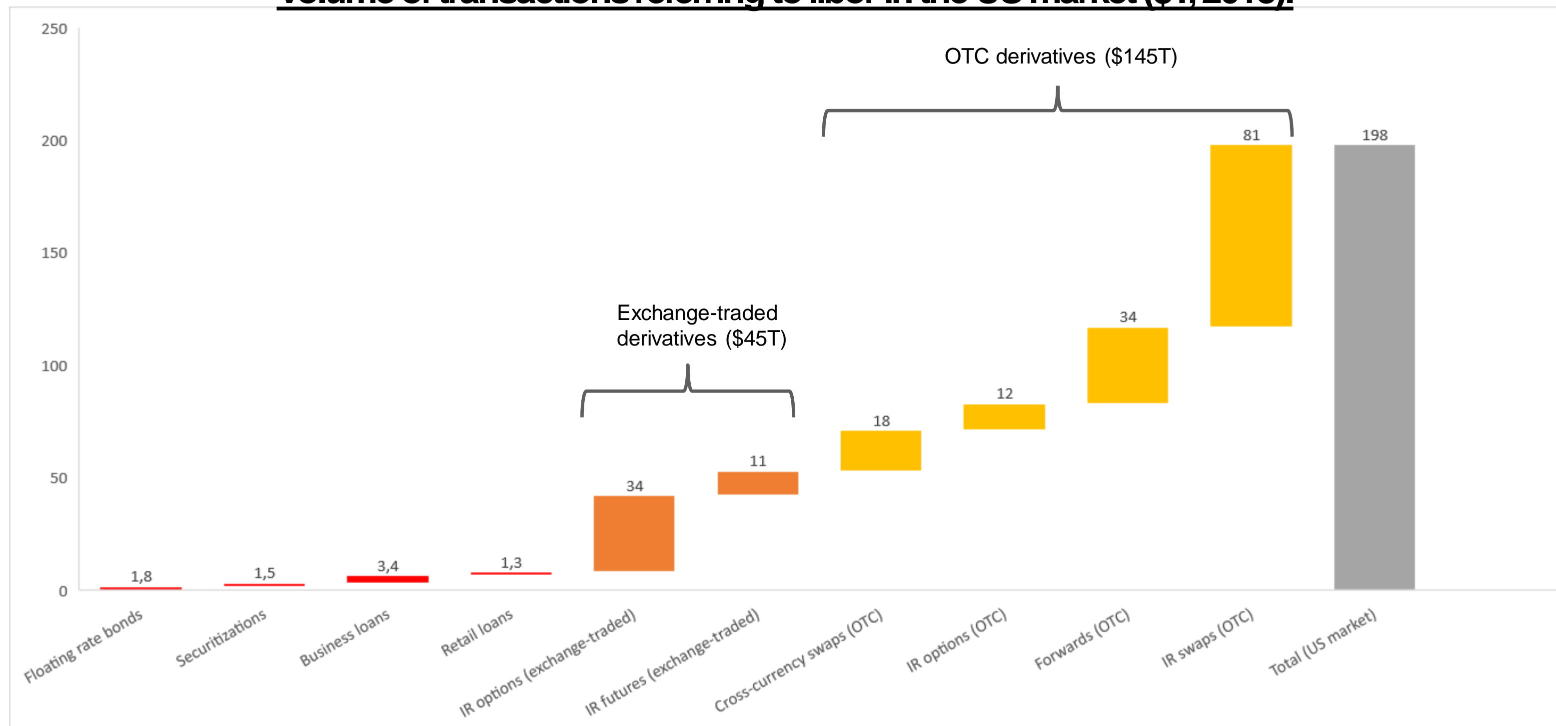
LIBOR – "The rate at which an individual Contributor Panel bank could borrow funds, were it to do so by asking for and accepting inter-bank offers in reasonable market size, just prior to 11.00 a.m. London time.„

- Born informally in 1969, it was embraced by the BBA in 1986
- It used to be set for ten currencies (including sterling, US dollars, Swiss francs and Japanese yen) and for 15 different "tenors" such as 3, 6, 9, 12 months etc (used to be 150 different LIBOR rates)

EURIBOR - not an estimate of what a panel bank thought it would be charged for borowing from other banks, but what it believed a prime bank was quoting another prime bank for interbank term deposits in the eurozone

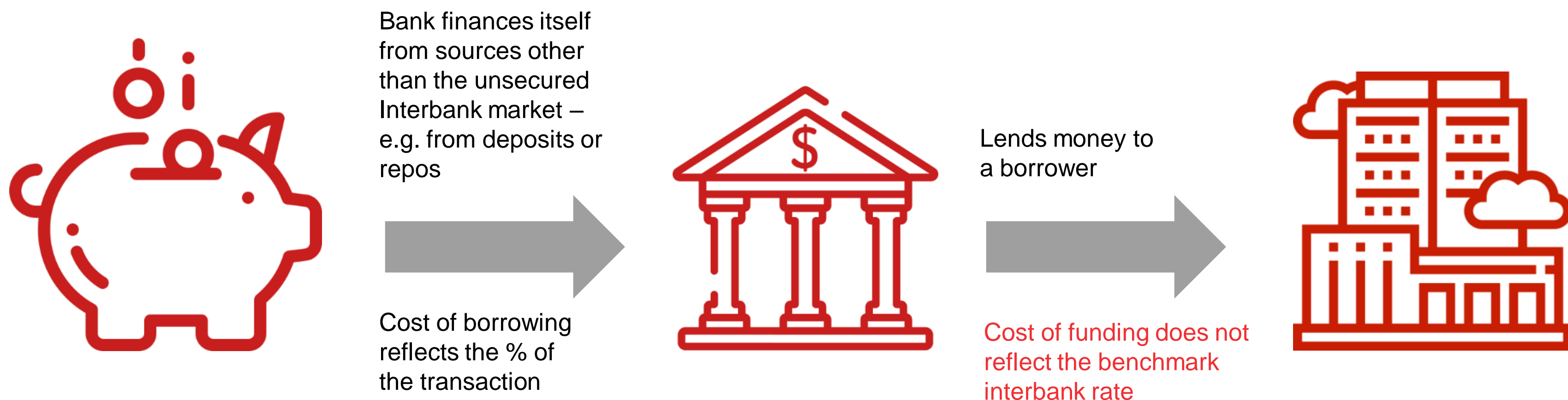
Used extensively: E.g. only in the US, the volume of transactions referring to LIBOR is ~$200T, majority in derivatives

Volume of transactions referring to libor in the US market ($T, 2018):



Total volume of world LIBOR market is ~$350T - Estimates vary from $240 tn (Oliver Wyman) to $400 tn (Bank for International Settlements)
Source: J.P. Morgan, Federal Reserve Board, BIS, Bloomberg, CME, DTCC, JPMorgan Chase and ARRC

But the matched funding principle based on interbank lending rates no longer reflects reality



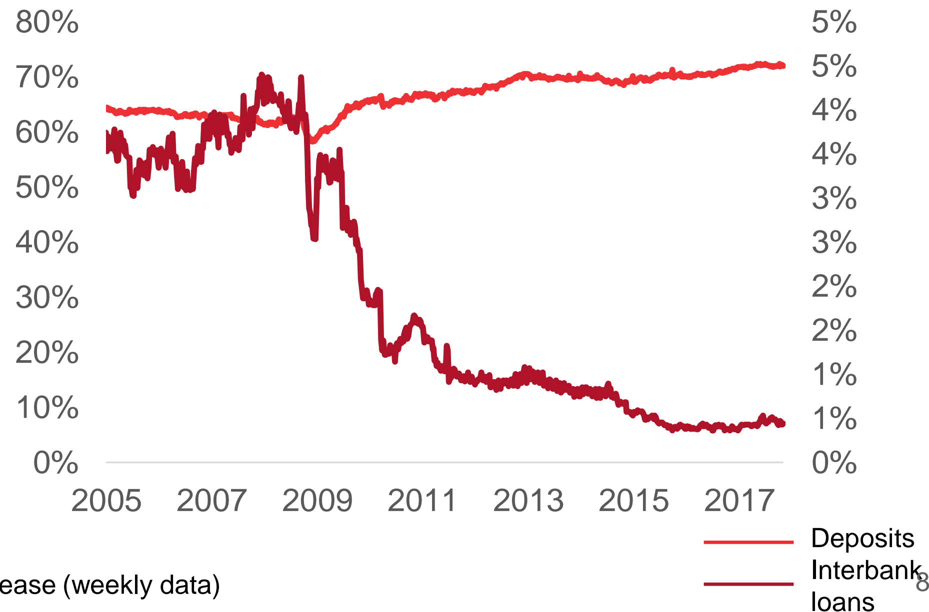
As interbank loan market transactions become scarcer, LIBOR's usefulness as a reference rate becomes questionable

Following the financial crisis the interbank loan market dried up

Sharp decrease in both nominal volume of interbank loans and their importance on balance sheets:

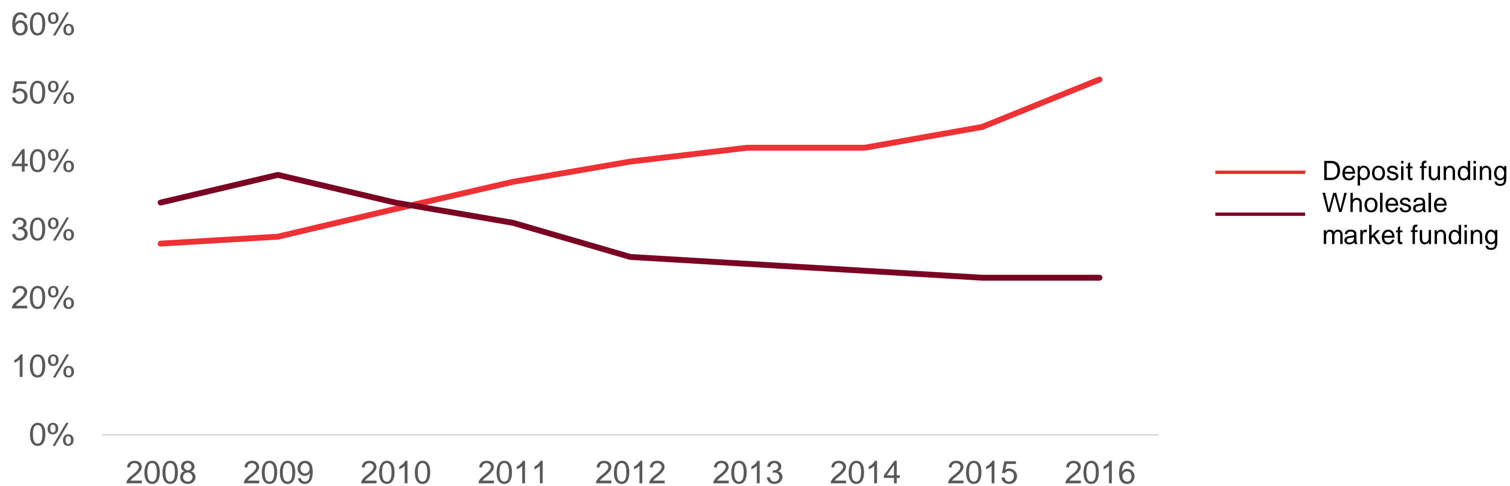
Interbank loans for commercial US banks (B USD)[1]

Deposits (left scale) and interbank loans (right scale) as % of commercial US bank assets(%)[2]



1) and 2) Source: Board of Governors of Federal Reserve System H8 release (weekly data)

Banks became more reliant on deposit funding relative to wholesale markets



In the wholesale market itself, banks have been shifting towards other sources of funding, e.g. repos and bonds

1) Source: ECB Statistical Data Warehouse, ECB Report on Financial Structures 2017

Drying up of the interbank market allowed manipulation: LIBOR/EURIBOR scandal (1/2)

- Between 2006 and 2012, there had been manipulation of LIBOR/EURIBOR
- Some people at panel banks had made submissions which did not reflect the rate at which they genuinely thought their banks could borrow funds
- They submitted rates which were thought to benefit the banks' trading positions and/or individual traders' bonuses

Drying up of the interbank market allowed manipulation: LIBOR/EURIBOR scandal (2/2)

Selected outcomes of various LIBOR/EURIBOR-related proceedings:

- Over **$ 9BN** in fines from both UK and US regulators relating to LIBOR fixing and further **~€ 2BN** levied by the European Comission in EURIBOR investigation
- **Criminal charges brought against ~30 people** in UK and US criminal investigations relating to LIBOR and EURIBOR[1]
- **9 people jailed in the UK** criminal proceedings - 5 in the LIBOR trial, 4 in EURIBOR trial
- Further convictions in the US investigations - 2 jailed (but charges dismissed in appeal), 2 more found guilty (awaiting sentences) with several more guilty pleas
- **Well over 100 people fired or suspended** by banks involved in the aftermath of the scandal
- The scandal resulted in **~$11BN of fines** and multiple criminal convictions

Tom Hayes, former UBS and Citigroup trader sentenced to 11 years in jail for his involvement in LIBOR manipulation scheme
Source: ft.com

1. Additionally, fines and professional bans issued against individuals by the regulators

Source: FT, Bloomberg, cfr.org, press releases of the regulators

Civil claims based on LIBOR/EURIBOR scandal (1/2)

Unsuccessful in transactional context

Property Alliance Group v Royal Bank of Scotland plc [2018] EWCA Civ 355

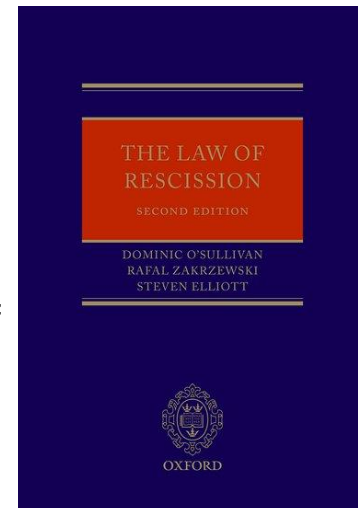
- PAG entered into sterling interest rate swaps with RBS; it lost GBP 8m when it terminated the swaps
- PAG sued RBS for, among other things, misrepresentations in respect of LIBOR – alleging that RBS knew of and participated in LIBOR manipulation
- Court of Appeal found that a misrepresentation could be implied that:
  - a LIBOR panel bank was not manipulating LIBOR in the currency relevant to the product and did not intend to do so in the future
- However, PAG's case failed because it presented no evidence that RBS had manipulated sterling LIBOR (although RBS admitted manipulating CHF and JPY LIBOR) so PAG did not establish that the representation made was actually false

Civil claims based on LIBOR/EURIBOR scandal (2/2)

Unsuccessful in transactional context

***Marme Inversiones 2007 SL v Natwest Markets plc & ors* [2019] EWHC 366**

- Marme entered into EURIBOR interest rate swaps in connection with EUR 1.5bn syndicated loan
- One of RBS's traders had been convicted of EURIBOR manipulation
- M sought rescission on grounds of implied misrepresentations by RBS (as an arranger) regarding the integrity of the EURIBOR setting process and the absence of its manipulation
- Picken J refused to imply such representations from RBS's conduct
  - even if made they would not bind the other banks in the syndicate (no authority); and
  - M did not rely on such representations because it had not considered the rate setting process when contracting / was not aware of them at the time
- Also held that any right to rescind would have been lost because the contract was affirmed by a payment made by M just before the court case was commenced



Why be a panel (or reference) bank?

- Liability to prosecution
  - Risk of being sued in a civil action
    - No revenue from acting as a reference bank

Changes introduced in LMA documentation

Regulator forced panel contributions to continue

2012 Wheatley Review: attempt to reform LIBOR

Changes introduced to LIBOR following Martin Wheatley's review:

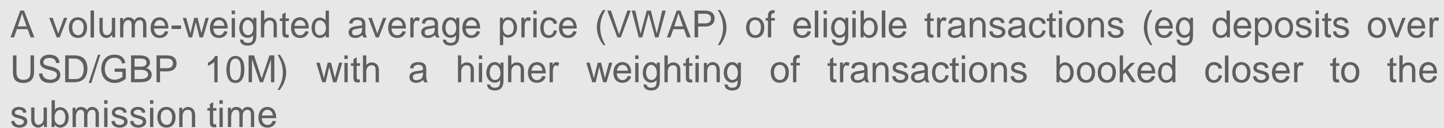
- Recommended reform rather than replacement of LIBOR
- LIBOR administration and supervision transferred from BBA (trade body) to ICE Benchmark Administration
- Evidence of actual transactions required to support LIBOR submissions
- Stronger supervision of submissions
  - E.g. mandatory compliance and conflict of interest procedures, external audit of past submissions
- Banks' individual LIBOR submissions published only after lapse of 3 months
- Benchmark rates for uncommon currencies and tenors ceased
  - Currently 35 LIBOR rates - 5 currencies for 7 tenors are published

Martin Wheatly, CEO of FCA

The newly implemented LIBOR waterfall (hybrid) methodology puts more weight on real transactions

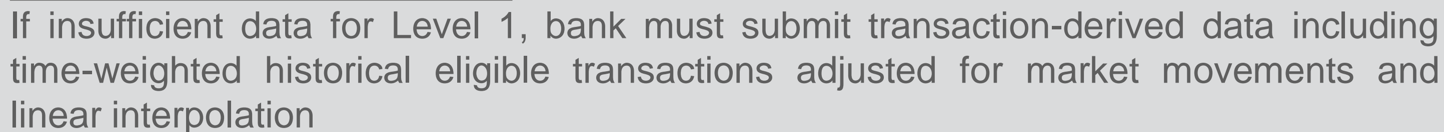
3 levels in ICE waterfall (hybrid) methodology – (similar one to be used by EMMI for hybrid EURIBOR):

Level 1: Transaction-based



A volume-weighted average price (VWAP) of eligible transactions (eg deposits over USD/GBP 10M) with a higher weighting of transactions booked closer to the submission time

Level 2: Transaction-derived



If insufficient data for Level 1, bank must submit transaction-derived data including time-weighted historical eligible transactions adjusted for market movements and linear interpolation

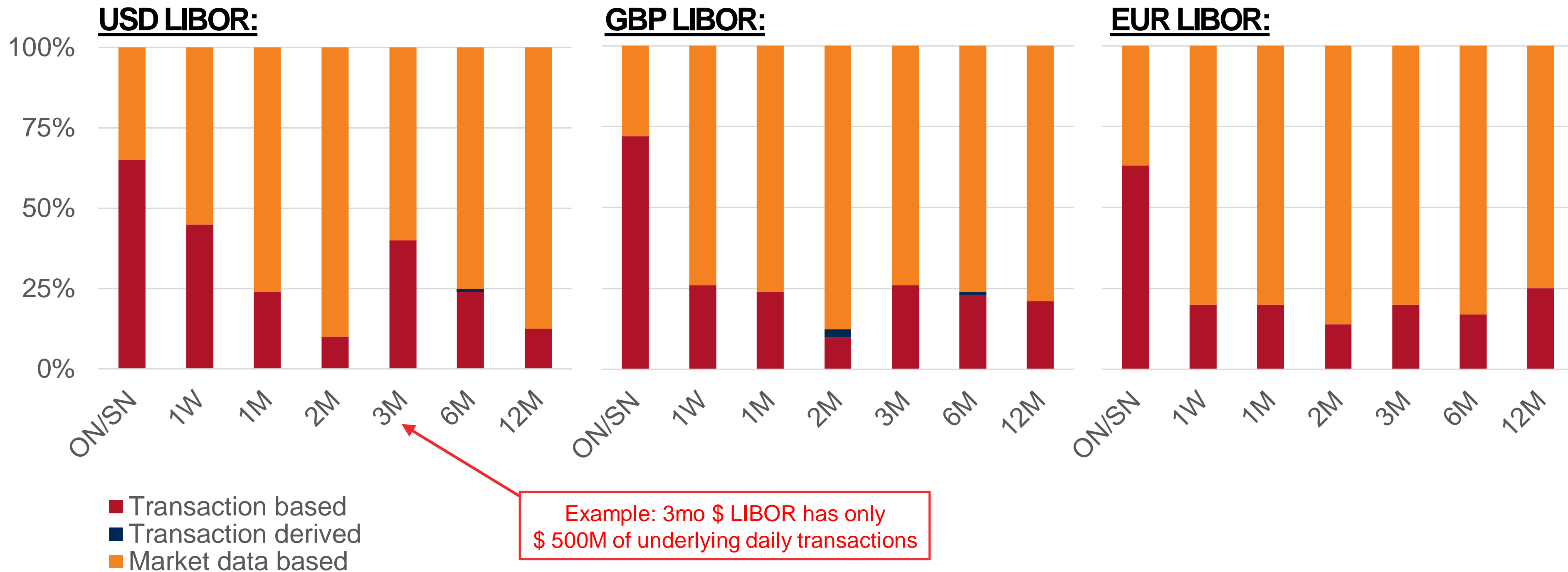
Level 3: Expert judgement

If insufficient data for Level 1 & 2, bank must submit an expert judgement, using the bank's own internally approved procedure (based on a set of permitted inputs) of the rate at which it could fund itself at the submission time on the unsecured wholesale funding market

Source: ICE

But continuing decrease in interbank lending has led to LIBOR rates becoming less transparent

Construction of LIBOR rates % split (transaction-based vs. transaction-dervied vs. market data based), 2018[1]:



1) Source: ICE LIBOR Transparency of LIBOR publications release, 2018, JP Morgan

The FCA decided that it will not compel banks to produce LIBOR submissions past 2021

„The absence of active underlying markets raises a serious question about the sustainability of the LIBOR benchmarks that are based upon these markets. If an active market does not exist, how can even the best run benchmark measure it?" (July 2017)

Andrew Bailey, Chief Executive of the FCA in his July 2017 LIBOR speech
Source: FCA

Drying up of the underlying market of interbank loans named as the main reason for scrapping LIBOR

Latest Andrew Bailey speech

15 July 2019

- Banks won’t be compelled to submit LIBOR rates after 2021
  - Some will leave the panel
- LIBOR is likely to be no longer considered „representative” by the FCA and other regulators
  - Under the EU benchmark regulation, there will be a legal restriction on using it as a reference rate in new contracts
- *„The base case assumption should be that there will be no LIBOR publication after end-2021.”*
  - (according to a 2017 survey by a LIBOR panel bank, 80% of respondents indicated they would prefer LIBOR to remain in some form)

In EU the Benchmark Regulation increased the requirements for benchmark administrators and banks

Key elements of the EU Benchmark Regulation:

- Mandatory governance mechanisms introduced for benchmark administrators and data providers (banks):
  - **Benchmark administrators need to be authorised and supervised** by a competent regulator in each Member State (in Poland: UKNF) [article 34]
  - **Governance, conflict of interest and oversight rules** for both administrators and banks [articles 4-7, 15, 16]
  - Regulators given the power to sanction administrators and banks for infringements [article 42]

- Principle of reliable market representation: **Benchmarks need to reflect the economic reality, be transaction-based** where available (discretion minimised); methodology needs to be verifiable and transparent [articles 11-13]

- **„Critical benchmarks"** introduced in the regulation – benchmarks with the highest significance for the market (as a general rule >€500 B of instruments must refer to them) – Commission reviews and maintains their list [article 20]
  - Stronger regulatory requirements for critical benchmarks – e.g. external auditing [article 7]
  - Mandatory administration and submission of data to a critical benchmark [article 21, 23]

Following the Regulation's entry into force EONIA rate to be scrapped (replaced with ESTER on Oct 2nd) and EURIBOR modified (due to non-compliance)

For details see: REGULATION (EU) 2016/1011 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of Investment funds – deadline for transition 1/1/2022

Risk-Free Rates

Replacements for LIBOR

- RFRs are averaged historical overnight rates
  - alternative benchmarks for existing interbank offerred rates (IBORs) in unsecured lending markets
  - based on active liquid markets
    - irony: US markets transitioned from RFR (Treasury bill rates) to LIBOR in the 1980/90s as it better reflected funding costs
- working groups in various currency jurisdictions have been selecting RFRs as replacement benchmarks…

Alternatives to LIBOR mostly in the form of RFRs

Currency	Chosen Risk-Free Rate	Secured (Y/N)	Administrator	Description	Overnight (Y/N)	Purely interbank (Y/N)	Publication date
Sterling (£)	**SONIA** (Sterling Overnight Index Average)	✗	Bank of England	Weighted average rate of unsecured overnight sterling transactions reported to BoE with a minimum transaction size of £ 25 M (modified in April 2018)	✓	✗	T+1
US Dollar ($)	**SOFR** (Secured Overnight Financing Rate)	✓	Federal Reserve Bank of New York	Cost of borrowing overnight collateralised by Treasury securities based on transactions cleared through the DVP service offered by FICC	✓	✗	T+1
Euro (€)	**ESTER** (Euro Short-Term Rate)	✗	European Central Bank	Weighted average of the wholesale unsecured overnight borrowing costs of euro area banks reported in accordance with MMSR – **live today**	✓	✗	T+1
Euro (€)	**EURIBOR** (Euro Interbank Offered Rate)	✗	European Money Market Institute (EMMI)	Reference term rate published by European Money Markets Institute (EMMI) representative of the rate at which credit institutions in the EU can borrow wholesale funds in euro (transaction size of min. € 20m)	✗	✗	T+1
Swiss Franc	**SARON** (Swiss Averaged Rate Overnight)	✓	SIX Group Ltd.	Overnight interest rate of secured funding for Swiss Franc based on transactions and quotes posted in the Swiss repo market	✓	✓	T+0
Japanese Yen (¥)	**TONAR** (Tokyo Overnight Av.)	✗	Bank of Japan	Uncollateralized overnight call rate for JPY transactions calculated and published by the BoJ	✓	✗	T+1

Source: BoE, ECB, Fed, Bank of Japan, SIX Group, Bank of International Settlements „Beyond LIBOR" primer, 2019

Implications

Shifting from LIBOR to RFRs is not like shifting from miles to kilometers

- RFRs will not be economically equivalent to LIBOR
  - RFRs = rates at which interest is paid on funds where credit, liquidity and other risks are minimal
- Will behave differently to LIBOR, especially under financial stress
- To consider why, let's compare characteristics of LIBOR and RFRs…

LIBOR vs. RFRs

LIBOR:

- Unsecured
- Forward looking – interest payable is known in advance

  Term premium - longer tenors priced higher than shorter ones

  LIBOR includes bank credit risk - reflects lenders' costs of money for a given term
- Multicurrency with rates published at the same time (11:55 London time)
- Liquid underlying markets in LIBOR-based products, most importantly derivatives
- Widely accepted in the markets
- Few underlying transactions
- Historically prone to manipulation

RFRs:

- Unsecured (SONIA) or secured (SOFA)
- Backward looking – overnight rates only

  No term nor term premium

  Not covering cost of banks' credit risk (near risk free)
- Rates constructed differently for different currencies, different administrators and publication time
- Markets of RFR-based products (e.g. derivatives) are just developing (and at different rates)
- Still in their infancy, little acceptance in the markets compared to LIBOR
- Transaction-based, based on liquid underlying money markets
- Difficult to manipulate

Pricing gap

Different characteristics of LIBOR and RFRs lead to pricing gap

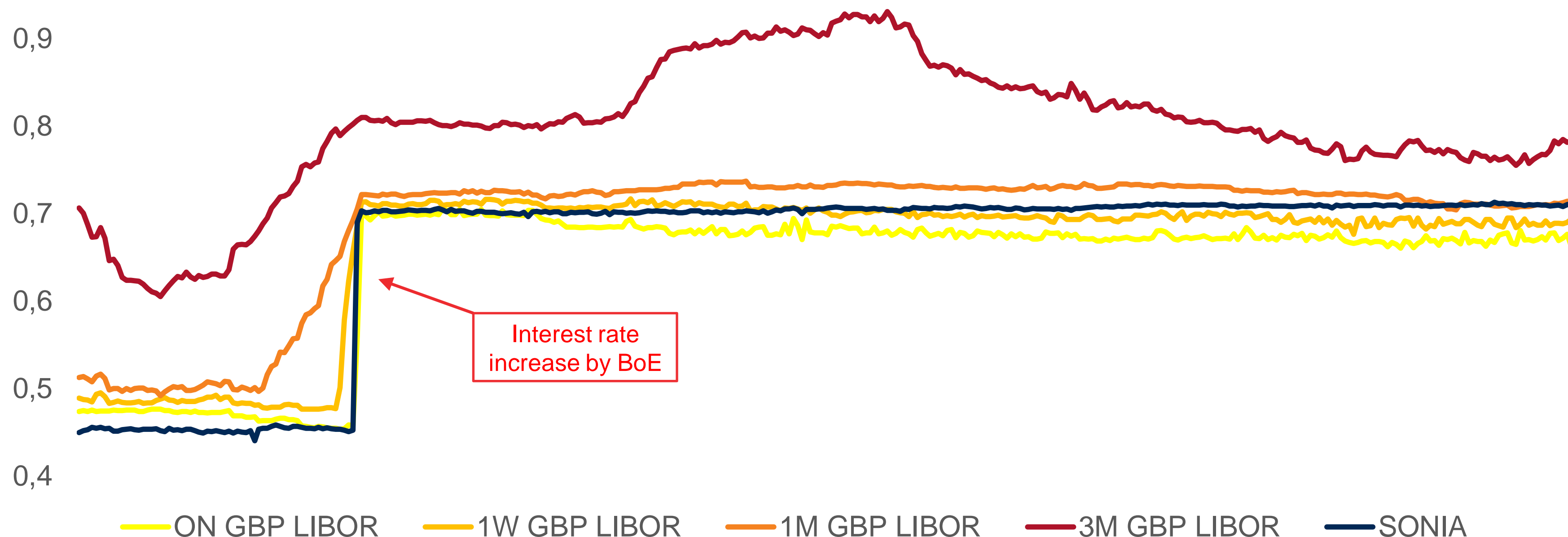
But LIBOR is not simply an RFR plus a number representing the spread

- RFRs exclude bank credit risk which is embedded in LIBOR
  - don't provide a natural hedge against stress in interbank market
- E.g. in 2018, funding costs for UK banks rose because of Brexit concerns (3M LIBOR rose) yet the SONIA futures market didn't reflect this
  - greater role for market disruption clauses?

- RFRs based on secured rates (repos) can move in opposite direction to unsecured ones in stressed markets
  - occurred in 2008
  - why? Collateral shortage and flight to safety

Comparison between SONIA and LIBOR rates shows term premium priced in longer tenors

Comparison between GBP LIBOR rates and daily Secured Overnight Interbank Average (SONIA, GBP) - %%



Source: BoE, Bloomberg

Term RFR rates not yet available

Options for term RFR rates (e.g. 1M, 3M, 6M):

1. **forward-looking** - basing them off futures or interest rate swaps
   - futures prices / fixed part of a swap - represent the market expectation of average RFRs during the relevant period
2. **backward-looking** – basing them on past RFRs over the relevant period

Forward-looking rates:

- preferred by Borrowers as interest payable is known at the start of the interest period – important for cashflow and risk management
- embed market expectation of future conditions
- but require sufficient market for calculation – currently there no such rates available

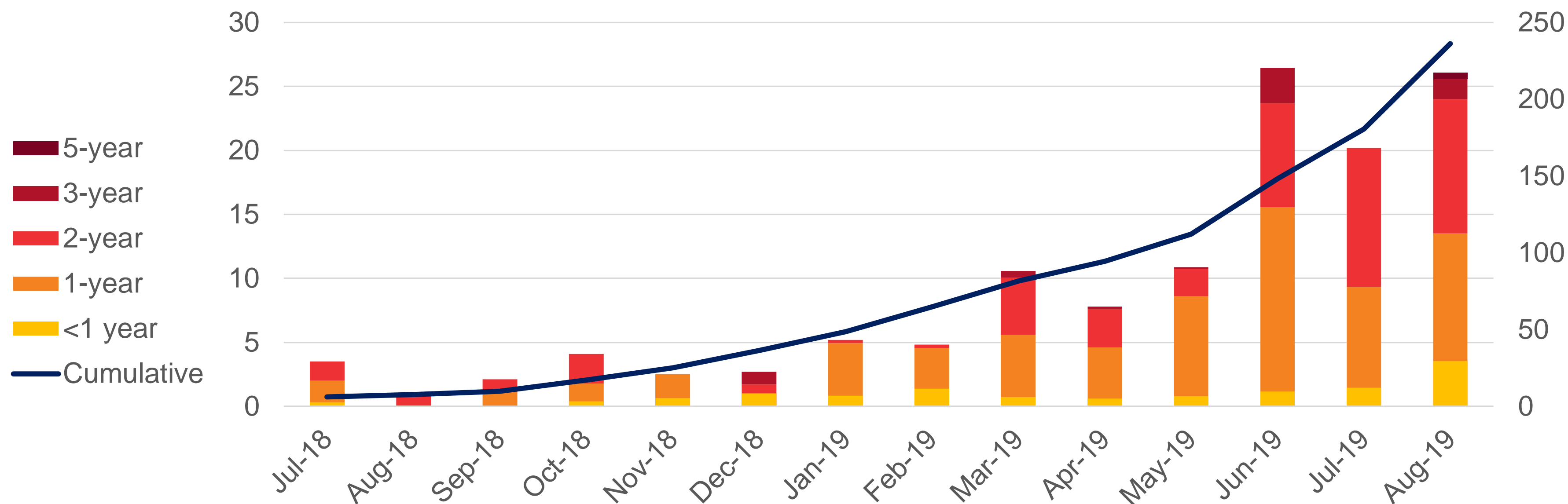
Backward-looking rates:

- easiest to calculate (whether on a compound or simple average basis)
- not prone to volatility at quarter or year ends
- but sluggish to respond to changes in ON rates
- already in use in floating rate notes (SONIA and SOFR)
- used for first SONIA bilateral loan

In some segments RFR-based instruments are growing rapidly…

Example from the US cash market:

New ($B, left scale, breakdown per tenor) and cumulative ($B, right scale) issuance of SOFR-based floating notes

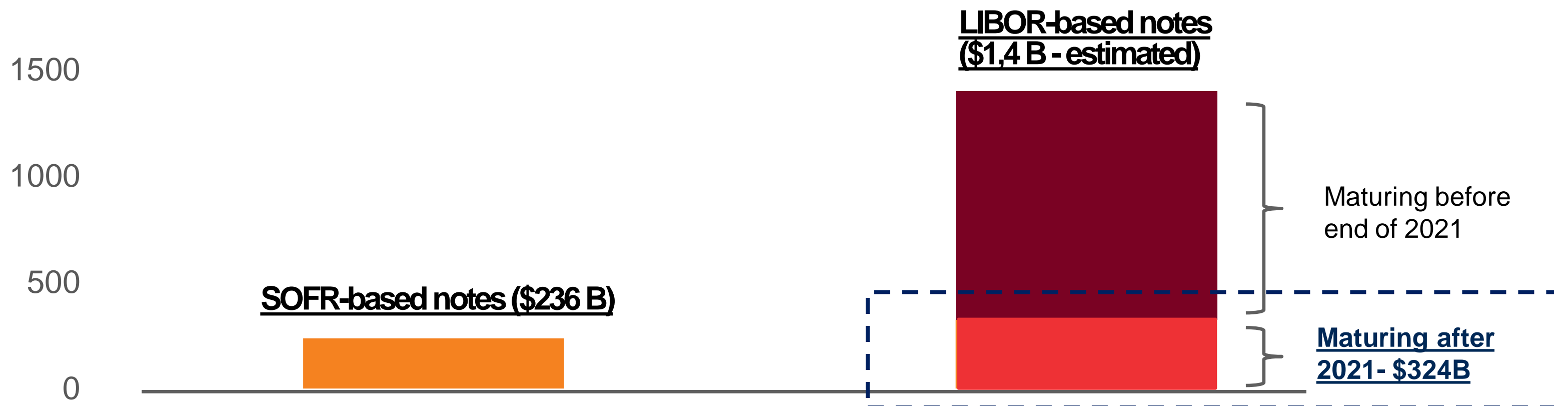


Source: Bloomberg,

…but so far LIBOR still dwarfs the RFR market

Example from the US cash market:

Cumulative issuance of SOFR-based floating notes vs. USD LIBOR-based floating notes ($B, 2019)



Legacy USD LIBOR-based bonds are a >300$B problem in themselves, not to mention newly issued ones; problem in respect of legacy loans is greater

Source: Bloomberg, Fed, Alternative Reference Committee 2018 report, own analysis

In loan and bond markets where transition is difficult first deals referencing RFRs have been emerging

Examples of notable RFR-based transactions in loan and bond markets:

- First loan entered into by a corporate with reference to SONIA
- Revolving credit facility provided to National Express by NatWest
- Undisclosed transaction value

- First successful LIBOR->SONIA shift in a legacy floating rate bond
- Bondholders' consent given to substitute GBP LIBOR reference to SONIA one once LIBOR is scrapped in an existing bond
- Total bond value GB 65 M

- Multiple bond issues tied to SONIA/SOFR by leading banks, e.g (more since):
  - SONIA: EIB: GBP 1B 5-year bond in June 2018; Lloyd's: GBP 750M 3-year bond in Sept. 2018
  - SOFR: Fannie Mae 6/12/18mo $6BN bond in July 2018; World Bank: $1BN 2-year bond in August 2018; Credit Suisse: $100M 6-mo bond in August 2018

But at this point in time, the market has a long way to go to be able to move away from LIBOR by 2021

Market outlook:

Derivatives:

- Adoption of RFRs in new deals, some segments more developed (e.g. GBP swaps vs. $ swaps)
- Overall volume still comparably low (e.g. $ 500B SOFR-based futures vs. $11T LIBOR-based)

Bonds:

- Substantial new issuance in both EU and the US – both SONIA and SOFR are becoming market standard
- However amending legacy transaction remains a major issue

Loans:

- Market slow to write new loans off RFRs (or amend legacy deals)
- First loans referencing RFRs started to appear in 2019 – e.g. National Express

Legal issues

Derivatives:

- Decisive shift towards using RFRs for new transactions
- ISDA working on providing fallback definitions (LIBOR->RFR)
  - Benchmark supplement published in 2018 to provide contract framework if there is no priority fallback
- Fallback provisions need to be incorporated into transactions either bilaterally or through protocols

Bonds:

- New LIBOR-based issuances tend to include fallback provisions to RFRs
  - Typically an independent advisor determines the fallback to RFR
- Legacy transactions (e.g. $324B of USD-LIBOR based notes maturing past 2021) the key issue
  - Each transaction need to be amended, in some jurisdictions (US) approval from 100% noteholders may be required

Loans:

- New syndicated loans written on the basis of LIBOR usually include the LMA's "Replacement of Screen Rate" clause
- Legacy transactions need to be individually amended

Source: Transition away from Libor, K. Hoyle, Butterworths Journal of International Banking and Financial Law, Sept. 2019, A. Bailey July 2019 speech, Bloomerg market data, own analysis

Implications for contracts

Loan Market Association

Two main issues:

1. Effect of discontinuation of LIBOR on existing loan contracts

2. How will new loan agreements based on RFRs differ from existing LMA Loan Agreements?

Implications for existing contracts

Fallback clauses in contracts

Fallback clause = a legal mechanism in contracts to provide a back-up plan when benchmark rate not available

Two approaches to fallback clauses:

- Hardwired – specifies what the new benchmark rate is to be
- Amendment

Implications for contracts

Hardwired approaches to fallback clauses

There are no hardwired approaches for loans at present

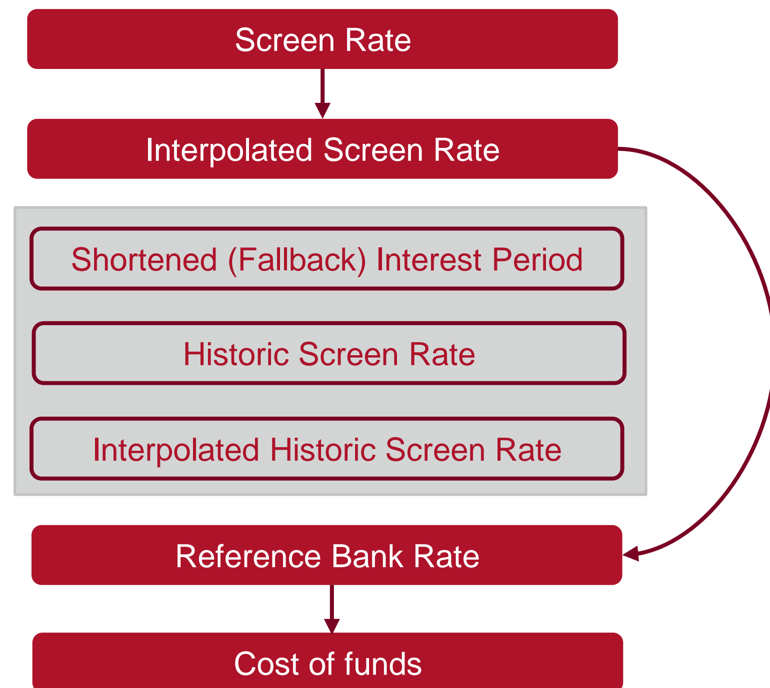
Danger that fallback mechanics may end up inconsistent across product classes:

- Derivatives markets = comfortable with average overnight rates + spread adjustment (eg based on historical difference between the RFR and LIBOR) (hardwired)
- Bonds = comfortable with a fixed rate fallback (hardwired)

Risk of mismatch between interest payable and hedging

Existing fallbacks in LMA Loan Documentation

- Changes made to benchmark interest rate fallback provisions in 2014 following Wheatley reforms
- Now two optional fallback provisions:
  - option 1 – additional fallbacks (gray)
  - option 2 – shortened waterfall (red only)
- These existing fallbacks are not designed to be used long-term, or where LIBOR has been permanently replaced by a different rate with a different methodology for calculation
- Fallback to reference bank rates is difficult - even more so if LIBOR ceases to exist - LMA documentation does not compel reference banks to quote
- Final fallback = cost of funds, however administering loans on this basis for any significant period of time is unworkable (experience from discontinuation of currencies/tenors in 2014)



Revised Replacement Screen Rate Clause

Option for long-term solution also added to LMA documents in 2014 – if Screen Rate *not available*, replacement = Majority Lenders decision

Majority Lenders decision to amend in wider range of circumstances (with or without a trigger event): eg. if a replacement rate is recommended by the administrator or a regulator

May 2018 LMA recommended Replacement Screen Rate clause:

42.5 *[Replacement of Screen Rate*[1]

Subject to paragraph (a) of Clause 42.4 (Other exceptions)[2]*, [if a Screen Rate Replacement Event has occurred in relation to any Screen Rate for a currency which can be selected for a Loan,]*[3] *any amendment or waiver which relates to:*

(a) *providing for the use of a Replacement Benchmark [in relation to that currency in place of that*[4] *Screen Rate]*[5]*; and*

(b)

(i) *aligning any provision of any Finance Document to the use of that Replacement Benchmark;*

(ii) *enabling that Replacement Benchmark to be used for the calculation of interest under this Agreement (including, without limitation, any consequential changes required to enable that Replacement Benchmark to be used for the purposes of this Agreement);*

(iii) *implementing market conventions applicable to that Replacement Benchmark;*

(iv) *providing for appropriate fallback (and market disruption) provisions for that Replacement Benchmark; or*

(v) *adjusting the pricing to reduce or eliminate, to the extent reasonably practicable, any transfer of economic value from one Party to another as a result of the application of that Replacement Benchmark (and if any adjustment or method for calculating any adjustment has been formally designated, nominated or recommended by the Relevant Nominating Body, the adjustment shall be determined on the basis of that designation, nomination or recommendation),*

may be made with the consent of the Agent (acting on the instructions of the [Majority Lenders][6]*) and the Parent.*[7]

"Relevant Nominating Body" *means any applicable central bank, regulator or other supervisory authority or a group of them, or any working group or committee sponsored or chaired by, or constituted at the request of, any of them or the Financial Stability Board.*

"Replacement Benchmark" *means [ ]*[8]*/[a benchmark rate which is:*

(a) *formally designated, nominated or recommended as the replacement for a Screen Rate by:*

(i) *the administrator of that Screen Rate [(provided that the market or economic reality that such benchmark rate measures is the same as that measured by that Screen Rate)]; or*

(ii) *any Relevant Nominating Body,*

and if replacements have, at the relevant time, been formally designated, nominated or recommended under both paragraphs, the "Replacement Benchmark" will be the replacement under paragraph (ii) above;

(b) *in the opinion of the [Majority Lenders]*[9] *and the Parent, generally accepted in the international or any relevant domestic syndicated loan markets as the appropriate successor to a Screen Rate; or*

(c) *in the opinion of the [Majority Lenders]*[10] *and the Parent, an appropriate successor to a Screen Rate.]*

Source: The recommended revised form of Replacement Screen Rate clause and User's Guide – LMA, December 2018

LMA Recommended Revised Form of Replacement Screen Rate Clause

"Slot in" clause

- snooze/lose option - allowing non-responding lenders votes to be disregarded
- LMA is working on a reference rate selection agreement form

Not a hardwired solution: whilst the financial markets are considering potential replacement benchmark rates for LIBOR and EURIBOR, it is difficult to specify drafting for such rates and therefore the facilitation of amendments in the future is an easier route

Negotiation points we currently see:

- whether the replacement screen rate requires the approval of all Lenders or Majority Lenders (and the Borrower)
- whether costs and expenses relating to any amendments to the Finance Documents relating to the replacement of the screen rate are for the Borrower

Implications for new contracts

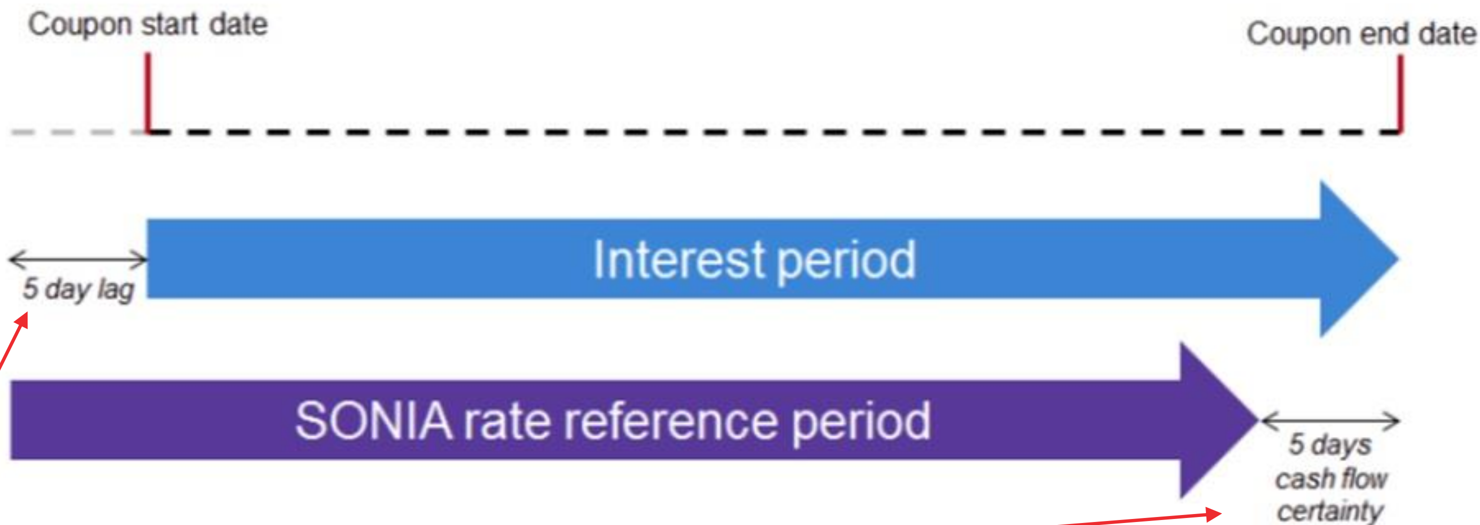
Loan Market Association

LMA exposure drafts of compounded RFR Facilities Agreement

- Not recommended forms; LMA is agnostic
- Published by LMA on 23 September 2019
  - Single currency USD SOFR-based facilty
  - Single currency GBP SONIA-based facility
- Interest for Interest Period based on compounded average RFR rate
- Calculated in arrears over an *observation period* starting a few days (*lag days*) before and ending a few days before the Interest Period

Implications for new contracts

Observation Period vs Interest Period



Lag Time

Implications for new contracts

Key points

New benchmark = ***Reference Rate*** – either:

1. ***Primary Screen Rate*** – produced by external provider (none at present, so mechanics for adding it later added)
2. ***Fallback Compounded Rate*** – calculated by Facility Agent in accordance with a (to be) specified calculation methodology

Implications for new contracts

Fallback Compounded Rate

- Exposure Drafts do not specify the methodology to be used
  (but has been published in other contexts, eg by FSB)

- Some choices will need to be made:
  - eg. whether to compound for every day in the observation period or only for RFR publication days
  - whether to apply rate from day before or after for weekends
  - how many decimal places to round off to

Implications for new contracts

Issues with the Observation Period

- Exposure Drafts follow note issuances which have referenced RFRs by including a lagging observation period (OP)
- Length of *Lag Time* (between OP and IP) not specified
- Will depend on (i) how notice is to be given of the interest payment required vs (ii) need to relect latest movements in RFRs
- Different *Lag Times* may be specified for different Interest Periods (shorter for shorter interest periods)

Implications for new contracts

New interest rate calculation

- Currently = LIBOR (cost of funds) + Margin
- Exposure Drafts have two options:

1. RFR + Margin (Margin would need to include cost of funds)
2. *Adjusted Reference Rate* + Margin

where Adjusted Reference Rate =

RFR + *RR Adjustment Spread* (=cost of funds)

Implications for new contracts

RR Adjustment Spread

- Exposure Drafts leave it blank
    - Envisage different levels of RR Adjustment Spread for different lengths of Interest Period
    - Suggest it may be fixed or variable
- Idea is that it acts as cost of funds for the Lenders

- If sufficient number of Lenders' cost of funds would exceed the Adjusted Reference Rate, market disruption would be triggered

Implications for new contracts

New Fallback provisions if RFRs not available

- If RFR not available for a given day, then fallback to:
  - *central bank rate* for that day (plus optionally an adjustment spread eg based on the 5 day historical difference between RFR and the central bank rate)
    - if not available, then fallback to cost of funds

Implications for new contracts

Break Costs – concept does not sit easily with RFRs

- Exisiting LMA docs – borrower must pay break costs when loan is prepaid prior to last day of Interest Period = interest to be received till end of interest period *minus* interest gained from depositing of that sum
- Now cannot be calculated on this basis as (i) calculation of interest is not based on matched funding principle and (ii) interest to be paid is unknown till end of period
- Exposure Drafts make Break Costs optional and leave definition blank
- Practice may develop of definining them as the breakage costs of an appropriate fixed/floating interest rate swap

Implications for new contracts

Market Disruption

- Exposure Drafts treat market disruption provisions as optional
- Provisions are included on the assumption that interest rates are based on *Adjusted Reference Rate* (ie. reference rate includes adjustment for lenders' cost of funds)
- Will be interesting to see what form lenders' protection against increased cost of funds will take if loans are based only on RFRs + Margin

What about EURIBOR (and EONIA)?

EURIBOR modified and EONIA to be scrapped in favor of ESTER

Changes in EU area reference rates:

(Modified)

Old EURIBOR
(Euro Interbank Offer Rate)

New EURIBOR

(Scraped by end 2021)

€ONIA
(€ Overnight Index Average)

€STR
(Euro Short-Term Rate)

Reflects the wholesale euro unsecured overnight borrowing costs of banks located in the euro area

Changes overview:

- Deals with more counterparties (e.g. MMFs, pension funds, insurers) included in calculation
- New hybrid methodology compliant with Benchmark Reg. – transaction data supplemented by expert judgement

- Much larger transaction base for ESTER – based on wholesale market transactions rather than just interbank ones
- Relies purely on transaction data and EU statistical reporting (MMSR)
- Administration by ECB
- T+1 rather than T benchmark

Source: ECB, European Money Markets Institute

What about WIBOR?

WIBOR reform is similar to EURIBOR reform

- WIBOR must be reformed to comply with the EU Benchmark Regulation
- (currently based on rates at which Fixing Participants are ready to place a Deposit with other Fixing Participants)
- Poland's benchmark administrator – GPW Benchmark SA – recently announced its transition plan for updating the methodology of WIBOR
- the methodology will follow the *data cascade method* of the BMR (the *waterfall*)
- involves collecting transactional data on deposits and committed quotes and from banks and non-bank financial institutions; and
- feeding that data into an algorithim which will weigh the data in accordance with a *waterfall* (eg giving more weight to banks and actual transactions)
- **not intended to result in a material change to WIBOR**

Message to loan market participants

Key takeaways

- Review your current financial and commercial arrangements to understand your exposure to IBORs
- Consider how any transition to RFRs will impact those transactions
- Discuss with your counterparties how they intend to deal with this issue
- Develop a project plan for making any required amendments
- Educate senior management and other internal stakeholders about the expected changes and impact on business (i.e., to manage expectations and avoid surprises)
- https://www.bakermckenzie.com/en/insight/publications/guides/libor-what-you-need-to-know

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