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LIBOR Transition in the Loan Markets

Frequently Asked Questions

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Contents

1	**Background**	**1**
1.1	Will LIBOR definitely disappear at the end of 2021?	1
1.2	Why are regulators so keen for the financial markets to stop using LIBOR?	1
1.3	What are RFRs and how are they relevant to LIBOR transition?	1
1.4	What are credit spread methodologies and how are they relevant to LIBOR transition?	2
1.5	How relevant to the loan markets is ISDA's work on LIBOR transition?	3
1.6	What impact does the EU Benchmarks Regulation have on the ongoing use of LIBOR in loan transactions?	4
1.7	What is happening to EURIBOR and other non-LIBOR interbank rates?	4
1.8	Why are regulators taking a different approach to EURIBOR (and some other interbank rates) than they are taking with LIBOR?	5
2	**New loans**	**5**
2.1	How is it expected that RFRs will be used to calculate interest in new loan transactions?	5
2.2	What are the LMA Exposure Drafts?	5
2.3	What is the significance of the "lag" in a compounded average in arrear RFR?	6
2.4	How is a compounded average in arrear RFR calculated?	6
2.5	Doesn't compounding in this way result in a very high interest rate?	6
2.6	Who will be responsible for calculating compounded average in arrear RFRs for use on loan transactions?	6
2.7	Is it anticipated that all types of loan products that have used LIBOR to date will use compounded average in arrear RFRs instead?	7
2.8	Are forward-looking term RFRs an alternative to compounded average in arrear RFRs?	7
2.9	What other alternatives are there to using compounded average in arrear RFRs as anticipated in the LMA Exposure Drafts?	8
2.10	So to what extent have the loan markets now transitioned away from using LIBOR on new loan transactions?	8
2.11	Is it common for new LIBOR-based loans to now include "hard-wired" RFR-based fall-backs?	9
2.12	Has the prospect of LIBOR being discontinued had any other impact on the terms of new LIBOR-based loans?	10
2.13	What are the key market developments that will enable a wider transition to RFR-based pricing on new loans?	10
3	**Legacy LIBOR loans**	**11**
3.1	What are the options for dealing with existing LIBOR-based loans with a term beyond 2021 (legacy LIBOR loans)?	11
3.2	Are any legislative solutions anticipated to avoid the need to manually amend legacy LIBOR loans?	11
3.3	Are any protocols available or anticipated to streamline the process of amending legacy loans?	12
3.4	What are the key market developments that will enable the wide-spread amendment of legacy LIBOR loans?	12
3.5	How advanced is the process of creating and publishing credit spreads for use in the loan markets?	13
3.6	Is there a standardised documentary approach to amending the terms of legacy LIBOR loans?	13
3.7	Who will instigate the amendment of legacy LIBOR loan agreements?	14
3.8	Who will pay for the amendment of legacy LIBOR loan agreements?	14
3.9	If a legacy LIBOR loan is subject to interest rate hedging, will that hedging need to be amended at the same time as the loan terms?	15

3.10 Can finance-linked hedging terms be amended by using the ISDA Protocol and hard-wired fallbacks? 15
3.11 What conduct and litigation risk issues should lenders consider when amending legacy LIBOR loans? 15

Glossary

ARRC	Alternative Reference Rate Committee. Established by the Federal Reserve Board and the Federal Reserve Bank of New York to help ensure a successful transition away from US dollar LIBOR across the markets that have historically used it.
BMR	EU Benchmarks Regulation. See paragraph 1.6.
BoE RFR Group	Bank of England Working Group on Sterling Risk-Free Reference Rates. Established to help ensure a successful transition away from sterling LIBOR across the markets that have historically used it.
FCA	The UK Financial Conduct Authority, being the regulator of LIBOR.
FRN	Floating rate note.
ICE	ICE Benchmark Administration Limited, being the administrator of LIBOR.
ISDA	International Swaps and Derivatives Association.
LMA	Loan Market Association.
LMA Exposure Drafts	See paragraph 2.2.
RFR	Overnight, virtually risk-free rate. See paragraph 1.3.

Introduction

For several decades now, a significant proportion of financing transactions denominated in sterling, US dollars, euro, Swiss franc and Japanese yen have used LIBOR as a reference rate to determine amounts payable (in particular interest payable) under the relevant financing transaction. Transitioning away from LIBOR is now a top priority for many financial institutions in Europe (including the UK), the US, the Middle East and beyond. The likelihood that LIBOR will disappear after 2021 is also increasingly concerning the even wider group of stakeholders, including businesses and consumers, who use products referencing LIBOR. This note answers the questions we are most frequently asked, by both financial institutions and their customers, about LIBOR transition in the context of the loan markets. The note's primary focus is on commercial loans under English law documentation. However, some of the answers refer to, or will also be relevant in, other financing contexts.

The note describes developments up to 14 February 2020. We hope you find it useful.

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1 Background

1.1 Will LIBOR definitely disappear at the end of 2021?

No. The end of 2021 is seen as a key deadline because:

- Andrew Bailey, chief executive of the FCA, announced on 27 July 2017 that the FCA would no longer use its influence or legal powers to persuade or compel LIBOR panel banks to continue making LIBOR submissions after 2021;

- the FCA announced on 24 November 2017 that it had secured the voluntary agreement of all 20 LIBOR panel banks to continue submitting contributions until the end of 2021.

Whether LIBOR continues after 2021 is much less certain and is likely to depend largely on the attitude of LIBOR's panel banks. They will have to weigh up the regulatory and other liability risks of continuing to make LIBOR submissions voluntarily against the risks to their own business of LIBOR disappearing at that time.

What regulators have repeatedly emphasised is that no one should assume that LIBOR will still exist after 2021.

1.2 Why are regulators so keen for the financial markets to stop using LIBOR?

The two main reasons are:

- the underlying market that LIBOR has historically sought to measure – the market for unsecured wholesale term lending to banks – has not been an active market since the financial crisis; and

- the financial markets' over-reliance on LIBOR creates systemic risk.

The second of these points is particularly key. LIBOR has evolved significantly in recent years such that it is arguably no longer even an interbank rate. In April 2019, the IBA completing the transitioning of LIBOR panel banks onto a new "Waterfall Methodology". It now describes LIBOR as "*a wholesale funding rate anchored in LIBOR panel banks' unsecured wholesale transactions to the greatest extent possible, with a waterfall to enable a rate to be published in all market circumstances*". If LIBOR, as reformed in this way, were still only being used for its original purpose – to price loans arranged in London – regulators might have been less concerned about its ongoing use. Compare, for example, the regulators' approach to EURIBOR (see paragraph 1.7).

1.3 What are RFRs and how are they relevant to LIBOR transition?

Across the full range of financial products that have historically used LIBOR, regulators want market participants to use rates based on overnight, virtually risk-free rates (**RFRs**) instead. Regulators in the home jurisdictions of each of the five current LIBOR currencies have now identified the preferred RFR for their local currency, each of which is now published, as follows.

Currency	Approved RFR	Administrator	Secured or unsecured?
US dollar	SOFR (Secured Overnight Financing Rate)	Federal Reserve Bank of New York	Secured
Sterling	SONIA (Sterling Overnight Index Average)	Bank of England	Unsecured
Euro	€STR (Euro Short-Term Rate)	European Central Bank	Unsecured
Swiss franc	SARON (Swiss Average Rate Overnight)	SIX Swiss Exchange	Secured
Yen	TONA (Tokyo Overnight Average Rate)	Bank of Japan	Unsecured

Regulators prefer RFRs to IBORs because RFRs:

- are based on deep, highly liquid overnight borrowing markets; and
- are calculated by reference to recorded transactions in those markets, rather than relying on submissions from panel banks.

However, there are disadvantages to using RFRs instead of LIBOR in the loan markets. These include:

- different RFRs measure different types of overnight borrowing (some secured and some unsecured, see table above), have different calculation methodologies and are published at different times, in each case in the principal financial centre of the currency for which they have been developed; and
- RFRs have only a single tenor – overnight. This makes it impractical to use "raw" RFRs in most loan transactions. This would create an interest rate that fluctuates each business day. For more information on how RFRs are likely to be used in the loan markets, see paragraph 2.1.

1.4 What are credit spread methodologies and how are they relevant to LIBOR transition?

Credit spreads are particularly relevant in the context of transitioning legacy LIBOR-based agreements to RFR-based alternative rates, whether that transition occurs by amending existing contractual terms, or through "hard-wired" fallbacks (the latter being rare in loan agreements, see paragraph 2.11.

In either case, the transition from LIBOR to an RFR-based rate should avoid any transfer of economic value between the parties. The total amount of interest the borrower pays after the transition should – to the extent possible - stay the same.

An RFR does not price in bank credit risk or term risk so will inevitably be lower than a term LIBOR (e.g. one, three or six months) in the same currency. RFR-based rates that are expected to be used significantly in loan transactions (such as compounded average in arrear RFRs) are likely to be higher than "raw" daily RFRs, but they will still be lower than LIBOR. Therefore, where LIBOR is replaced in an existing contract with an RFR-based rate, adding a credit spread to the latter is a useful method of avoiding any transfer of economic value.

Creating standardised published spreads between specific LIBORs and the RFR-based rates that will most commonly replace them is key to a smooth transition away from LIBOR in legacy loans, for the following reasons:

- if the transition occurs through a hard-wired fallback, an objectively ascertainable spread avoids the need for any party to exercise a discretion to determine it; and
- if the transition occurs through a manual amendment, a published, market standard spread avoids any need for the parties to negotiate the spread on a deal-by-deal basis.

The development of approved, published credit spreads is also likely to be an important catalyst in growing the market in new RFR-based loans. See paragraph 2.13 below.

For more information about progress on creating and publishing credit spreads for use in the loan markets, see paragraph 3.5.

1.5 How relevant to the loan markets is ISDA's work on LIBOR transition?

ISDA has provided a key "thought leadership" role in the LIBOR transition process. It has focused on developing fallbacks based on RFRs to include in legacy IBOR-based derivatives contracts with a view to ensuring contractual continuity. Its broad approach is to:

- amend the definitions of IBORs in the 2006 ISDA Definitions by adding a hard-wired fallback to:
    - a compounded average in arrear RFR; plus
    - a credit spread based on the historical difference between the relevant IBOR and that compounded average in arrear RFR,

  with the switch to that fallback occurring automatically on an "Index Cessation Event" or (potentially) on a "non-representative" statement from the FCA (under which the FCA states publicly that LIBOR is no longer representative of the market it seeks to measure); and
- publish a Protocol to enable parties to incorporate this mechanism into legacy trades.

ISDA plans to complete this work in the first half of 2020.

It is likely that the loan markets will adopt adapted versions of some of the methodologies ISDA has developed, such as those relating to credit spreads. However, ISDA's use of a Protocol and hard-wired fallbacks to deal with legacy IBOR-based derivatives:

- is not an approach the loan markets can realistically copy for dealing with legacy LIBOR loans (see paragraphs 2.11 and 3.3); and

- is unlikely to be appropriate for amending finance-linked hedging terms (see paragraph 3.10).

1.6 What impact does the EU Benchmarks Regulation have on the ongoing use of LIBOR in loan transactions?

The BMR has, and is likely to have, a more limited impact on the loan markets (outside of consumer credit and regulated mortgages) than in other product areas that use LIBOR, such as derivatives and debt capital markets.

The BMR contains obligations on contributors to, and administrators and users of, benchmarks. Most of these apply after the transitional period provided for in BMR (Article 51), which now ends on 31 December 2021.

Article 28(2) of the BMR requires a supervised entity that uses a benchmark (which includes LIBOR) to have robust written plans in place setting out what actions will be taken if a benchmark "materially changes or ceases to be provided". Supervised entities must reflect these plans in their contractual relationships with clients. Supervised entities are, broadly, regulated firms, including credit institutions and investment firms

However, while parties to LIBOR-based bonds and derivatives are likely to be "using" LIBOR for the purposes of the BMR, loan transactions (other than consumer credit and regulated mortgage contracts) are out of scope. As a result, parties to commercial loans have not generally considered it necessary to include hard-wired fallbacks in their loan agreements (on which see paragraph 2.11) in order to comply with the BMR.

The BMR may nevertheless indirectly affect LIBOR-based loans by contributing to LIBOR's demise. The obligations it imposed on benchmark contributors may be a factor that encourages LIBOR panel banks to stop making voluntary submissions after 2021.

1.7 What is happening to EURIBOR and other non-LIBOR interbank rates?

EURIBOR and TIBOR (the rate for Japanese yen in the Tokyo interbank market) will continue to be used for the foreseeable future. There are also currently no plans to discontinue the main local IBORs used in the Middle East markets – EIBOR, SAIBOR, OMIBOR and QIBOR. However, as the underlying currencies to which these local Middle East benchmarks apply are pegged to US dollars, the discontinuation of US dollar LIBOR may still have an impact on their ongoing use.

EURIBOR has undergone significant reform in recent years, moving to a new "hybrid methodology" during 2019. Its future currently appears so settled that the LMA plans to produce an exposure draft of a multicurrency facilities agreement which continues to use it: loans in currencies other than euro will be RFR-based, but EURIBOR will remain the benchmark interest rate for euro loans (rather than €STR, the euro RFR).

By contrast, EONIA, the overnight interbank rate for euro (equivalent to overnight LIBOR) will be discontinued on 3 January 2022. Until then, EONIA will simply track €STR (the euro RFR), being €STR plus a fixed spread of 8.5 basis points. In the loan markets, the discontinuation of EONIA is most relevant for euro swingline facilities. The LMA published a note in October 2019 with suggested drafting for new facility agreements incorporating euro swingline facilities, to take account of the phasing-out of EONIA. This provided for interest on euro swingline loans to be calculated by reference to €STR or "Enhanced €STR" (the latter being an economic equivalent to EONIA) instead of EONIA.

1.8 Why are regulators taking a different approach to EURIBOR (and some other interbank rates) than they are taking with LIBOR?

The lower systemic risk involved in the continued use of other IBORs, when compared to LIBOR, is likely to be a significant factor. See paragraph 1.2 above.

2 New loans

2.1 How is it expected that RFRs will be used to calculate interest in new loan transactions?

In English law agreements, and agreements governed by other laws based on English law documentation (as is common, for example, in the Middle East), we anticipate that most (but not all) loan products that have used LIBOR to date will instead use compounded average in arrear RFRs with a short lag period, typically of five business days. This is primarily on the basis of the following:

- This is the approach the UK regulators are advocating. In January 2020, the BoE RFR Group published Use Cases of Benchmark Rates: Compounded average in arrear, Term Rate and Further Alternatives. It argued that 90% of loans by volume should be able to transition to this methodology. Although the remit of the BoE RFR Group is limited to the transition of sterling LIBOR, the analysis of whether "compounded averaged in arrears RFRs" are suitable for a particular product is not currency dependent. So its views may also be of interest to, and influence practice in, US dollar and other LIBOR currency products.

- The (relatively few) RFR-based loans made to date under English law have used this methodology.

- The LMA's Exposure Drafts provide for this methodology for sterling and US dollar syndicated loans.

- In the bond markets, RFR-based sterling FRNs issued to date have also used compounded average in arrear SONIA with a short lag (although some SOFR-based US dollar FRNs have used a simple average of SOFR with a short "lockout" period instead).

2.2 What are the LMA Exposure Drafts?

In September 2019, the LMA released "exposure drafts" of two single currency term and revolving facilities agreements that broadly indicate how compounded averaged in arrears RFRs might be calculated and used in syndicated loan facilities. One LMA Exposure Draft is for sterling loans; the other works with US dollars. The interest rate under both Exposure Drafts is based on compounded average in arrear RFRs (SONIA in the case of the sterling LMA Exposure Draft; SOFR in the case of the US dollar LMA Exposure Draft).

The LMA Exposure Drafts are a vehicle to consult the market on a number of issues relating to the use of RFRs in lending transactions – there being insufficient loan market practice for the LMA to produce recommended forms at this stage. For more information, see our December 2019 note LIBOR discontinuation – the LMA Exposure Drafts and other recent loan market developments.

2.3 What is the significance of the "lag" in a compounded average in arrear RFR?

LIBOR for an interest period is fixed at the beginning of that interest period: all the parties know then how much interest the borrower will have to pay at the end of the interest period. By contrast, the compounded average in arrear RFR over a period cannot be determined until the end of that period. A "lag" mechanism provides that the interest payable over an interest period is not determined by the compounded average in arrear RFR over the interest period itself, but over an "observation period". The observation period is the same length as the interest period but starts and ends a specified number of days before the relevant interest period. This lag between the interest period and its observation period ensures the parties know the interest payable at the end of that interest period a few days in advance of the payment date.

2.4 How is a compounded average in arrear RFR calculated?

While the LMA Exposure Drafts are clear on the broad method of using compounded average in arrear RFRs, they do not specify the equation for doing so. The Financial Stability Board's June 2019 guide to using overnight RFRs provides sample equations and useful guidance.

Broadly, calculating the compounded average of an RFR over a specified observation period involves compounding and averaging the RFR itself over that observation period. It does not involve any compounding of accrued interest. The compounded average rate is calculated at the end of the observation period and then applied to the principal to calculate the accrued interest payable at the end of the interest period. As such, compounded average in arrear RFRs do not involve any "capitalisation" of interest – the principal amount of the loan does not increase as interest accrues during the interest period.

2.5 Doesn't compounding in this way result in a very high interest rate?

No. Compounded average in arrear RFRs are still likely to be lower than equivalent LIBORs. Compounding of interest is associated with high interest costs because compounding often arises in the context of default interest on overdue amounts. Commercial agreements (including loan agreements) often provide for accrued but unpaid default interest to be compounded (i.e. added to the principal amount of the loan) at periodic intervals. If overdue amounts remain outstanding for a significant period, the total amount payable can increase significantly. By contrast, in the context of compounded average in arrear RFRs, the compounding:

- does not apply to the margin element of the interest rate, only to the RFR itself; and
- only applies for the duration of the relevant interest period (typically three months) – at the end of which the borrower will pay all accrued interest.

2.6 Who will be responsible for calculating compounded average in arrear RFRs for use on loan transactions?

It is anticipated that compounded average in arrear RFRs for the most commonly used periods (in particular one month, three months and six months) will eventually be published in all the LIBOR currencies. Once they are, there will ordinarily be no need for parties to transactions to calculate the rate manually.

Until then, it will generally be the responsibility of agents (on syndicated transactions) and lenders (on bilateral transactions) to do the calculation. The LMA Exposure Drafts refer to the

(not yet existing) third party published screen rate as the "Primary Screen Rate". During any observation period where this Primary Screen Rate is not available, the documents provide for the agent (or another willing finance party) to calculate the interest rate manually. This is known as the Fallback Compounded Rate. Once an appropriate candidate for the Primary Screen Rate comes into existence, the parties can stop using the Fallback Compounded Rate and instruct the agent to designate the candidate screen rate as the Primary Screen Rate without amending the facilities agreement.

The publication of compounded average in arrear RFRs for the most commonly used interest period tenors (one, three and six months) will be a key step in the market's transition towards their use. Although the calculation of compounded average in arrear RFRs is complicated, the underlying methodologies for LIBOR and EURIBOR are also now far from straightforward. Market participants are nevertheless comfortable using them because doing so does not require them to apply those methodologies manually – they just use the screen rate. Once compounded RFRs are published, it is likely that market participants will soon become used to using "one month compounded SONIA" and "three month compounded SOFR" (for example) in the same way.

2.7 Is it anticipated that all types of loan products that have used LIBOR to date will use compounded average in arrear RFRs instead?

No. In its January 2020 publication Use Cases of Benchmark Rates: Compounded average in arrear, Term Rate and Further Alternatives, the BoE RFR Group acknowledged that using compounded average in arrear RFRs with a short lag period could be impractical for some loan types including:

- loans to smaller corporate wealth and retail clients;
- trade and working capital products;
- export finance;
- Islamic finance;
- loans to borrowers in emerging market jurisdictions with exchange controls.

These products have been identified as problematic because it is particularly important for parties to these products to be able to ascertain the amount of interest that will accrue during an interest period at the outset of that interest period or significantly in advance of the interest becoming payable. Identifying an alternative for these products is therefore key, and could also be relevant for parties to other loan products that are uncomfortable using the compounded average in arrear approach with a short lag period.

2.8 Are forward-looking term RFRs an alternative to compounded average in arrear RFRs?

To replace LIBOR, many loan market participants have called for the development of forward-looking term rates derived from RFRs (**term RFRs**) for each LIBOR currency. Like LIBOR, term RFRs would make it possible to calculate the interest payable over an interest period at the beginning of that interest period. However, the UK and US regulators, in particular, have put pressure on the loan markets to switch from using LIBOR to using RFRs without waiting for the development of such forward-looking term RFRs, which may not be available in the foreseeable future. This is not just a question of timing. One of the perceived advantages of RFRs over IBORs is that RFRs are derived directly from transaction data in very deep

markets. By contrast, LIBOR derives from what are now very shallow markets and relies on submissions from a limited number of panel banks participating in those markets. That advantage may not apply to term RFRs, which are likely to be based not on overnight borrowing transactions themselves, but on derivative transactions based on the overnight borrowing market.

For example in July 2018, the BoE RFR Group published a consultation paper on developing forward-looking term SONIA reference rates (**TSRRs**). It suggested the most feasible method of creating a TSRR in the short term was using data from the SONIA Overnight Index Swap (**OIS**) market (a summary of responses to the consultation in November 2018 broadly endorsed this suggested approach). However, as SONIA OIS are generally traded over-the-counter rather than on a regulated exchange, it noted that "*the necessary price transparency…is currently insufficient to produce a [term rate] based on firm quotes*".

Despite this, the BoE RFR Group is still hoping to finalise the development of TSRRs with a view to publishing them from Q3 2020. See UK RFR Working Group Roadmap, 2020. However, it anticipates that TSRRs will only be used for "niche" products.

The prospect of term RFRs being available soon in LIBOR currencies other than sterling is even lower. For example:

- the ARRC has suggested the earliest a SOFR term RFR can be expected is the fourth quarter of 2021; and
- the National Working Group on Swiss Franc Reference Rates has indicated that a SARON term RFR is unlikely to be feasible and recommends using compounded average in arrear SARON wherever possible.

2.9 What other alternatives are there to using compounded average in arrear RFRs as anticipated in the LMA Exposure Drafts?

The main alternatives are likely to be:

- compounded average in arrear but with a full interest period lag;
- central bank base rates; and
- fixed rates.

For more information, see our note LIBOR transition – are full interest period lags a viable way to simplify some compounded RFR loans?

2.10 So to what extent have the loan markets now transitioned away from using LIBOR on new loan transactions?

The transition away from LIBOR has been much slower in the loan markets than in other markets that have traditionally used LIBOR, in particular derivatives and debt capital markets. Based on published information, only a small number of RFR-based loans have been concluded – all since summer 2019 – including, in Europe:

- NatWest / National Express - A bilateral SONIA-based revolving credit facility.
- NatWest / South West Water – An amendment to an existing bilateral LIBOR loan now based on SONIA.
- NatWest / SSE – A bilateral SONIA-based revolving credit facility.

- Deutsche Bank European Commercial Real Estate Group / Kennedy Wilson – A bilateral SONIA-based loan.
- UBS / Halter AG and SenioResidenz AG - Two bilateral SARON-based commercial real estate finance loans in Swiss francs.

In December 2019, Royal Dutch Shell also announced that it had signed a new English law US dollar syndicated revolving credit facility agreement (as borrower), which references LIBOR but with a hard-wired fallback to SOFR. Our understanding is that the SOFR mechanics that would apply after the switch to this fallback broadly follow those in the LMA Exposure Draft for US dollars.

We have not yet seen any significant transition away from LIBOR to any other pricing alternative, such as fixed rates or central bank base rates. For new floating rate loans in the European loan markets, interest is still usually IBOR-based. Other than for euro loans referencing EURIBOR, we expect this to change in the near future. In its Priorities and roadmap for 2020 published in January 2020, the BoE RFR Group stated that lenders should not be issuing new LIBOR-based sterling loans after the end of Q3 2020. If lenders have updated their operating systems, financial modelling and documentation so as to be in a position to transition their sterling loans by this deadline, they are also likely to be able to transition their loans in other LIBOR currencies (including US dollars) at or around the same time.

2.11 Is it common for new LIBOR-based loans to now include "hard-wired" RFR-based fallbacks?

Market participants entering into new LIBOR-based loans with a tenor beyond 2021 do so in the knowledge that LIBOR may well disappear during the term of the loan. There are broadly two approaches to this risk:

- rely on a right to amend the pricing terms as needed at the relevant time (the **Amendment Approach**); or

- amend the LIBOR fallbacks in the original loan agreement so that there is an automatic switch to an alternative rate based on an RFR at a specified trigger point (the **Hard-wired Approach**).

In the European loan markets, there has been limited adoption of the Hard-wired Approach. The loan markets are still grappling with the details of how RFRs are to be used in loan transactions. While that remains the case, the Hard-wired Approach cannot generally set out a comprehensive set of alternative terms that will apply at the relevant trigger date. Instead, the Hard-wired Approach will typically require the lender (on a bilateral transaction) or agent (on a syndicated transaction) to "fill in the blanks" on some of the amended terms at the point the switch to the RFR-based fallback occurs (such as determining the credit spread). We have seen lenders adopt this approach in some of their bilateral standard form facility agreement templates. However, in the syndicated markets, this approach is less practical - agents are generally uncomfortable exercising this type of discretion. Once parties know what alternative to LIBOR they want to use and are able to use it, they will generally amend the terms of their new loan to make that alternative the primary source of interest calculation, rather than as a fallback.

In the meantime, European lenders are generally taking the view that they will be able to amend any new LIBOR-based loans along with the rest of their legacy LIBOR-based book as needed at the relevant time and are therefore favouring the Amendment Approach.

To facilitate the Amendment Approach, the LMA published a revised "Replacement of Screen Rate" clause in May 2018. This potentially makes it easier to amend a syndicated facility on an actual or imminent discontinuation of LIBOR (or other relevant interest rate benchmark). It does so by providing that relevant amendments require Majority Lender, rather than all lender, approval. The clause is therefore of limited scope and is not relevant to a bilateral facility. However, with occasional minor variations, the clause has become largely standard in European syndicated transactions.

The US loan market has shown a greater interest in the Hard-wired Approach. The ARRC launched consultations during the second half of 2018 on contractual fallback language across various products, including syndicated lending. It asked whether, in anticipation of the discontinuation of US dollar LIBOR, market participants preferred to:

- rely on a right to amend the pricing terms at the relevant time; or
- "hard-wire" into the original loan agreement an automatic switch to an alternative rate based on a term RFR.

Many respondents preferred the latter option, although a term version of SOFR did not yet (and still does not) exist. Despite this feedback, we understand that even in the US market, use of the Hard-wired Approach has been fairly limited to date.

Following the consultations referred to above, the ARRC published recommended fallback language, both for the Amendment Approach and the Hard-wired Approach, for various products that use US dollar LIBOR, including syndicated loans and bilateral business loans. Our experience is that parties to US dollar loans governed by English law have generally followed the drafting recommendations of the LMA, rather than those of the ARRC.

2.12 Has the prospect of LIBOR being discontinued had any other impact on the terms of new LIBOR-based loans?

Some lenders now require their LIBOR-based facility agreements to state expressly that the borrower will pay the reasonably incurred costs of the lender or (on a syndicated transaction) agent in any future amendment to the facility terms relating to LIBOR transition. However, this is by no means a market standard approach. Indeed borrowers often argue for the opposite – a clear statement that the borrower will not have to pay any other party's costs on any amendment relating to LIBOR discontinuation. For more information about the costs of amending legacy LIBOR loans, see paragraph 3.8.

2.13 What are the key market developments that will enable a wider transition to RFR-based pricing on new loans?

- Published compounded average in arrear RFRs, particularly in US dollars and sterling, in the most common tenors used for interest periods – one, three and six months.
- Banks completing the process of recalibrating their operating systems, and the software supporting them, so that they are compatible with compounded average in arrear RFRs.
- The publication of market-approved credit spreads between the main LIBOR tenors, particularly in US dollars and sterling, and equivalent compounded average in arrear RFRs. It is not anticipated that LIBOR-RFR credit spreads would ordinarily be referred to in new RFR-based loan terms. However, borrowers are used to gauging the pricing of a loan by reference to the margin that will apply on top of LIBOR. In new loans, borrowers

will be paying a different margin on top of an RFR-based rate with which they are less familiar. Until that familiarity grows, an approved credit spread is likely to help lenders explain to their customers what this new margin really means.

3 Legacy LIBOR loans

3.1 What are the options for dealing with existing LIBOR-based loans with a term beyond 2021 (legacy LIBOR loans)?

For legacy LIBOR loans that do not contain hard-wired RFR-based fallbacks (being the vast majority), there are broadly three options:

- amend the loan terms so the interest is calculated by reference to an RFR-based rate (or other benchmark acceptable to the relevant regulator). Although few legacy LIBOR loans have been amended to date, most banks with significant legacy LIBOR books are actively planning to adopt this approach, by undertaking major "bulk" repapering projects;

- amend the loan terms to include a hard-wired fallback to an RFR-based rate plus a credit spread. Although there have already been isolated examples of amendments of this nature (see paragraph 2.10) we do not anticipate there being a large uptake of this option. Once parties know what alternative to LIBOR they want to use and are able to use it, they will generally amend the loan terms to make that the primary source of interest calculation, rather than as a fallback; or

- do nothing, relying on the existing fallbacks in the agreement. Under typical fallbacks, the rate of interest following a permanent discontinuation of LIBOR is likely to be each lender's own cost of borrowing plus the margin (instead of LIBOR plus the margin). This is clearly unattractive for a borrower. On a syndicated facility agreement, it is also unattractive for an agent, who will have to calculate different interest rates for different lenders. While superficially more attractive for a lender, this is unlikely to be a viable long-term solution. Failing to take active steps to address LIBOR discontinuation could adversely affect a lender's relationship with both its customers and its regulators.

3.2 Are any legislative solutions anticipated to avoid the need to manually amend legacy LIBOR loans?

In a speech in New York in July 2019, Andrew Bailey, chief executive of the FCA, mooted the possibility of legislation helping with the transition of the financial markets away from LIBOR, including "*legislators redefin[ing] LIBOR as RFRs plus fixed spreads for…tough legacy contracts*".

However most legacy LIBOR loans (at least outside the consumer space) are unlikely to count as "tough legacy contracts", and so would not be the primary target of any legislative solution. Legacy LIBOR-based bonds are usually seen as the most difficult product to transition away from LIBOR, because:

- they are often difficult to amend;

- unless amended, many will convert to a fixed rate on and from the permanent discontinuation of LIBOR, fixing at the last available published LIBOR; and

- many have long tenors well beyond 2021.

In November 2019, the ARRC announced that it was exploring a legislative solution for New York law US dollar LIBOR-based contracts. It suggested that this would apply across all asset classes, but would only apply on a mandatory basis to existing LIBOR-based contracts (i) with no fallbacks at all or (ii) that provide for a fallback to a fixed rate based on the last available LIBOR (or similar). So, for example, there would be no automatic application to a loan agreement with a fallback to a lender's own cost of funds.

Outside the US, there has been little substantive progress towards a legislative solution. In December 2019, the BoE RFR Group announced that it was forming a new "Tough Legacy Task Force". Its remit is to consider "potential mitigants suggested by market participants" to address "tough legacy" risks. This could possibly include legislative solutions, but there has been no firm commitment to pursue this option.

In short, the parties to an English law legacy LIBOR loan with a scheduled tenor beyond 2021 should not rely on a legislative solution to ensure it continues to operate smoothly after 2021. They should assume that they will need to amend the terms of the loan before the end of 2021.

3.3 Are any protocols available or anticipated to streamline the process of amending legacy loans?

It is not anticipated that an ISDA style protocol (see paragraph 1.5) will be developed for amending the terms of legacy LIBOR loans. The main reasons for this are:

- loan terms are not as standardised as derivative terms;
- derivatives are always bilateral. If both parties to an existing derivatives transaction sign up to a protocol, this will amend the terms of that transaction. Facility agreements often have multiple parties, making it harder to effect change in this way;
- many derivative contracts are between financial institutions. If a relatively small number of financial institutions sign up to an ISDA Protocol, this can result in the amendment of a significant number of derivative contracts. By contrast, most borrowers are only party to one (or a small number) of facility agreements at any one time.

3.4 What are the key market developments that will enable the widespread amendment of legacy LIBOR loans?

For loans that will transition to compounded average in arrear RFRs (anticipated to be the majority):

- published compounded average in arrear RFRs, particularly in US dollars and sterling, in the most common tenors used for interest periods – one, three and six months;
- banks completing the process of recalibrating their operating systems, and the software supporting them, so that they are compatible with compounded average in arrear RFRs; and
- the publication of market-approved credit spreads between the main LIBOR tenors, particularly in US dollars and sterling, and equivalent compounded average in arrear RFRs. This is so that when a lender proposes replacing an interest rate of LIBOR plus margin of x% with a compounded average in arrear RFR plus margin of y%, it can explain the difference between x and y to its customer.

3.5 How advanced is the process of creating and publishing credit spreads for use in the loan markets?

In December 2019, the BoE RFR Group published a Consultation on credit spread methodologies for fallbacks in cash products referencing GBP LIBOR. The derivatives market has already identified a preferred method of calculating credit spreads between a LIBOR that is being replaced and an RFR-based rate that is replacing it: fix the spread at the date of replacement based on the average historical difference between the two rates. One would expect the loan and other cash markets to follow this approach. However, that is just one of the options identified in the consultation.

The consultation is only directly relevant where parties are converting from LIBOR to an RFR-based rate on the following events (each a **trigger event**):

- the discontinuation of LIBOR itself; or
- a regulatory announcement that LIBOR is no longer representative of the underlying market.

The intention is that on those trigger events, the spreads would be calculated and published by an identified third party (the **spread publisher**) to facilitate a change from LIBOR to RFR-based pricing on relevant transactions. ISDA has already chosen Bloomberg to do this job for derivatives. This precise scenario is much more likely to be relevant to FRNs than to loans. FRNs have increasingly included hard-wired fallbacks that would apply on a trigger event, in part to ensure compliance with the BMR. By contrast, commercial loans are (broadly) outside the scope of the BMR and rarely include a hard-wired fallback to an RFR-based rate (see paragraph 1.6). Parties to LIBOR-based loans are therefore more likely to amend them manually in advance of a trigger event.

To facilitate these manual amendments – which the consultation document calls "active conversions" – the loan markets really need the spreads to be published on a daily basis (once the methodology for calculating them has been agreed) until such time as LIBOR is permanently discontinued. Calculating and publishing the spreads only on a very limited number of trigger events will not be sufficient.

The daily publication of spreads for use in the loan markets should be achievable. For the purposes of calculating spreads for derivatives fallbacks, ISDA is anticipating that Bloomberg will publish fallback rates daily on a "what if" basis before the discontinuation of LIBOR (i.e. what would the spread be if the "trigger event" were today).

The December 2019 consultation document stated that there will be a separate consultation on spreads for "active conversions" in the cash markets.

3.6 Is there a standardised documentary approach to amending the terms of legacy LIBOR loans?

On 25 October 2019, the LMA released another document in exposure draft form – the Reference Rate Selection Agreement (the **RRSA**). The purpose of the RRSA is to help streamline the process of replacing LIBOR with an RFR-based rate in the many legacy transactions that have tenor going beyond 31 December 2021.

The scheme of the RRSA is that:

- all parties to the legacy LIBOR-based facilities agreement whose benchmark rate is to be replaced will execute the RRSA;
- in the RRSA, those parties will make high-level selections from a series of pre-determined key options for amending the legacy facilities agreement;
- the RRSA will authorise the agent and the obligors to enter into a separate amendment agreement amending the legacy facilities agreement; and
- that amendment agreement will bind all parties to the legacy facilities agreement and implement in detail the high-level key choices taken by all parties in the RRSA.

The RRSA is therefore not a recommended form of amendment agreement. It simply provides a mechanism to enable the agent and borrower to agree amendments (in a separate document) within an agreed framework, without having to obtain further consents from the syndicate. The RRSA therefore would have no application in a bilateral transaction.

It is too early to tell whether there will be significant take-up of the RRSA when syndicated legacy LIBOR loans are being amended. Other than the RRSA, there are no standard or recommended form documents available dealing with the amendment of legacy LIBOR loans.

3.7 Who will instigate the amendment of legacy LIBOR loan agreements?

We anticipate that lenders will generally instigate this process, on both bilateral and syndicated transactions. On syndicated transactions, a lender wishing to start an amendment process would first need to put forward a proposal to the agent, and ask it to circulate this among the syndicate for discussion and agreement, before any proposal is put to the borrower.

3.8 Who will pay for the amendment of legacy LIBOR loan agreements?

Facility agreements generally provide that if a borrower requests an amendment to the loan terms, it must pay the reasonably incurred costs of the lender (on a bilateral transaction) or agent (on a syndicated transaction) in connection with that amendment. As a result, lenders and agents rarely have to pay for amendment costs – loan terms are usually only ever amended at the request of the borrower. However, the repapering of lenders' legacy LIBOR loans is likely to be an exception – it is more likely that lenders will instigate this process (see above).

The terms of some recent loans do specifically require the borrower to pay for the lender's costs in connection with LIBOR-related amendments, regardless of who instigated the amendment (see paragraph 2.12). However, this is the exception.

Otherwise, if a lender were determined that its borrower should pay for the lender's costs, it potentially has some commercial leverage to engineer this. It could point out that if the loan terms are not amended, the borrower is likely to have to pay the lender's cost of funds plus margin after LIBOR is discontinued (see paragraph 3.1).

It is too early to say how lenders will approach this. However, most banks are treating the amendment of their large legacy LIBOR books as a regulatory-driven project, not unlike ring-fencing, EMIR and MiFID2. It is quite possible that, as with those other project types, banks will not seek to pass on their costs to their customers.

3.9 If a legacy LIBOR loan is subject to interest rate hedging, will that hedging need to be amended at the same time as the loan terms?

Yes, in order to ensure that the borrower (and lender(s)) benefit from a true hedge of interest rate risk, the terms of the hedging will need to be amended so that the floating rate element in it is consistent with the amended floating rate in the loan.

3.10 Can finance-linked hedging terms be amended by using the ISDA Protocol and hard-wired fallbacks?

For background information on the ISDA's work on hard-wired fallbacks and related Protocol, see paragraph 1.5. Our view is that these mechanisms are not suitable for amending finance-linked hedging terms for two main reasons:

- the hard-wired fallbacks in the updated 2006 ISDA Definitions will only take effect on specified "index cessation events" (or, potentially, on a "non-representative" statement from the FCA). Huge numbers of hedged legacy LIBOR loan terms will be amended at various times between now and the end of 2021. The parties will need to effect the amendment of the hedging terms at the same time; and

- for each LIBOR currency and tenor the hard-wired fallback provided for in the updated 2006 ISDA Definitions will comprise a standard RFR-based rate plus a standard credit spread. This will not always correspond to the rate replacing LIBOR when a legacy LIBOR loan is amended.

We therefore anticipate that parties to legacy finance-linked hedging transactions will need to amend their terms manually, at the same time as amending the legacy LIBOR loan terms to which the hedging relates.

3.11 What conduct and litigation risk issues should lenders consider when amending legacy LIBOR loans?

The specific conduct obligations of a lender will depend on the jurisdiction(s) in which it is incorporated or operating. Regulated entities in the UK should in particular note the FCA's Questions and answers for firms about conduct risk during LIBOR transition, published in November 2019. In relation to a lender's engagement with its corporate borrowers, we consider the following to be the key litigation risks:

- *Exercising contractual discretions*. It is anticipated that most commercial legacy LIBOR loans with a tenor beyond 2021 will transition to an RFR-based rate by amendment agreement (see paragraph 2.11). However, in some legacy LIBOR loans that transition process may involve the lender, agent or other "finance party" exercising a discretion. For example, if a loan has a hard-wired fallback or gives the lender a unilateral right to amend the terms following certain trigger events, the lender may be responsible for adjusting the margin to account for the difference between LIBOR and the replacement rate. Where a party to an English law contract exercises a discretion of this nature, it is generally under an obligation not to exercise that discretion irrationally, capriciously or arbitrarily (sometimes referred to as a "Braganza duty"). Similar implied duties may apply under other laws. One would not expect a lender to fail to meet this obligation, but lenders should keep clear records of their decision-making processes before exercising contractual discretions of this nature.

- *Avoiding assumption of an advisory role.* Across all lending products, lenders will need to engage with their customers to explain how they propose to amend existing loan terms to address the risk of LIBOR discontinuation. However, it is important that lenders avoid creating an advisory relationship with their borrowers. For example, in product areas where compounded average in arrear RFRs are impractical (see paragraph 2.7) there may be different approaches to replacing LIBOR across the market for that product. Where that is the case, if a lender "recommends" a specific option to a customer, it may incur a duty to the client in respect of that option's suitability to the client. Lenders should make clear that borrowers are responsible for taking their own decisions, particularly where those customers do not have their own legal counsel.

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