Baker McKenzie.

Global: LIBOR transition: Are overnight rates overrated? Recent developments in RFR term rates and credit-sensitive rates

As LIBOR transition has proceeded, participants in the financial markets have faced choices between possible LIBOR replacements.

This client alert examines recent developments in the US and the UK with respect to both term rates based on risk-free-rates (RFRs) and credit-sensitive rates (CSRs), and also examines CSRs and term rates in the other LIBOR jurisdictions.

Key take-aways

1. There have been recent developments with respect to both term rates based on RFRs and CSRs. The available choices, and regulatory and market acceptance of alternatives to RFRs, varies by currency and market.
2. At present, the US has seen more development of (and receptivity to) CSRs than the UK.
3. Although versions of term SONIA exist, UK regulators have put in place a limited use case of term SONIA in the UK loan market. A term SOFR has not yet been recommended by US regulators, but such a recommendation may occur soon, and term SOFR is not expected to be subject to a limited use case in the US loan market.
4. In Japan and the euro zone, TIBOR and EURIBOR, which are CSRs, will continue after LIBOR cessation.

As LIBOR transition has proceeded, participants in the financial markets have faced choices between possible LIBOR replacements. In some markets, there have been recent developments with respect to both term rates based on risk-free-rates (RFRs) and credit-sensitive rates (CSRs). As is the case with so much else in LIBOR transition, the available choices, and regulatory and market acceptance of alternatives to RFRs, varies by currency and market. As many have noted, the post-LIBOR landscape will likely involve multiple rates.

Overnight RFRs have been identified in the jurisdiction of each LIBOR currency, and trading markets in such RFRs have seen much development (although the depth of liquidity varies significantly by currency). Many derivative transactions have transitioned to RFRs, and RFRs have also been used in cash markets, in many cases being used to calculate interest in arrears (rather than in advance). RFRs differ from LIBOR in that they are overnight rates, and do not reflect counterparty credit risk.

In addition, consensus has proved elusive in arriving at loan market conventions for RFR interest in arrears, with the US and UK markets currently not being aligned.[1] Many in the market have looked to see if there are alternatives to using RFRs that are determinable in advance or reflect credit risk.

At present, the US has seen more development of (and receptivity to) CSRs than the UK. Although versions of term SONIA exist, UK regulators have put in place a limited use case of term SONIA in the UK loan market. A term SOFR has not yet been recommended by US regulators, but such a recommendation may occur soon, and term SOFR is not expected to be subject to a limited use case in the US loan market.

The desire for alternatives to RFRs is in tension with the concerns of regulators that rates other than RFRs are less robust than RFRs, and that use of such rates may decrease liquidity in the transactions on which RFRs are based, rendering the RFRs less robust. The Financial Standards Board (FSB) has pointed out that term rates based on RFRs are by their nature derivative of RFRs, and are necessarily based on lesser transaction volumes than RFRs. [2] The FSB views strong markets in RFRs as important to the systemic health of financial markets. The Financial Conduct Authority (FCA) has stated that RFRs "provide the most robust benchmark interest rate available, derived from markets that have remained active and reliable through times of stress."[3]

Despite the existence of term rates and CSRs, many still expect the majority of liquidity to be in RFRs.[4]

In order to be widely used, any forward term rate or CSR would need to comply with benchmark principles developed by the International Organization of Securities Commissions (IOSCO).

Two LIBOR jurisdictions (the euro zone and Japan) have chosen to follow a multiple rate approach, where existing non-LIBOR term rates that include credit risk (EURIBOR and TIBOR, respectively) will continue after LIBOR cessation.[5] This article will discuss the status of term rates and CSRs in each LIBOR jurisdiction.

---

[1] See our previous alert, From one into many: Replacement rates for LIBOR.

[2] FSB, Interest rate benchmark reform – overnight risk-free rates and term rates (12 July 2018).

[3] Edwin Schooling Latter, LIBOR transition – the critical tasks ahead of us in the second half of 2020 (14 July 2020).

[4] See, e.g., "Liquidity Will Centre on RFRs, Panellists Say," ISDA IQ In Brief (Day 1 AGM).

[5] The European Central Bank has recently (11 May 2021) issued its recommendations and guidance in relation to suitable fallback rates to EURIBOR should EURIBOR be discontinued. In Japan, the JBA TIBOR Administration (JBATA) has also recently announced its intention to consult on the discontinuation of Euroyen TIBOR at the end of December 2024.

US

Term rates based on SOFR

The development of a forward term rate for US dollars based on SOFR has been the last step of the Alternative Reference Rates Committee's (ARRC) Paced Transition Plan[6] since the plan was first announced in 2017. This last step has been conditioned on sufficient liquidity developing in SOFR-derivatives markets to produce a robust, IOSCO-compliant term rate. The Paced Transition Plan had targeted the first half of 2021 for this step.

In the course of LIBOR transition in the US, the ARRC has stated several times that market participants should not wait for a forward term rate based on SOFR to emerge before transitioning from LIBOR, and has also said that a term SOFR rate might not be developed at all.[7] In October 2019, the ARRC noted that at the time the depth and liquidity in SOFR markets was not sufficient to produce an IOSCO-compliant term SOFR rate.[8] In March, the ARRC said that it would not be in a position to recommend a forward-looking SOFR term rate by mid-2021. Recently, however, the ARRC has made several, more hopeful statements that it may recommend such a term rate in the relatively near term, provided that SOFR derivatives and cash markets grow.[9]

The CME Group currently publishes a term SOFR rate that is IOSCO-compliant, but which has not been recommended by the ARRC.[10] The CME rate has one, three and six-month tenors. The ARRC has selected CME Group as the administrator that it plans to recommend for a forward-looking SOFR term rate, once market indicators for the term rate are met.[11]

In the ARRC's announcement of CME's Group's selection, Tom Wipf, the chair of the ARRC, stated that "Given that continued progress in developing SOFR derivatives market liquidity is readily achievable, a recommended term rate is now in clear sight." The announcement of the selection of CME Group also permits market participants to plan around what an ARRC-recommended term SOFR will look like.[12]

At a recent ARRC symposium, the ARRC indicated that it would produce best practices for the use of term SOFR. Unlike in the UK (see below), the ARRC is not expected to posit a restrictive use case for term SOFR.

The ARRC's model LIBOR fallback provisions for syndicated loans, floating rate notes and securitizations all use a term SOFR (but only if, and to the extent that, such rate is recommended by the ARRC) as the first step of the waterfall to select a replacement rate.[13] Although no such rate exists now (or existed at the time that the model fallbacks were drafted), the placement of such rate in the waterfall reflects the US market's interest in such a rate.

[6] ARRC Paced Transition Plan.

[7] See, e.g., ARRC Provides Update on Forward-Looking SOFR Term Rate: Market Participants Encouraged to Transition without Reliance on SOFR Term Rate (23 March 2021); ARRC Releases Request for Proposals for the Publication of Forward-Looking SOFR Term Rates (10 September 2020) (noting that the "RFP does not constitute a guarantee that any SOFR term rate or administrator will ultimately be recommended by the ARRC"); ARRC, Frequently Asked Questions (Version: 27 April 2021)

[8] ARRC Minutes for the October 22, 2019 Meeting.

[9] See, e.g., Market Indicators that Would Support an ARRC Recommendation of a Forward-Looking SOFR Term Rate (6 May 2021); Key Principles to Guide the ARRC as it Considers the Conditions it Believes are Necessary to Recommend a Forward-Looking SOFR Term Rate (20 April 2021); ARRC Releases Update on its RFP Process for Selecting a Forward-Looking SOFR Term Rate Administrator (21 May 2021).

[10] See here.

[11] ARRC Releases Update on its RFP Process for Selecting a Forward-Looking SOFR Term Rate Administrator (21 May 2021).

[12] Tom Wipf, the ARRC chair, said that the announcement "should allow market participants to plan ahead for the recommendation of CME Group as the term rate administrator soon."

[13] ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans, ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Floating Rate Notes and ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Securitizations. The ARRC was careful

CSRs

In the US, several CSRs have been developed and proposed as alternatives to LIBOR and rates based upon SOFR. Unlike SOFR, which is an RFR, CSRs include a counterparty risk component (as LIBOR does). The most prominent examples of such rates are Ameribor, the Bloomberg Short Term Bank Yield Index (BSBY), the ICE Bank Yield Index, and the IHS Markit Credit Inclusive Term Rate (CRITR) and Credit Inclusive Term Spread (CRITS).[14] Such rates are also similar to LIBOR in that they are forward term rates.

The Loan Syndications and Trading Association (LSTA) has developed alternative language to LIBOR fallback provisions that would allow these CSRs to be used in preference to, in lieu of, or in deference to a SOFR-based rate once the fallbacks are triggered.[15] ISDA has amended its interest rate definitions to add Ameribor and BSBY as floating rate options.[16]

CSRs are attractive to some lenders because they are thought to reflect funding costs better than SOFR. However, CSRs for dollars are based on thinner transaction volumes compared to SOFR. Some have expressed the view that CSRs may prove more volatile than SOFR as a result of this, and therefore may be less attractive to nonfinancial borrowers.[17] In the US, regulators have stated that multiple rates may be appropriate in LIBOR transition.[18]

Recently, Duluth Holdings announced a new $150 million credit facility priced by reference to BSBY. The credit facility is agented by Bank of America.[19] In addition, Covenant Review recently noted that it had become aware of several syndicated loan transactions that include an early opt-in trigger (in addition to the early opt-in trigger in the ARRC model LIBOR fallback), which permits the transition to rates other than SOFR in advance of the permanent cessation of USD LIBOR, if new issues or amended deals using an alternative rate (such as a CSR) exist in the market.[20]

The CME Group announced that it will launch interest rate futures based on BSBY in the third quarter of 2021.[21]

UK

Term rates; use cases

In the UK, regulators have expressed a clear preference that the use case for term SONIA rates should be limited. The Working Group on Sterling Risk-Free Reference Rates has stated that use of SONIA compounded in arrears was appropriate and was likely operationally achievable for approximately 90% by value of the Sterling LIBOR

---

to note in such provisions that, at the time they were drafted, there was no certainty that a term SOFR would be recommended by the ARRC at the time when the fallbacks came into effect.

[14] IHS Markit Begins Publishing Daily Credit Inclusive Term Rate (CRITR) and Credit Inclusive Term Spread (CRITS) for US Dollar Funding (1 June 2021).

[15] LSTA, Market Advisory "Credit Sensitive Rate" Slot-in Rider for Fallback Language (8 April 2021).

[16] Supplement 72 ("USD-AMERIBOR Term", published May 6, 2021); Supplement 73 ("USD-BSBY", published 6 May 2021).

[17] See, e.g., Risk.net, Prudential, Goldman cast doubt on Libor-like replacement rates (11 May 2021). Tom Wipf of the ARRC has stated that the use of rates that are sensitive to market stress can be appealing to lenders, but that "it's not very clear, speaking to non-financial borrowers, why they would feel this would be appealing to them. Because really, what's the logic in having non-financial corporates' costs go up because bank spreads or commercial paper is widening?" Risk.net, ARRC's Wipf 'puzzled' by appeal of Libor-like benchmarks (28 April 2021). Mr. Wipf also stated that he found it "puzzling" why market participants would find rates that feel "like LIBOR" appealing "after all we've been through." Id.

[18] See, e.g., Letter of Jerome Powell to Senator Tom Cotton, May 28, 2020.

[19] See here.

[20] Covenant Review, LIBOR Transition: Does Your New Loan Allow Early Opt-In of Credit Sensitive Rates Instead of SOFR? (20 May 2021).

[21] CME Group to Launch Bloomberg Short-Term Bank Yield Index (BSBY) Futures in Q3.

loan market.[22] The Working Group identified smaller corporate, wealth and retail clients as those that might benefit from a term SONIA rate. The Working Group also identified trade finance and Islamic finance as sectors that could use a term SONIA rate. The FCA has also stated that the use of forward-looking term rates was meant to be limited.[23] The FICC Market Standards Board (FMSB) published a "transparency draft"[24] of a standard on the use of term SONIA that sets out further details concerning the limited use cases for a term SONIA rate. The draft has been endorsed by the UK regulators, and when the final form is published, the expectation is that there will be strong levels of compliance from the relevant institutions and FMSB members.

In the UK, certain term SONIA rates, which are IOSCO-compliant and permitted for use in live transactions, have been published since January 2021. There are currently two providers: ICE Benchmark Administration (IBA) and Refinitiv (using similar methodologies). There is limited visibility on current usage levels due to the nature of the products involved.

The FCA has announced that it would consult on whether to require the IBA to continue publishing one-month, three-month and six-month Sterling LIBOR after the end of 2021 on a synthetic basis, for an extended period.[25] The synthetic Sterling LIBOR is provisionally slated to be based on one of these existing term SONIA rates plus relevant credit adjustment spreads for each of the tenors. This would be intended primarily to deal with tough legacy issues.[26]

CSRs

In a recent speech, Andrew Bailey, the governor of the Bank of England, stated that it was not clear that CSRs had truly addressed the weaknesses of LIBOR.[27] Mr. Bailey further stated that in England, the clear consensus was to not use CSRs in LIBOR transition.

Japan

In Japan, TIBOR will continue to be available after LIBOR is scheduled to cease. We are not aware of any other CSR being used for yen transactions.

In addition to TIBOR, the Tokyo term risk-free rate (TORF) has been published by Quick Corp. since 26 April.[28] TORF is based on market data for OIS transactions in yen, and has one, three and six-month tenors.

The Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks has stated that TONA "shall be the main alternative benchmark for the JPY interest rate swaps market. However, market participants are not necessarily precluded from using other alternative benchmarks including . . . [TORF] and TIBOR, as demand for those benchmarks is expected to remain depending on the purpose of trade."[29]

[22] The Working Group on Sterling Risk-Free Reference Rates, Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives (January 2020).

[23] See, e.g., Andrew Bailey, LIBOR: preparing for the end (15 July 2019).

[24] FSMB, Standard on use of Term SONIA reference rates (transparency draft).

[25] FCA announcement on future cessation and loss of representativeness of the LIBOR benchmarks (5 March 2021).

[26] The FCA recently commenced a consultation on how it would use two new powers granted to it by amendments to the UK Benchmarks Regulation under the Financial Services Act 2021. These new powers are (i) the ability to permit some or all "legacy" use of a critical benchmark and (ii) the ability to prohibit some or all new use of a critical benchmark when we have been notified by its administrator that it will cease to be provided. FCA, Consultation Paper CP21/15 Benchmarks Regulation: how we propose to use our powers over use of critical benchmarks (May 2021). The consultation closes on 17 June 2021.

[27] Andrew Bailey, Descending safely: Life after Libor - speech by Andrew Bailey | Bank of England (11 May 2021).

[28] See here; see also Statement regarding Calculation and Publication of Production Rates for Term Reference Rates (Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks).

[29] Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks Minutes for the March 26, 2021 Meeting.

At the recent ISDA Annual General Meeting, a panel discussed TORF and TONA, and noted that, although many of Japan's banks were prepared to shift to TONA, many corporate clients had expressed a preference for TORF. One panelist argued that use of TORF should be limited, to avoid having a repeat of issues seen in connection with LIBOR, where a large volume of contracts would be priced based on transactions in much smaller markets.[30]

Also with respect to yen transactions, the FCA has announced that it would consult on whether to require the IBA to continue to publish one-month, three-month and six-month yen LIBOR after 2021 on a synthetic basis, for one additional year.[31] This would be intended primarily to protect market integrity by allowing more time to complete the transition away from yen LIBOR.

The euro zone

In the euro zone, EURIBOR will continue to be available after LIBOR is scheduled to cease. We are not aware of any other CSR or term rate being used for euro transactions.

The working group on euro risk-free rates has consulted on a forward-looking term rate based on €STR, the identified RFR for euro, and has proposed a forward- and backward-looking €STR term structure as a component of fallback recommendations from EURIBOR.[32] The forward-looking term structure would be based on a methodology that the working group examined in 2019.[33] This methodology would require a successful transition from EONIA to €STR and the development of meaningful liquidity in €STR OIS markets.

On 11 May 2021, the ECB published its official recommendations and guidance for EURIBOR fallbacks in financial products.[34] These broadly follow the format of other LIBOR currency jurisdictions. For example, the guidelines for corporate loans are to use backward-looking compounded €STR where feasible and a forward-looking term €STR in more limited circumstances (and, if not available, a "last reset" compounded €STR methodology).

The continued availability of EURIBOR has meant that there has been little, if any, meaningful transition towards €STR in cash markets. Until such time as there is an official announcement regarding the end of EURIBOR, this is expected to remain the case for some time to come.

Switzerland

In 2018, the national working group for Swiss Franc reference rates expressed the view that a robust term SARON rate was not feasible in the Swiss market.[35] We are not aware of any term rate or CSR being used for Swiss franc transactions.

[30] "TONA Liquidity Set to Rise, Says Panel," ISDA IQ In Brief (Day 2 AGM).

[31] FCA announcement on future cessation and loss of representativeness of the LIBOR benchmarks (5 March 2021).

[32] Public consultation by the working group on euro risk-free rates on €STR-based EURIBOR fallback rates (23 November 2020).

[33] Second public consultation by the working group on euro risk-free rates on determining an ESTER-based term structure methodology as a fallback in EURIBOR-linked contracts: Summary of responses (February 2019).

[34] Recommendations by the working group on euro risk-free rates on EURIBOR fallback trigger events and €STR-based EURIBOR fallback rates (europa.eu).

[35] Minutes from the meeting of the National Working Group on CHF Reference Interest Rates (31 October 2018).

Your contacts

Matthew Cox
Partner
matthew.cox
@bakermckenzie.com
+ 44 20 7919 1322

John Lawlor
NA Senior Professional Support
Lawyer
john.lawlor
@bakermckenzie.com
+ 1 312 861 2926

Duncan McGrath
Partner
duncan.mcgrath
@bakermckenzie.com
+ 61 2 8922 5108

Nick O'Grady
Partner
nick.ogrady
@bakermckenzie.com
+ 44 20 7919 1101

Mark Tibberts
Partner
mark.tibberts
@bakermckenzie.com
+ 1 212 626 4370

Gabby White
Knowledge Lawyer
gabby.white
@bakermckenzie.com
+ 44 20 7919 1891

Baker McKenzie.

Leading and closing complex deals - every day

We are a transactional powerhouse providing commercially-focused, end to end legal advice to maximize deal certainty and secure the intended value of transactions. Our 2,500 lawyers combine money market sophistication with local market excellence. We lead on major transactions with expertise spanning banking and finance, capital markets, corporate finance, restructuring, funds, M&A, private equity and projects. The combination of deep sector expertise, and our ability to work seamlessly across each of the countries where we operate, means we add unique value in shaping, negotiating and closing the deal.

TRANSACTIONAL POWERHOUSE
Banking & Finance