Baker McKenzie.

November 2022

In The Know

Leveraged Finance Newsletter

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Welcome to the world of risk-free rates

When we last wrote on the topic of LIBOR transition for In The Know at the end of 2021,[1] the path ahead was uncertain and speculation lingered around whether LIBORs would ever actually be withdrawn. Thankfully, much has fallen into place in the intervening period and the move away from LIBORs toward alternative near risk-free rates (RFRs) is in full swing. In this article we assess the progress to date and the challenges that remain.

Key points:

- LIBOR transition has progressed well for sterling, Swiss franc and Japanese yen financial contracts with wide acceptance, and adoption, of RFRs in all market sectors in new contracts and dwindling volumes of legacy contracts still awaiting remediation.
- Whilst progress for US dollar financial contracts has been slower, work has accelerated during 2022. However, US dollar LIBOR transition poses unique challenges due to its widespread use globally.
- Clear and consistent market consensus has developed around the application of RFRs in sterling, Swiss franc and Japanese yen financial contracts with a compounded in arrears rate structure favoured for the majority of loans.
- US dollar loan markets in the US, in contrast, are consistently favouring a forward-looking term rate based on SOFR, the US RFR (Term SOFR). This consensus is impacting the US dollar markets outside the US with increasing use of Term SOFR in US dollar transactions with non-US entities.
- Whilst there are no current plans for EURIBOR to cease publication, interbank offered rates for other currencies either may, or in some cases will, cease in future. This will pose a continuing challenge for market participants to monitor and adapt to changes.

The experience of sterling, Swiss franc and Japanese yen markets

Market participants received a reality check in March 2021 when the UK's Financial Conduct Authority (**UK FCA**) announced that all LIBOR currency/tenor pairs (with the exception of one-, three- and six-month USD LIBORs) would either cease or be "*unrepresentative*" after 31 December 2021. The decision was taken to give extra time for these most

1 "From One into Many: Replacement Rates for LIBOR"

well-used USD LIBOR tenors, until 30 June 2023, primarily due their systemic importance and the perceived (lack of) market readiness for an earlier date.

No noticeable disruption was experienced in sterling, Japanese yen and Swiss franc markets after the end of 2021. A smooth transition in these currencies has been achieved due to a number of factors that enabled the markets to be ready for the end of LIBOR. These facts include:

- Widespread adherence[2] to the ISDA IBOR Fallbacks Protocol 2020 (and the application of similar rules to cleared derivatives via changes to central counterparty clearing house rules), which allowed the vast majority of legacy derivatives contracts to incorporate an automatic switch from LIBOR to the relevant RFR after 31 December 2021. With derivatives exposures constituting the greatest volume and total amount of all LIBOR exposures, this was a vital development in reducing overall LIBOR exposures and systemic risk with LIBOR cessation.

- Regulatory pressure, particularly in the UK and Switzerland, which required supervised market participants to cease the use of LIBORs for new transactions well in advance of the cessation deadline and take steps to remediate as many legacy exposures as possible before such date.

- RFR currency working groups issuing recommended market conventions for working with RFRs in various asset classes, which gave comfort to market participants to move forward with pilot deals and allowed market consensus to coalesce around such conventions.

- Major industry bodies, such as the International Swaps and Derivatives Association (**ISDA**), the Loan Market Association, the Asia Pacific Loan Market Association and the Loan Syndications and Trading Association, producing template documentation for RFRs and running education sessions to raise awareness of LIBOR transition issues.

- Financial institutions, working together with technology providers, investing in systems upgrades to allow interest to be calculated on an RFR basis.

- *"Tough legacy"* legislation in the UK and the European Union (EU) providing solutions for many unremediated legacy contracts. In particular, the UK FCA exercised its newly legislated powers to compel the continued publication of a synthetic form of one-, three- and six-month GBP LIBOR and one-, three- and six-month JPY LIBOR after the end of 2021. These rates use a different methodology to the original LIBORs, being a version of Term SONIA[3] (in the case of sterling) and TORF[4] (in the case of Japanese yen) plus a credit adjustment spread (CAS).[5] The intention is that synthetic LIBORs allow legacy contracts to continue without disruption such that any contractual references to GBP LIBOR or JPY LIBOR will automatically be to their synthetic versions (which continue to be published by the same administrator on the same screens and at the same time as "*original*" LIBORs). In the EU, legislation has been passed that allows the statutory designation of alternative rates in in-scope contracts. For example, the statutory designated replacement for Swiss franc LIBOR is SARON plus a CAS.

ISDA recently reported that close to 100% of sterling, Swiss franc and Japanese yen risk is now traded on a risk-free rate basis.[6] Use of RFRs in cash markets in these currencies is also now the norm.

Great progress was, and continues to be, made in dealing with legacy LIBOR contracts. In February 2022, the Bank of England estimated that less than 2% of the total original sterling LIBOR legacy stock remained and efforts continue to reduce this even further. A Bank of Japan survey[7] on JPY LIBOR transition showed that, as of the end of December 2022, 98% of general loans and 97% of syndicated loans had successfully transitioned, along with 99% of bonds and the same percentage of derivatives. The Swiss National Working Group was wound down after the end of March 2022 due to the transition to SARON being *"conceptually completed and the operational transition…on track."*[8]

All this progress has meant that synthetic LIBORs for sterling (apart from the three-month tenor) will cease to be published after 30 March 2023 and all synthetic Japanese yen LIBORs will cease after 31 December 2022.

To date, we are not aware of any public litigation relating to LIBOR transition in the UK, Switzerland or Japan.

2 There were 15,405 adhering parties as at 1 November 2022 (ISDA 2020 IBOR Fallbacks Protocol – International Swaps and Derivatives Association).
3 Term SONIAs are forward-looking term rates based on transactions in the sterling RFR (SONIA) derivatives markets. Whilst both ICE Benchmark Administration (ICE) and Refinitiv produce Term SONIAs, it is the ICE versions that are used in synthetic GBP LIBORs.
4 Similar to Term SONIA, the Tokyo Term Risk-Free Rate (TORF) is a forward-looking term rate based on transactions in the Japanese yen RFR (TONA) derivatives markets.
5 A credit adjustment spread is an add-on to an RFR to reflect the (generally) lower value of RFRs in comparison to equivalent LIBORs.
6 RFRs are now half of the market | (clarusft.com) August 2022.
7 Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks, Key Results of the Questionnaire Survey on the Progress in the Transition away from JPY LIBOR.
8 Minutes - 28th Meeting of the Working Group, 9 November 2021 (snb.ch)

... and US dollars

Transition in US dollar markets was slower off the mark but the pace of adoption of the US dollar RFR (**SOFR**) took off in the last quarter of 2021 and accelerated throughout 2022 in both the US and UK markets. Building on the existing keys to success, the drivers for USD transition were as follows:

- The "SOFR First" initiative to prioritize derivatives markets trading in SOFR over those trading in USD LIBOR started in phases commencing in 2021. SOFR trading has recently increased to over 57%[9] of all USD traded risk.
- The availability of Term SOFR (published by CME Group)[10] and, in July 2021, its formal recommendation or allowance for use in all asset classes except for derivatives (with an exception being made for hedging Term SOFR-referencing cash products). The cash markets in the US were reluctant to use an RFR methodology that was not forward-looking and so this development really kick-started transition in the cash markets. It was only possible because of increased activity in SOFR derivatives, generated through the SOFR First initiative, which allowed Term SOFRs based on those SOFR derivatives to be considered sufficiently robust.
- US regulatory "*guidance*" to cease new issuance of all USD LIBOR products by regulated financial institutions by 31 December 2021.
- State and federal "*tough legacy*" laws that will impose statutory alternatives rates to USD LIBOR in US law contracts that do not have satisfactory existing fallbacks and remain unremediated when USD LIBOR ceases.[11]

The Alternative Reference Rate Committee's (**ARRC**)[12] readout for its September meeting[13] demonstrates the momentum in US dollar transition in the US markets, with SOFR swaps now making up around 90% of all US dollar interest risk traded (linear swaps) and close to 100% of all new syndicated lending and floating rate notes in 2022 referencing SOFR. That said, considerable work remains to be done in the US on the remediation of USD LIBOR legacy deals for many lenders and borrowers, as noted in the results of the ARRC's recent loan remediation survey.[14] According to that survey, despite past market efforts to actively transition loans, many transactions were expected to rely on fallbacks (some of which are "amendment approach" instead of hardwired) after June 2023, and some borrowers and syndicate lenders had not yet been contacted about transition plans or seen active transition amendments prepared by agents.

Of course, US dollars are widely used outside of the US markets and the transition picture there is more mixed. In jurisdictions such as the UK, where the UK FCA has required regulated entities to follow the US regulatory guidelines to cease USD LIBOR issuance after 31 December 2022 and indeed prohibited its use in certain financial contracts and instruments,[15] great strides have been made with both new originations and legacy contracts. The UK, Swiss and Japanese markets have also benefited from the experience of earlier transitions to RFRs for their own currencies and have been able to apply those learnings and practices to drive change in US dollar transactions in their local markets simultaneously with those local currencies. However, some jurisdictions lag behind and continue to issue new USD LIBOR contracts without robust fallbacks, have not fully updated their IT systems

9 RFRs are now half of the market | (clarusft.com) August 2022.
10 Subsequent to the ARRC recommendation of CME Term SOFR, ICE Benchmark Administration has launched ICE Term SOFR Reference Rates.
11 New York passed a tough legacy law that applies to New York law-governed contracts. Article 18-C, New York General Obligations Law. So did several other US states. In addition, after passage of those state statutes, the US Congress enacted a tough legacy statute. 12 U.S.C. §5801. The federal statute expressly preempts US state tough legacy laws related to benchmark replacement.
12 The ARRC is the RFR working group for US dollars.
13 ARRC September 8 Meeting Readout.
14 ARRC Loan Remediation Survey Results.
15 Article 21A Benchmarks Regulation - Notice of Prohibition on New Use of a Critical Benchmark.

to handle RFRs and suffer from general awareness of this issue among customers. In addition, certain private credit and other non-supervised lenders have continued to originate USD LIBOR loans or have been slower to transition legacy USD LIBOR transactions. We not as well that the US tough legacy legislation does not apply to tough legacy USD LIBOR debt instruments that are not governed by US law.

Some lenders in the US have used credit-sensitive rate indices that are not derived from SOFR, such as BSBY (set by Bloomberg) and Ameribor (set on the American Financial Exchange).

What's market for leveraged deals?

The recommendations of the sterling RFR working group have heavily influenced the sterling-denominated leveraged loan market. Since March 2021, UK-supervised entities have been obliged to ensure that they issue no new GBP LIBOR-referencing loans.

With over 18 months of SONIA-based loans behind us, a clear consensus has emerged that such loans are based on a compounded-in-arrears structure with a five business day lookback period and a daily non-cumulative compounded rate (**DNCCR**) methodology. This structure allows some reflection of the time value of money (via compounding) and some degree of notice of the overall interest payment (via the lookback period) and facilitates intra-period events such as prepayments and loan transfers (via the daily accruals possible by using the DNCCR methodology). In contrast to US dollar loans, generally no credit adjustment spread is added to the SONIA rate for new originations.

Again contrasting with the US dollar loan market, there is no widespread use of Term SONIA in the loan markets despite such rate being available.[16] This is principally due to the UK FCA's discouragement of its use in all but a very limited range of circumstances (primarily those where rate certainty from the first day of an interest period is essential). The FICC Markets Standards Board (FMSB) also published a voluntary "Standard on use of Term SONIA reference rates"[17] setting out these specific use cases, which is supported by the Bank of England and the UK FCA.

SONIA, like other RFRs, is structurally different to LIBOR — it is not seen as a proxy for a lender's cost of funding and there is no matched funding assumption. This has led to increasing challenges to some of the previously standard and little-negotiated provisions in syndicated loan agreements that were predicated on these concepts. Features such as market disruption clauses, fallbacks to a lender's cost of funds if the main benchmark is unavailable and break funding costs are all now up for discussion, and many borrowers have successfully challenged their continued relevance and inclusion.

16 Both ICE and Refinitiv calculate and publish versions of Term SONIA in a variety of tenors.
17 FMSB publishes final Standard on the use of Term SONIA reference rates - Financial Markets Standards Board

Many loans made under English law-governed facility agreements have adopted the same approach for other currencies as they do for sterling (setting aside euro about which you can read further below). This, in some cases, contrasts with practice in the market local to the relevant currency. For example, the Swiss National Working Group's recommended convention for syndicated Swiss franc loans was a compounded in arrears structure but utilizing the cumulative compounded rate methodology (rather than the DNCCR recommended for sterling). In Japan both TORF (the risk-free rate based term rate for Japanese yen) and TIBOR (a Japanese yen IBOR) have been adopted in place of JPY LIBOR, rather than Compounded in Arrears TONA.[18]

The practice in the US leveraged loans market heavily favors the use of Term SOFR (although some borrowers have preferred Daily Simple SOFR). The widespread use of Term SOFR has not been without issue. Firstly, there is no tenor shorter than one month, creating practical issues where interest periods are shorter than this. Secondly, US regulators have not permitted the use of Term SOFR on a general basis in derivatives, with Term SOFR hedging limited to end-user facing products that hedge Term SOFR cash products. The proportion of SOFR-based derivatives that reference Term SOFR is dwarfed by those using SOFR itself. Lenders that are providing hedging for Term SOFR loans have liabilities that they cannot precisely cover in the main derivatives market. Further, hedging costs for a Term SOFR loan may be greater than for a Daily Simple SOFR or Compounded in Arrears SOFR loan due to the lesser amount of liquidity in Term SOFR derivatives.[19]

Somewhat uniquely to USD loans, where SOFR and (until next 30 June) USD LIBOR continue in parallel, there has been a great deal of debate around the use and level of credit adjustment spreads. The UK FCA's March 2021 LIBOR cessation announcement was the trigger for setting fixed CASs for derivatives contracts referencing USD LIBOR, with such CASs to be applied when USD LIBOR ceases (i.e. over two years after that date). The CASs are intended to compensate interest-receiving parties for an expected reduction in overall interest received due to differences between USD LIBOR and SOFR, it generally being the case that SOFR is lower than USD LIBOR because it does not reflect the bank credit risk and term premium incorporated in USD LIBOR. After industry consultation, the "agreed" method for calculating a "fair" CAS for legacy derivatives was to take, for each LIBOR currency/tenor pair, the median difference between that LIBOR currency/tenor and the relevant RFR compounded over the same period for the five years ending on 5 March 2021.[20] The continuation of USD LIBOR in parallel with SOFR has meant interest payers can compare these CASs with current spot spreads between USD LIBOR and SOFR and what they have been seeing is that the spot spreads have generally been lower.[21] Indeed in parts of 2022, SOFR has actually been higher than USD LIBOR. This has created disincentives for parties to actively transition legacy USD LIBOR exposures adopting such fixed CASs.[22]

For new originations the difference has been even starker. The US leveraged loan market has seen a variety of approaches to this, including no CAS, a 0.10%, 0.15% and 0.25% "CAS curve" for one-, three- and six-month interest periods, a 0.10% flat CAS regardless of interest period duration and the five-year historic median CAS noted above.

However, the recent environment of rising interest rates has seen some indication of transactions incorporating a CAS (as opposed to no CAS) or including a CAS higher than such curve.

Given that many legacy loans incorporate provisions that, either automatically or with agreement among the parties, seek to facilitate a change of interest basis from LIBOR to RFRs by taking into account recommendations from RFR currency working groups and/or regulators and, in some cases, market practice, there is plenty of scope for disagreement around what represents a "fair" CAS (if any). Whilst the threat of litigation has failed to materialize in relation to sterling, Japanese yen and Swiss franc LIBOR transition, the same may not be the case in the US.

Into 2023 and beyond

The end of USD LIBOR is looming in little over six months' time, and the challenge of transitioning legacy USD LIBOR contracts persists. The UK FCA and ICMA have noted that particular issues may exist with respect to USD LIBOR bonds issued under English or other non-US documentation.[23]

18 Tokyo Financial Exchange has announced that it will offer some options and futures products that use compounded TONA beginning in 2023. TFX to launch compounded TONA based products | News File Tokyo Financial Exchange Inc.

19 Certain financial institutions have pressed for US regulators to lift the use-based restriction on Term SOFR hedges to increase liquidity. See, e.g., Risk.net, Lag in the SOFR-linked non-linear derivatives market: three barriers to transition.

20 These can be found HERE.

21 For example, on 30 September 2022, the spot spread between three-month USD LIBOR and three-month Term SOFR was 0.16142% as compared with the five-year median spread of 0.26161%.

22 The SOFR Academy has proposed to handle the CAS issue differently, using USD Across-the-Curve Credit Spread Indices ("AXI"), which are intended to be used in conjunction with SOFR. See Invesco USD Across-the-Curve Credit Spread Indices (AXI) now accessible via Bloomberg and Refinitiv - SOFR Academy.

23 See UK FCA, FCA encourages market participants to continue transition of LIBOR-linked bonds | FCA, and ICMA, Response to FCA Consultation Paper CP22/11 on Winding Down 'Synthetic' Sterling LIBOR and US Dollar LIBOR.

The UK FCA has recently launched a consultation on compelling ICE to publish synthetic versions of the one-, three- and six-month tenors of USD LIBOR until the end of September 2024.[24] These synthetic USD LIBORs are proposed to be composed of the equivalent Term SOFRs published by CME Group together with addition of a fixed CAS. Whilst this would assist with unremediated contracts that are not covered by US "*tough legacy*" laws, there is undoubtedly a challenge to encourage the use of SOFR in new originations worldwide and to deal with the still enormous stock of legacy exposures.

Some multicurrency facilities in the US market have used a "*daily simple*" mechanism to calculate interest for RFRs in non-USD currencies, rather than calculating interest on a compounded in arrears basis.[25]

It is noticeable that the US market practice in relation to US dollar loans is influencing other markets. An increasing number of English law papered deals now include Term SOFR, rather than compounded in arrears SOFR, for US dollars, and are adopting a number of the same positions in relation to CASs. We anticipate that this trend will continue.

All those involved in leveraged deals should familiarize themselves with the US dollar rate replacement options and, where it makes sense to do so, seek to actively transition existing exposures as soon as practicable. This will avoid the expected scramble of activity as 30 June 2023 nears.

And a few words on euro loans and non-LIBOR IBORs?

The noises from the Eurozone remain firmly behind the continued publication of EURIBOR. Following its reform in 2019 and even a new panel bank member (Raiffeisen) (re-)joining in 2022, euro users, at least in cash markets, remain wedded to the rate. However, it remains to be seen whether the success of RFRs in other major currencies, particularly US dollars, will influence this thinking.

The development of alternative RFRs and cessation of IBORs for other non-LIBOR currencies are actively under consideration. For example, all remaining Canadian Dollar Offered Rates are scheduled to cease after 28 June 2024 and Poland's Financial Supervision Authority recently announced plans to end WIBOR in 2025. In many jurisdictions where no decision has been taken on terminating an IBOR, the relevant regulators have overseen the development of alternative RFRs and are actively encouraging their use.[26]

For the euro itself, the end of 2021 saw the end of an overnight risk-free rate (**EONIA**) and this has increased use of €STR in derivatives markets. Term €STRs are also being developed by ICE/EMMI[27] and Refinitiv[28] (similar to Term SONIAs and Term SOFRs for sterling and US dollars respectively, these are forward-looking rate based on transactions in the derivatives markets), which may ultimately encourage the adoption of Term €STR in the loan markets.

24 UK FCA "Consultation on 'synthetic' US dollar LIBOR and feedback to CP22/11" (November 2022)
25 See, e.g., the LSTA Simple RFR Multicurrency Concept Document.
26 See, e.g., FSB, Interest rate benchmark reform: Overnight risk-free rates and term rates.
27 Efterm® for one-week and one-, three-, six- and twelve-month tenors was launched on 10 October 2022 (Launch of EFTERM® (emmi-benchmarks.eu)).
28 A prototype for one-week and one-, three-, six- and twelve-month tenors was launched on 26 October 2022 (Refinitiv launches prototype forward-looking €STR term rate | Refinitiv).

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