Edition 8: July 2020

COMMERCIAL BANKING

IBOR TRANSITION NEWSLETTER

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Welcome to our eighth Newsletter, which provides an update on the transition away from LIBOR and other Interbank Offered Rates (IBORs). 2021 is fast approaching and this newsletter aims to raise awareness and provide updates on key developments. We will continue to send this newsletter to you regularly during the period of transition. We hope you will find it informative.

Please contact your Relationship Team if you have any questions or queries on the contents.

What has happened recently

During July, UK and US regulators placed increased emphasis on the need to move away from LIBOR and their efforts to facilitate transition gathered pace. “The message is now clear to those who have remained on the side-line: this is a necessity not a choice and there are eighteen months left to transition,” remarked Andrew Bailey, Governor of the BoE, at a jointly hosted webinar with the New York Federal Reserve. Andrew Bailey noted that proposed legislation to tackle ‘tough legacy’ situations and the finalisation of the ISDA protocol are important steps in the ‘endgame’, which is becoming clearer. ISDA definitions and protocol to support LIBOR transition are due to be published in the coming weeks, subject to regulatory approval.

Andrew Bailey also stressed that: 1) from October all UK Banks should be offering alternatives to LIBOR; 2) there should be no further sterling LIBOR linked lending after the end of March 2021; and 3) the pool of contracts referencing LIBOR is shrunk to an irreducible minimum ahead of LIBOR’s expected cessation leaving behind only those contracts that genuinely have either no or inappropriate alternatives and no realistic ability to be renegotiated or amended. On this last point, he warned that those who do decide to rely upon regulatory action enabled by government legislation will have no control over the subsequent economic terms of the contract.

Key FCA announcements

In June, the UK Government announced that it intends to bring forward legislation giving the FCA enhanced powers to help manage and direct the orderly wind-down of critical benchmarks such as LIBOR, and to help deal with the problem of “tough legacy” contracts. In simple terms, “tough legacy” contracts are those that cannot transition – see the “A closer look” section for more detail; other good sources of information on this legislation include the statement from the FCA welcoming regulation to support LIBOR transition and an accompanying questions and answers document.

Aside from commenting on the “tough legacy” legislation, in a letter to ISDA, the FCA also clarified the basis for which a notice that LIBOR will no longer be representative or cease will be provided (e.g. one or more banks stops quoting after 2021), and that the fallback rates themselves will apply from whichever of the events of cessation or loss of representativeness occurs first. The dates of these events of cessation or unrepresentativeness may change following the original announcement. Both the dates and mechanics behind LIBOR’s eventual end are important because they have an effect on how contractual fallbacks will operate in both cash and derivative products; for example, the date of the announcement of cessation or unrepresentativeness will dictate the calculation point for the ISDA spread adjustment. As a result, the FCA sees many advantages in providing market participants with advance notice of cessation or loss of representativeness and they will work to help to achieve this

ARRC issues new recommendations

Elsewhere, good progress specific to US dollar transition is also being made. The Alternative Reference Rates Committee (ARRC) issued several recommendations and updates at the close of June. These included two further recommendations for spread adjustments for use in fallbacks for cash products. The first, was that the spread adjustment will match the value of the ISDA spread adjustments to USD LIBOR; with special considerations and a 1-year transition period applying to consumer products. The second, was where there is a pre-cessation event, the 5-year historical median spread adjustment will be determined at the same time as the ISDA spread adjustments. Both recommendations follow a supplemental consultation on technical issues related to spread adjustment methodologies for cash products issued in May.

The ARRC has also provided an update on the recommended contractual fallback language for USD LIBOR denominated syndicated loans, to include the use of simple daily SOFR in arrears in the second step of the waterfall and to include a more permissive early opt-in trigger allowing parties to switch over to an alternative rate before LIBOR is officially discontinued or determined to be non-representative. For context, these updates amend the "Hardwired Approach" initially released in April 2019, and are in line with one of the ARRC's 2020 Objectives to publish revision to syndicated loans' hardwired fallback language by 30th June, and support the Best Practice Recommendation that syndicated loans begin using hardwired fallback language no later 30th September 2020.

The recent work on US dollar transition coincides with comments from New York Fed President John Williams, who alongside Andrew Bailey, echoed the motivations for a timely transition. Looking ahead, President Williams outlined the key focus areas of the ARRC, which include addressing the challenges associated with legacy contracts, the development of a forward-looking SOFR rate, and finalising the ARRC recommended spread adjustment for legacy contracts transitioning to SOFR.

New reference materials are available

In support of all of the work toward transition, the pool of reference materials has continued to grow. The ARRC released a transition aid for SOFR adoption, intended to support market participants in their transition to SOFR from USD LIBOR. In addition, the ARRC is hosting a SOFR Summer Series, of webinars taking place in July and August designed to educate audiences on LIBOR transition. Meanwhile, the BoE has confirmed the publication date for a compounded SONIA index for 3rd of August. Each day's index will be made freely available on the BoE's Interactive Statistical Database by 10:00 a.m. London, England time on the business day after it is first published. The index series will be provided back to 23rd of April 2018. On top of this, ISDA has provided a new publication to help prepare for the discontinuation of LIBOR titled "Benchmark Reform at a Glance".

A closer look

"Tough legacy" and UK legislation

The FCA defines (in its Benchmarks Regulation – proposed new powers publication) "tough legacy" contracts as those which genuinely have no or inappropriate alternatives to LIBOR, and no realistic ability to be renegotiated or amended or in simple terms contracts that cannot transition before end 2021. Thankfully, it is understood that such contracts only represent a small minority of situations. In all other cases, regulators and the industry expects to end the use or dependency on any LIBOR currency or tenor as a reference rate before cessation at the end of 2021.

To address the potential issues that will be presented by these "tough legacy" contracts after cessation, the UK government is proposing legislation that will provide the FCA with the regulatory powers to enable it to manage and direct an orderly wind-down ahead of eventual LIBOR cessation and in such a way that protects consumers and ensures market integrity. To achieve this, the legislation will give the FCA the authority to direct methodological changes that allow for the use of a LIBOR benchmark solely for "tough legacy" contracts. Any action taken by the FCA will be after the FCA has deemed a LIBOR rate and tenor to be non-representative; this is most likely to be due to there being insufficient input data (bank submissions) for the LIBOR in question.

The UK legislative solution does not represent a panacea for the "tough legacy" problem. In June, the FCA commented that the use of these powers might not be possible in all circumstances or for all LIBOR

currencies, for example where the inputs necessary for an alternative methodology are not available in the relevant currency. In addition, the FCA has highlighted that parties who rely on regulatory action enabled by the legislation will not have control over the economic terms of that action. This is in contrast to those contracts which can transition ahead of the end of 2021.

The outcome of potentially different approaches required for “tough legacy” in UK and US jurisdictions is another key consideration. The UK has an existing regulatory framework which covers the use of critical benchmarks such as LIBOR within the UK and the European Union. This means that the UK government approach is to legislate to amend and strengthen that existing regulatory framework, rather than to directly impose legal changes on LIBOR-referencing contracts that are governed by English law. The US, in contrast, which does not have a similar legislative framework, is considering imposing legal changes to LIBOR referencing contracts under New York law.

Looking ahead, the FCA has promised to consult with the market on “tough legacy” contracts and publish a policy statement on how it will exercise its powers in relation to dictating a change in the calculation methodology. Further clarity on what constitutes a legacy contract is still pending and changes to the underlying methodology of calculating LIBOR, in the event it is deemed non-representative, is yet to be determined. On this final point, the FCA has indicated that it will consider the work already done in terms of establishing credit and term adjustment spreads, some of which have already been adopted for risk free rate transitions and are to be specified within the revised fallback language due to be published by ISDA at the end of July.

In summary, the approach towards what will constitute an extremely limited pool of “tough legacy” contracts is to extend the life of LIBOR for use only in those contracts through the introduction of a more robust methodology dictated by the FCA. Once it is announced that a LIBOR rate has been deemed either non-representative or due to cease, the clock will be ticking for the vast majority of contracts that will need to transition to an alternative rate either before or at the point the LIBOR rate can no longer be used or is no longer available. Greater clarity on ‘tough legacy’ is anticipated in coming months.

For additional information from Lloyds Banking Group on the transition from LIBOR, please see our website which includes our 'LIBOR: the countdown to 2021' paper and latest reference materials here:

Click here to visit our website >

Please let your Relationship Manager know if you have any feedback or suggestions.

Yours sincerely

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IBOR Transition Programme
Lloyds Bank Commercial Banking

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