CLEARY GOTTLIEB

ALERT MEMORANDUM

LIBOR Transition: The Time to Act is Now

11 February 2020

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

LONDON

Jim Ho
+44 20 7614 2284
jho@cgsh.com

Ferdisha Snagg
+44 20 7614 2251
fsnagg@cgsh.com

Jonathan Griggs
+44 20 7614 2312
jgriggs@cgsh.com

On 16 January 2020, the Bank of England (the "BoE"), the UK Financial Conduct Authority (the "FCA") and the Working Group on Sterling Risk-Free Reference Rates ("RFRWG") published a set of documents outlining priorities and milestones for 2020 on LIBOR transition.[1]

UK regulators have signalled that 2020 is a critical year in the transition efforts from LIBOR to alternative risk-free rates such as the Sterling Overnight Index Average ("SONIA"), the RFRWG recommended replacement rate for Sterling LIBOR-referenced transactions. The suite of publications released last month set out key priorities and milestones for transition progress in 2020, and help to provide greater clarity on a number of issues central to LIBOR transition. An overarching theme of the documents (and the heading of the associated press release) is that for affected market participants, both on the sell- and buy-side, "the time to act is now". In this alert memorandum, we highlight the key priorities and expectations set out by the BoE, the FCA and the RFRWG for 2020, as well as providing an update on some of the issues addressed by the publications. We also include a checklist of things the buy-side should know in order to prepare for LIBOR discontinuation and guidance for bond issuers looking to amend their legacy floating rate notes.

TOP LEVEL PRIORITIES AND EXPECTATIONS FOR 2020	
RFRWG	BoE & FCA
— No new issuances of GBP LIBOR-based cash products maturing beyond 2021 by end of Q3 2020. — Taking steps throughout 2020 to promote and enable widespread use of SONIA compounded in arrears ("Compounded SONIA") and demonstrate that it is easily accessible and usable.	— The BoE and FCA support the targets set by the RFRWG. — **The intention is that Sterling LIBOR will cease to exist after the end of 2021. No firm should plan otherwise.** — Action in the following areas is key and should feature in firms' planning from Q1 2020: • product development;

[1] https://www.fca.org.uk/news/press-releases/next-steps-libor-transition-2020-time-act-now.

— Taking steps to enable a further shift in volumes from GBP LIBOR to SONIA in the derivative markets.

— Establish a clear framework to manage transition of legacy LIBOR products to significantly reduce the stock of Sterling LIBOR referencing contracts by Q1 2021.

— Considering how best to address issues relating to “tough legacy” contracts.

- reviewing infrastructure, including updating loan system capabilities;
- client communications and awareness; and
- updating documentation.

— Market makers should work to ensure the market standard for Sterling interest rate swaps is SONIA from 2 March 2020 onwards.

2020 ROADMAP – KEY MILESTONES

Q1 2020

— “Tough Legacy” paper expected to be published by the RFRWG Tough Legacy Task Force in mid-Q1 2020 establishing the anticipated extent of “tough legacy” contracts, particular factors which make these “tough legacy” contracts less likely to be able to convert away from LIBOR and any potential mitigants suggested by market participants to address the risks identified.

— A “beta” forward-looking Term SONIA Reference Rate (“TSRR”) is expected to be published for testing purposes by end-Q1 2020.

— Market makers are encouraged to switch the convention for Sterling interest rate swaps from LIBOR to SONIA on 2 March 2020.

— The end of Q1 2020 is targeted for key infrastructure to become available from Treasury Management Systems and loan vendors to use compounded SONIA.

— ISDA protocol on IBOR Fallbacks for 2006 ISDA Definitions (the “ISDA Protocol”) is expected to be published by end-Q1 2020.

Q2 2020

— Summary feedback on the RFRWG consultations on credit spread adjustments for SONIA in cash products is expected to be published in mid-Q2 2020.

— A cash legacy transition paper is expected to be published by the RFRWG in Q2 2020 to assist participants in amending legacy loans referencing LIBOR by Q1 2021.

— The expected target for adoption of the ISDA Protocol is end of Q2 2020.

Q3 2020

— Provisional live TSRR aimed to be published by administrators in Q3 2020.

— Target for end of Q3 2020 for no more new GBP LIBOR cash product issuances.

CLARIFICATION OF CERTAIN ISSUES IN 2020

WHAT IS THE TERM SONIA REFERENCE RATE AND IS IT APPLICABLE TO MY BUSINESS?

— In April 2017, the RFRWG recommended SONIA as their preferred risk-free rate ("RFR") replacement for GBP LIBOR.

— Compounded SONIA has been traded in the derivatives market for over 20 years. SONIA is an overnight interest rate that is calculated using an average of the previous day's Sterling-denominated deposit transactions. Compounded SONIA relies on a compounding methodology to calculate SONIA over a longer interest period. The daily values of SONIA throughout the relevant interest period are compounded, with the calculated rate being set a few days in advance of the payment date to allow for the payment to be known in advance and settled.

— However, due to its backward looking nature, and the short lag-time between the rate becoming known and payment becoming due, Compounded SONIA may not be appropriate for all types of borrowers and transactions.

— Smaller corporate, wealth and retail clients, for whom simplicity and/or payment certainty is a key factor, may wish to consider alternative rates, such as TSRR, which is a forward-looking rate based on SONIA overnight indexed swap ("OIS") data.

— Trade and working capital products that use forward discounted cash flows may require a forward-looking rate, as might export finance and emerging market loan clients that require much more time to make payments of interest.

— It will likely not be appropriate for Islamic finance products to utilise Compounded SONIA, because the variable rate of return needs to be pre-determined.

— Four administrators (FTSE Russell, ICE Benchmark Administration, Refinitiv and IHS Markit) are working on the development of TSRR. It is expected that TSRRs will be published in Q1 2020 for a period of observation so that market participants can understand the nature and behaviour of the rates before they are used.

— UK authorities have made clear their preference for the market to adopt a broad-based transition to Compounded SONIA, with the use of TSRR being limited. Regulators have identified certain key benefits of Compounded SONIA over TSRR:

- Compounded SONIA is more robust than the prospective TSRR, because the volume of transactions underlying Compounded SONIA is currently approximately 13 times the volume of transactions in the SONIA OIS markets underlying the prospective TSRR on an average day.
- Compounded SONIA is becoming more widely used in the derivatives markets. Market participants with hedged cash products will want the rates in their cash products to be calculated on the same basis as their derivatives to minimize the risk of a spread developing and ensure effective hedging.
- Compounded SONIA is now the norm for sterling-denominated floating rate notes ("FRNs"). Compounded SONIA can therefore be used consistently across the derivatives, bonds and securitisation markets.
- Compound-in-arrears rates will be available in all currencies where an RFR rate is available. However, term rates will not be made available in all currencies (for example, CHF). For multi-

currency borrowers, using Compounded SONIA supports a consistent approach across different currencies where possible.

- The RFRWG has released a "Decision Tree Model" to determine whether Compounded SONIA or TSRR is more appropriate for your business and product areas in which you have exposure. The RFRWG considers that Compounded SONIA is likely operationally achievable for approximately 90% by value of the Sterling LIBOR loan market.
- It is advisable to consult internally, as well as with your product providers and professional advisors, to determine whether Compounded SONIA is operationally workable or appropriate for your business.

BOND ISSUERS TAKE NOTE: TRANSITIONING AWAY FROM LIBOR REFERENCING BONDS BY WAY OF CONSENT SOLICITATION

— There are still certain outstanding bond contracts which reference Sterling LIBOR that are due to mature beyond the end of 2021. These "legacy bonds" will need to be transitioned to a SONIA-based reference rate. A failure to transition these legacy bonds may adversely impact the bond (for example, many legacy bond contracts contain a fallback to a fixed rate in the event that the floating rate cannot be determined) and create contractual uncertainty and litigation risk.

— The RFRWG considers that the most orderly transition from LIBOR to SONIA in floating rate bond contracts is to replace or amend these contracts *before the fallback provisions are triggered*, that is, before LIBOR is discontinued or declared by the regulators to no longer be representative. This can be achieved by way of consent solicitation to amend the bond conditions through bondholder consent.

— As of the date of this alert memorandum, eight consent solicitations with a total nominal value of £4.2 billion have succesfully amended English law legacy bond contracts from LIBOR to SONIA.

— Unless these are already explicitly provided for in the bond terms and conditions, there are no mandatory terms governing such transition. Parties may agree on the specific fallbacks and spread adjustments methodologies (which are designed to minimize value differences between LIBOR and the applicable RFR).

— In each of the consent solicitations that have taken place so far, the interest rate provisions have been amended to reference SONIA compounded daily in arrears plus a fixed spread adjustment (which looks at the difference in value of LIBOR and SONIA basis swaps over time and adds this to the original margin of the bond). It is hoped that the publication by ISDA of finalised arrangements for calculating a spread adjustment for fallbacks in derivatives contracts will enhance bond market participants' confidence in existing methodologies for calculating the spread adjustment in relation to alternative RFRs in the floating rate bond market.

— The RFRWG has published a number of considerations for market participants when conducting consent solicitations in order to transition English law bonds away from LIBOR:

1. **Consider each legacy bond separately:** Market participants should carefully consider the suitability of consent solicitation as an appropriate course of action in respect of *each* legacy bond, in all cases assessed on its own merits.
2. **Consent fees and other incentives may not be appropriate:** Given it is in the interest of both issuers and bondholders to remove exposure to LIBOR risks, consent solicitations undertaken for this purpose have not typically involved the payment of consent fees or any

other incentives to vote for the resolutions effecting amendment or transition away from LIBOR.

3. **Consider pre-announcing a consent solicitation by way of an RNS announcement:** To enable open dialogue between issuers and bondholders regarding the terms of any consent solicitation, issuers may consider pre-announcing a consent solicitation by way of an RNS announcement.
4. **Consider any other necessary consequential amendments:** There may be necessary consequential amendments required as a result of transitioning the relevant bonds to a replacement RFR. Issuers and bondholders should therefore consider the necessity and consequences of making any *additional* amendments to the conditions of the bonds.
5. **Consider timing issues related to the pricing date for any adjustment spreads:** Parties should consider the implications of any delay between the date on which the extraordinary resolution is passed and the pricing date for any adjustment spread as market prices may move. The same consideration applies to a gap between the date on which the amendment is deemed effective and the pricing date for the adjustment spread.
6. **Parties should adhere to the timing deadlines related to the consent solicitation process:** All parties to the consent solicitation (including, as applicable, the custodians, agents and trustees) should have regard to timing deadlines specified in bond documentation and ensure the timely sequencing of steps required to give effect to the consent solicitation. This should ensure a smoother and more efficient consent solicitation process.

LIBOR TRANSITION: WHAT THE BUY-SIDE NEED TO KNOW IN 2020

— **Buy-side responsibility**: The responsibility for transitioning away from LIBOR does not just fall on banks and financial products providers. All users of a contract referencing LIBOR must ensure that LIBOR dependence is removed by end-2021.

— **Establish where your LIBOR exposures are**: LIBOR references may be found in mortgages, loans, deposit facilities, derivatives, floating rate notes as well as in ancillary contract terms (leasing and servicing contracts), company pension schemes, commercial contracts and discount rates used in valuations. It is important to understand what will happen to these contracts if LIBOR is no longer available.

— **Familiarise yourself with SONIA (and the chosen RFRs for other LIBOR currencies to which you are exposed) and what it means for you and your business**: SONIA is not a like-for-like replacement for LIBOR and cannot be directly substituted into existing contracts. Given the differences between LIBOR and SONIA, your business may need to make changes to your systems in order to use and make payments linked to SONIA. The same exercise should be undertaken for alternative RFRs where your business is exposed to LIBOR referencing contracts for other currencies.

— **Speak to your bank, product provider, financial services professional or advisor**: Ask your bank what preparations they are making and what that means for your business. It is important that you understand how the new rates differ so you are prepared when providers get in touch about transition and the actions needed.