COVINGTON

LIBOR Transition: A Step Plan for Businesses

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Finance

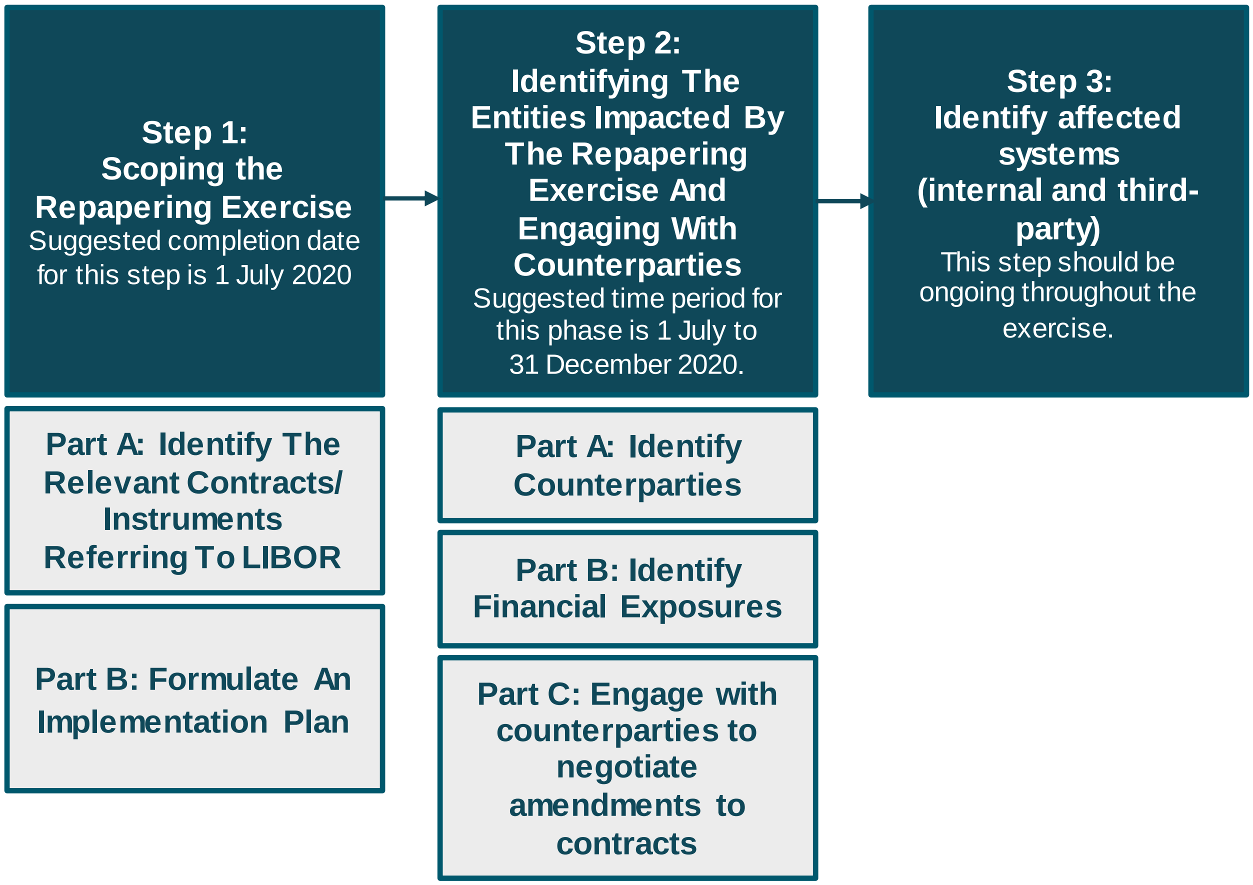
Overview

In July 2017, the UK Financial Conduct Authority (FCA) announced the likely discontinuation by the end of 2021 of the London Interbank Offered Rate (LIBOR), the interest rate index used in calculating floating or adjustable rates for many loans, bonds, derivatives and other financial contracts.

As LIBOR underpins approximately U.S. $300 trillion in financial products, the possibility of its discontinuation will trigger a major repapering of all the contracts that currently reference LIBOR. This repapering is needed because the LIBOR reform has not been anticipated by the contracts, which threatens both business and contract continuity. (For more information on LIBOR generally and further background on the reform, see Practical Law's *Practice note, Interest rate benchmark reform: reform of existing rates*.)

This step plan has been designed to assist in-house lawyers and their colleagues in corporate treasury teams tasked with advising on and project managing the LIBOR repapering exercise. The repapering process is likely to be initiated by some counterparties such as financial institutions. However, following this step plan will enable businesses to take a proactive role in negotiating the exercise successfully and minimise business disruption. The flowchart overleaf summarises the steps that should be taken.

Flowchart step plan for implementing the LIBOR transition



Step 1: Scoping the Repapering Exercise

The suggested completion date for this step is **1 July 2020**

Part A: Identify The Relevant Contracts/Instruments Referring To LIBOR

Check that all the group's contracts are digitised. If planning to use an automated solution, it may be necessary to digitise the older contracts and other instruments, which may not be in digital form. If relevant, ensure that this is done in a format compatible with the automated solution that you have chosen

Part B: Formulate An Implementation Plan

- Nominate a person responsible for gathering and centralising all contracts for each business unit, each team and so on. Involve IT and assistants as much as possible as they can be crucial tools for this gathering exercise. IT may be able to access relevant servers and download all files and folders which, if using an automated solution, can then be scanned and analysed by AI tools. All contracts should be sent to an internal central location, ideally to a sharing platform. The central location will organise the contracts in accordance with specified criteria: for example, teams, type of contracts and so on.

- Ensure access is given to the relevant persons on a need-to-know basis. For example, access should be given to the relevant in-house legal team members/working groups responsible for reviewing the contracts, but may not need to be given to the entire legal team. The finance and risk teams may also need access to be able to assess the group's financial exposures.
- Ensure that the contracts are regrouped logically. For example, hedging documents (ISDA master agreements) should be placed in the same bucket as the loan documentation they relate to, as should internal contracts that relate to ones with external counterparties (for example, intragroup funding arrangements that are "back-to-back" with financing provided by external lenders).
- Once the contracts have been stored on the central location, they should be analysed either manually by a team of paralegals or lawyers or by using an AI tool. An AI tool may potentially be able to extract the provisions of each contract impacted by LIBOR reform. A spreadsheet with a list of each LIBOR provision impacted may be generated for each contract. LIBOR provisions and clauses which are likely to be impacted include interest payment clauses, payment dates and repayment dates, break costs, margin, default interest clauses, fall-back interest provisions, ancillary contract terms (leasing and servicing contracts), as well as discount rates used in valuations.
- It may be prudent to combine the latter exercise with the identification of other contracts which use interbank rates other than LIBOR, including EURIBOR, and assessing whether it would be commercially sensible to make any changes at this time. For example, identifying performance benchmarks in derivative contracts.
- Decide on an approach to amending the contracts and create a template amendment agreement for each type of contract, including agreeing with the counterparty who is leading the amendment process. For instance, it may be agreed to move straight to a replacement rate and/or insert a hardwired switch over mechanism and/or streamline the process for making the necessary amendments at a later date (for example, reducing the majority required to make necessary amendments in the case of a syndicated financing). This will be the most labour-intensive part of the process given the number of contracts involved. Using a document automation or AI tool may ease the process of preparing the amendment agreements. However, the templates produced will then have to be tailored for each contract by the dedicated working group.
- Identify which business unit/person is responsible for agreeing on the replacement rate provisions.

Step 2: Identifying The Entities Impacted By The Repapering Exercise And Engaging With Counterparties

The suggested time period to complete this phase is **1 July to 31 December 2020**.

Part A: Identify Counterparties

- **Intra-group**

  This should (hopefully) be the easiest part of the process as it involves entities within the group. Designate one or more persons from the dedicated working group/within the business unit to contact each entity. It may be possible in this instance to enter into a global amendment for all group entities in order to document the replacement provisions.

- **Corporate Counterparties**

  This is similar to the process for intra-group. However, it will not be possible to enter into a global amendment agreement. Amendments will be effected on a case by case basis.

- **Financial institutions**

  Contact the relevant relationship manager of each financial institution. The group may have loan and other financing agreements (of different types) with its relationship banks in numerous jurisdictions so it would make sense to centralise the LIBOR transition process with each of them rather than dealing with contacts in each of those jurisdictions. Other financial institutions (local banks, for example) will have to be contacted individually. A way to manage this could be for a person for each team/business unit (as appropriate) to lead that process and then report to a dedicated team by a pre-agreed date. In most contracts relating to project finance projects/syndicated loans, the lenders' consent will be required (as opposed to just the agent bank's consent), either at a majority level, special majority or unanimous level. If intercreditor arrangements are in place, the consent of other lending groups may be required (for example, the junior creditor group may need the consent of the senior creditor group to amend the junior financing arrangements and vice versa).

Part B: Identify Financial Exposures

- Companies must identify any financial exposure likely to be caused by a repapering exercise. Replacing a reference to LIBOR with a reference to the relevant near risk-free rate (RFR) in a contract is likely to have an economic impact on the group. What is required to compensate for this economic impact may depend on the product concerned. RFRs are numerically lower than LIBOR, so they would inevitably affect the values of these products. There will likely be exposures to interest rate risk, affecting mutual liabilities and creating a gain for one party, but a loss for another. This could cause disputes where an equivalent value or compensation may not be agreed to rectify the balance. Parties will need to decide and agree on a suitable replacement rate for each type of contract/each contract (for example, the relevant RFR/Bank of England base rate/standard variable rate of a particular bank).
- Building an inventory of the group's exposure may help build a taxonomy of new provisions to suitably replace the original provisions that require repapering. For example, if contracts are amended to include new fall-back provisions envisaging a

transition from LIBOR to RFR on certain trigger events, a methodology to calculate a spread or term adjustment to add to the RFR to make it the economic equivalent of LIBOR may be required. To do so, companies need to know what their exposure is. It is important to understand the commercial implications of the changes. Risk management, legal and accounting issues are likely to be at the forefront of this exercise and to account for any potential disparities arising between LIBOR and its replacement. Business input will be required to determine any credit spread or term adjustment that is required to be added to the replacement RFR being adopted in the contract so that the new rate is as economically close as possible to the LIBOR rate being replaced. This will require engagement with both the finance and risk divisions of the group.

Part C: Engage with counterparties to negotiate amendments to contracts

- Once an agreement has been reached with each counterparty, the amendments to the contracts may be implemented. Global amendments may be entered into with certain counterparties in relation to multiple bilateral agreements if the same RFR (and related provisions) will be used for all relevant contracts. Where more than one counterparty is involved or contracts with the same counterparty do not contain the same affected provisions, bespoke amendment agreements will have to be entered into.

Step 3: Identify affected systems (internal and third-party)

This step should be ongoing throughout the exercise.

- Some repapering exercises have a knock-on effect on the group's systems. In the case of moving to a rate other than LIBOR, which is embedded in many companies' systems for various calculation purposes, this is likely to be the case. Building an inventory of the systems that use LIBOR, for example, will help to develop detailed business requirements for system enhancements to integrate and "operationalise" fallback language contemplating a change to another rate (or, indeed, the actual change if the switch to another rate is effected immediately) into operations and IT processes. This should be checked with IT and operating teams.
- Ensure appropriate document retention and good housekeeping.

Other considerations to be taken into account

Businesses will need to consider the impact of the following on the repapering exercise:

- *Impact of COVID-19*
- *Tax considerations*
- *Accountancy considerations*

Impact of COVID-19

The FCA has confirmed that the end of 2021 deadline has not changed despite the COVID-19 pandemic (see Practical Law's *Legal update, COVID-19: FCA statement on impact on firms' LIBOR transition plans*). Firms cannot rely on LIBOR continuing to be published after this date even under the current circumstances. However, the FCA has acknowledged that the pandemic may cause delays in the implementation of some transition programmes, especially in the loan market. For example, within sterling cash markets, whilst the transition to the Sterling Overnight Index Average (SONIA) in the bond market has been largely completed, the FCA, the Bank of England, and the Working Group on Sterling Risk-Free Rates (RFRWG) recognise that it will not be feasible to complete the transition away from LIBOR across all new sterling LIBOR linked loans by the original target date (30 September 2020). There will likely be continued use of LIBOR-referencing loan products into Q4 2020, in order to maintain the smooth flow of credit to the real economy.

In a statement issued on 29 April 2020 (see *Legal update, COVID-19: FCA updates statement on impact on firms' LIBOR transition plans*), the RFRWG has recommended that:

- By the end of Q3 2020 lenders should be in a position to offer non-LIBOR linked products to their customers;
- After the end of Q3 2020 lenders, in agreement with their borrowers, should include clear contractual arrangements in all new and re-financed LIBOR-referencing loan products to aid conversion ahead of end-2021, through pre-agreed conversion terms or an agreed process for renegotiation, to SONIA or other alternatives; and
- All new issuance of sterling LIBOR-referencing loan products that expire after the end of 2021 should cease by the end of Q1 2021.

Despite the challenges presented by COVID-19, the FCA has, nonetheless, seen continued progress on LIBOR transition. The FCA, the Bank of England and the RFRWG will continue facilitating the LIBOR transition through the following measures:

- Publishing the RFRWG's approach on dealing with "tough legacy" contracts; and
- Building on methodologies to calculate a fair credit spread adjustment in legacy cash products to assist transitioning from LIBOR in cash markets.

Tax considerations

On 19 March 2020, HMRC published a consultation document and draft guidance on the expected replacement of LIBOR and similar benchmark rates after 2021 (see *Legal update, Consultation and draft guidance on UK tax impact of benchmark rate reform*). The comment period for this consultation has just been extended to 28 August 2020 because of COVID-19 (see *HMRC: Consultation on the taxation impacts arising from the withdrawal of LIBOR*). HMRC's views do not give great certainty on the direct tax impact but this is understandable; as HMRC notes, the tax treatment will, largely, be governed by the accounting treatment, which is still under review.

When an instrument is amended to reflect the replacement of LIBOR, one party might need to make a payment (or payments) to the counterparty to compensate for the changes in terms. The nature of this payment will depend on which party makes it.

If a borrower makes a payment to its lender in respect of a change to the calculation of interest, this is likely to be treated as interest, since it represents compensation for the use of the money advanced by the lender. HMRC states that, in this case, the borrower may have to withhold UK tax from the payments in a similar way to withholding from "ordinary" payments of interest under the instrument.

If a lender has to make a payment to its borrower, HMRC comments that this cannot be interest because it cannot be compensation for the use of any money. Instead, HMRC suggests that such a payment is likely to be an expense incurred by the lender to make sure the borrower continues to make (increased) interest payments. As such, UK withholding is unlikely to be necessary.

Additional payments relating to derivative contracts would be exempt from UK withholding under section 980 of the Income Taxes Act 2007.

If a payment is recognised in a company's income statement, it is likely to be brought into account for tax purposes. For companies, this is likely to be under either the loan relationship or derivative contract regimes; for other businesses, this is likely to be under the rules for trades or property businesses.

Accountancy considerations

From an accountancy point of view, the LIBOR reform may have an impact on cash-flow hedges and the 'highly probable' test. Cash-flow hedge accounting under both IAS 39 and IFRS 9 requires future hedged cash flows to be 'highly probable'. Where these cash-flows depend on an IBOR (for example, future LIBOR-based interest payments on issued debt hedged via an interest rate swap), the question arises as to whether, the issued debt's cash-flows can be considered 'highly probable' beyond the date at which the relevant IBOR is expected to cease being published.

The International Accounting Standards Board (IASB) has launched a project addressing the impact of benchmark rates (specifically IBORS) on financial instruments and financial reporting (see *IASPlus: IBOR reform and the effects on financial reporting*).

The project is divided into two phases, with Phase 1 looking at pre-replacement issues (financial reporting in the period before the replacement of an existing interest rate benchmark), which was concluded on 26 September 2019. The IASB subsequently published the Interest Rate Benchmark Reform (Amendments to IFRS 9, IAS 39 and IFRS 7), effective for annual periods beginning on or after 1 January 2020, with earlier application permitted. The amendments to IFRS 9, IAS 39 and IFRS 7:

- modify specific hedge accounting requirements, provided that the interest rate benchmark on which the hedged cash flows and cash flows from the hedging instrument are not altered due to interest rate benchmark reform;
- are mandatory for all hedging relationships that are directly affected by the interest rate benchmark reform;
- are not intended to relieve entities of any other consequences stemming from interest rate benchmark reform (for example, if a hedging relationship no longer meets the requirements for hedge accounting for reasons other than those specified by the amendments, discontinuation of hedge accounting is required); and
- require specific disclosures about the extent to which the entities' hedging relationships are affected by the amendments.

Phase 2 of the project looks at replacement issues, helping entities provide useful information to users of financial statements when changes are made to contractual cash-flows or hedging relationships, as a result of the transition to alternative benchmark rates. The proposed amendments pertain to the modification of financial assets, financial liabilities and lease liabilities, specific hedge accounting requirements and disclosure requirements. The proposed amendments are designed to address issues that might affect financial reporting when an existing interest rate benchmark is actually replaced, and include:

- **Modifying financial assets, financial liabilities and lease liabilities:**

  The IASB proposes a practical expedient for modifications required by the reform. These modifications are accounted for by updating the effective interest rate. All other modifications are accounted for using the current IFRS requirements.

- **Specific hedge accounting requirements:**

  Hedge accounting would not be discontinued solely because of the IBOR reform. Hedging relationships (and related documentation) must be amended to reflect modifications to the hedged item, hedging instrument and hedged risk. Amended hedging relationship should meet all qualifying criteria to apply hedge accounting, including effectiveness requirements.

- **Disclosures:**

  In order to allow users to understand the nature and extent of risks arising from the IBOR reform to which the entity is exposed to, and how the entity manages those risks and its progress in transitioning from IBORs to alternative benchmark rates, the exposure draft suggests that an entity would disclose information about:

  - how the transition from interest rate benchmarks to alternative benchmark rates is managed and progress made at the reporting date;
  - the carrying amount of financial assets and financial liabilities that continue to reference benchmarks subject to the reform, disaggregated by significant interest rate benchmark;
  - for each significant alternative benchmark rate to which the entity is exposed, an explanation of how the entity determined which modifications qualified for the practical expedient, including a description of significant judgements the entity made to determine the qualifying modifications; and
  - to the extent that the IBOR reform has resulted in changes to an entity's risk management strategy, a description of these changes and how the entity is managing those risks.

The IASB proposed that the application of all proposed amendments be mandatory. The IASB has also considered that the nature of the proposed amendments is such that they can only be applied to modifications of financial instruments and changes to hedging relationships that satisfy the relevant criteria; no specific end of application requirements need to be specified.

Stress-test the plan

The plan needs to be stress-tested against the scenario of LIBOR ceasing to exist at the end of 2021.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our London team:

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