KEY POINTS

- Financial institutions need to communicate clearly and fairly with their customers on matters such as:
  - LIBOR transition mechanisms;
  - interest calculation methodology; and
  - break costs, market disruption and other interest-related contractual indemnities.
- Financial institutions should be alive to the risk of:
  - mis-selling claims regarding their customer communications prior to transition;
  - disputes over the ambit of the legislative fix;
  - challenges over when and how contractual fallbacks operate when LIBOR is discontinued; and
  - disputes over what should happen to contracts where no variation is agreed, there are no effective fallback provisions and the legislative fix does not apply.
- To mitigate these risks, financial institutions should continue with the transition process to identify difficult legacy contracts, implement a clear customer communications strategy, and document and preserve all key decisions and customer communications in case they are challenged.

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LIBOR transition: managing customer relations

This article seeks to identify where friction points in borrower/lender relations may arise during the LIBOR transition process and how they may result in litigation. It then outlines some prudential measures banks should take to minimise the risk.

INTRODUCTION

One inevitable impact of the demise of LIBOR (whether at the end of 2021 or, possibly, in the case of certain US Dollar tenors, on 30 June, 2023) will be the significant complication of the methodologies for the calculation and payment of interest.

Financial institutions have been grappling with the complexities of LIBOR transition since the original announcement by the Financial Conduct Authority in 2017. Corporates, however, who will often be significantly less accustomed to the concepts used for the new interest calculation, will need to master these in a much shorter timeframe. That puts a significant burden on the financial institution in terms of their regulatory conduct requirements. The complexities will inevitably lead to some disputes and financial institutions need to prepare for these as well.

This article seeks to identify where friction points in borrower/lender relations may arise and how they may result in litigation and to outline some prudential measures banks should take to minimise the risk.

The substitute risk free rate (RFRs) to be used most commonly as a base for the substitution of LIBOR in the currencies in which it is currently utilised have now been widely identified and include the Secured Overnight Financing Rate (SOFR) for US Dollars and the Sterling Overnight Index Average (SONIA) for Sterling.

Less clear is how LIBOR will be transitioned to those rates in existing facilities and how those rates will be applied to calculate interest due.

TRANSITIONAL ISSUES

The RFRs and LIBOR are conceptually and administratively different in a number of ways:

- LIBOR is a forward looking term rate for periods of different maturities whereas RFRs are (mostly) backwards looking and measure interest charged overnight. Although forward looking RFRs are being published, the FCA has advised against using these except in a minority of cases;
- LIBOR measures the average rates at which those submitting to LIBOR could obtain wholesale unsecured funding for set periods. It therefore incorporates an element of bank and term credit risk. RFRs vary in what they measure: for example, SOFR measures the broad cost of borrowing USD overnight collateralised by US government securities. RFRs do not incorporate bank and term credit risk in the same way as LIBOR. Over an equivalent period RFRs are typically lower than LIBOR;
- LIBOR and each RFR are administered by different parties and published at different times.

In addition, the transitional periods may vary for different currencies and interest periods, particularly if the consultation by the Intercontinental Exchange (ICE) regarding a possible extension to the date of cessation of US dollar LIBOR for certain tenors to 30 June 2023 becomes fact.

It follows that the transition will be complex. In particular:

- The economic basis on which the interest calculations were underpinned will change. RFRs generally being lower than LIBOR (because they are not affected by bank and term credit), lending banks will seek to be compensated for the shortfall by adding a credit adjustment spread to the RFR. Parties will need to agree how that is calculated. There are a number of approaches being discussed in the market, such as the five year historical median approach or a forward looking approach. The details of these approaches are beyond the remit of this article but they are complex and will produce different results depending on the day on which they are calculated. In any event, it is important that parties try to eliminate value transfer between them to the extent possible.

- The calculation of the interest payable will be significantly more complicated. Under existing LIBOR referencing transactions, interest can easily be calculated at the beginning of the interest period by reference to the relevant rate, the loan outstanding and the length of the interest period. With RFRs however:
  - Interest will be calculated over an "observation period", which is equivalent to the relevant interest period but shifted back by a number of banking days known as the "look back". In this way, borrowers will have the relevant look back number of days' notice of the total interest payment due. This will provide a substantially shorter window for borrowers to arrange payment than was the case with LIBOR-based calculations.
  - Interest may involve an "observation shift" – where there is a difference in the incidence of non-banking days between the observation period and the interest period, how should the rate be weighted? Should this be by reference to the observation period or by reference to the interest period?
  - Because the RFRs are overnight rates, the calculation of interest over the observation period needs to be made using the different daily rates (unlike LIBOR where the borrower can look at the screen rate for the relevant tenor to determine the benchmark rate for the whole of the interest period). A number of calculation methods have been suggested. Borrowers will only be made aware of the amount of interest payable, and of the relatively complex methodology for calculating it, shortly before the payment is due. Systems for notifying the borrowers of interest payable, its calculation and permitting them to verify the amounts need to be implemented.

In addition, following transition, certain other contractual provisions of the facility may need re-consideration. In particular:

- **Break costs:** Currently in floating rate loan documentation, if a borrower prepays the loan mid-interest period, it will be obliged to pay to the lender break costs. Break costs are currently calculated on the assumption that the lender is match funding its loan. That is inappropriate where a loan references RFRs. RFRs accrue on a daily basis and are not an approximation of the cost to the bank of maintaining the loan. Nonetheless, lenders may suffer a loss if their funding arrangements for maintaining a loan are interrupted by a prepayment, and it is likely that lenders will seek to be compensated for this. There are a number of ways in which this could be addressed, such as by the inclusion of indemnity wording or prepayment fees.
- **Market disruption**: Floating rate loan agreements are generally drafted on the basis that LIBOR is an approximation for a bank's cost of funds, although in reality very few banks match fund themselves in the interbank market. The current market disruption clause in Loan Market Association (LMA) based documentation enables a bank to change the basis on which interest is calculated if a prescribed proportion of the syndicate is unable to fund themselves at LIBOR. However RFRs are mostly some kind of overnight deposit rate, and as such they do not represent a bank's cost of funds. So what happens if the bank transitions from LIBOR to a RFR (with an associated credit adjustment spread) but cannot actually fund itself at that new rate in the market?

  In the switch exposure drafts published by the LMA, the lender retains an ability to change the basis on which interest is calculated if a prescribed portion of the syndicate are unable to fund themselves at a rate equivalent to the cumulative compounded RFR plus the credit adjustment spread (defined as the "Market Disruption Rate").

  However, this could present problems for a borrower.
  - First, the market disruption clause can be invoked very close to the actual interest payment date when the contractual rate is ascertained. A change in the basis upon which interest is calculated at such a late stage could create budgeting difficulties for the borrower.
  - Second, because the use of RFRs as a benchmark in loan transactions is new, it is as yet uncertain as to whether proposed pricing will sufficiently reflect the cost of funds to a lender of maintaining the loan. As such, there may be a greater chance that this kind of provision is invoked. On the other hand, and for the same reason, a lender may want the ability to change the basis on which interest is calculated, if in fact the pricing of the deal using the new benchmark does not reflect their cost of funds.
- In any transaction where there are related LIBOR referencing financial products (such as a hedging agreement) then, so far as possible, those products should transition to RFRs at the same time and on the same basis. With respect to interest rate hedging, ISDA has published an IBOR Fallbacks Supplement which amends the floating rate options referencing IBORs in the 2006 ISDA Definitions. The amendments set out there will apply to transactions incorporating the 2006 ISDA Definitions entered into after 25 January 2021 unless the parties specifically agree to exclude them. The amendments provide that upon the occurrence of certain trigger events (such as IBOR cessation or a declaration by the regulator of the administrator of the IBOR benchmark that it is unrepresentative of the market it is intended to measure),

references to IBOR floating rate options will transition to new fallback rates calculated using RFRs as a benchmark.

In addition, ISDA has published a Protocol to incorporate the amendments to the 2006 ISDA Definitions into legacy transactions entered into prior to 25 January 2021. If parties opt to enter into the Protocol, then the amendments will apply to all legacy LIBOR referencing derivative contracts entered into between the parties to the Protocol unless those contracts are expressly excluded.

It is important to note that there are some differences between the market conventions recommended for SONIA and SOFR referencing loan agreements and those which have been applied in calculating the fallback floating rates in the IBOR Fallbacks Supplement and Protocol. For example, the ISDA fallback rate is calculated using a two day look back and an observation shift. This is inconsistent with the equivalent Bank of England Sterling Reference Rates Committee recommended market conventions for the calculation of SONIA (which as noted previously have also been applied to SOFR in the London market). In addition, there may also be different trigger events for LIBOR transition contained in the loan agreement and corresponding hedging agreements, particularly in older contracts. LIBOR transition with respect to hedged transactions will therefore need to be carefully managed and documented. So far as possible, differences between interest provisions in loan agreements and hedging agreements should be minimised to reduce the risk of disputes arising at a later date about the extent to which the loans have been adequately hedged.

CONDUCT RISK DURING LIBOR TRANSITION

The FCA has published a Q&A relating to Conduct Risk during LIBOR transition.[1] It includes the following recommendations:

- An overarching concern of the FCA will be whether institutions have taken reasonable steps to treat customers fairly. In particular in choosing RFRs, considering the contract as a whole, institutions need to ensure the replacement rate is fair and should consider the following:
  - LIBOR discontinuation should not be used to move customers with continuing contracts to replacement rates that are expected to be higher than what LIBOR would have been, or otherwise introduce inferior terms; and
  - institutions that insert fall back provisions in existing contracts to replace LIBOR with a new reference rate should ensure they communicate effectively how these fallback provisions are expected to operate.
- Institutions must communicate information to customers in a way that is clear, fair and not misleading. Information should be presented in good time to allow customers to make informed decisions about relevant products and the risks to which the customer may be exposed.
- Institutions who continue to market, distribute and/or sell LIBOR products that mature beyond end-2021 must explain fully what will happen in the event of LIBOR ending and its effect on the customer.
- To avoid the risk that customers do not understand how the change will affect them, institutions should consider offering alternative products that do not reference LIBOR.
- When dealing with existing customers with legacy contracts that need to be amended, institutions should communicate in good time to ensure customers can consider all the options available and respond before end-2021.

To ensure customers are appropriately informed, institutions should:

- engage with customers early to raise awareness and educate them on general implications and timing of LIBOR transition for both existing and new contracts; and
- ensure all client communications linked to LIBOR transition are clear, fair and not misleading. This means:
  - institutions should describe the risks and impacts from LIBOR discontinuation for existing LIBOR linked products;
  - where alternative options are presented for new products or to change existing LIBOR referencing contracts, any range of options should be reasonable and fairly presented, including the benefits, costs and risks; and
  - consider the knowledge and experience of the intended audience.

The FCA has also emphasised that it will challenge institutions who delay conversations with customers affected by LIBOR to the point the customer is left with insufficient time to understand their options and make informed decisions.

"TOUGH LEGACY" CONTRACTS AND THE LIBOR TRANSITION

An area of particular concern for the market has been how to transition so-called "tough legacy" LIBOR referencing contracts, where there is no realistic prospect of converting LIBOR to an alternative RFR or amending the contract to introduce fallbacks.

For these contracts, through its Financial Services Bill, the government has proposed a "legislative fix" that would provide the FCA with various powers, including the ability to designate a change to the methodology for calculating LIBOR following its cessation. This would mean that, where a "tough legacy" contract references LIBOR, it would be treated as a reference to LIBOR, but calculated using a new methodology (known as "synthetic LIBOR").

The details of the legislative solution will be the subject of FCA consultation during the course of this year. For now, a significant degree of uncertainty remains about how it will operate, including how a "tough legacy" contract will be defined and how synthetic LIBOR will be calculated. Also unclear is the extent to which such a legislative solution might have an indirect impact on other

LIBOR referencing transactions which fall outside the scope of "tough legacy" contracts but are nonetheless challenging to transition.

DISPUTES RISK

The FCA currently estimates that there are US$260trn in LIBOR referencing contracts that will need to be transitioned. Given the enormity and complexity of the task at hand, even with the industry's best efforts, it seems inevitable that litigation will arise in some cases.

The risk of value transfer will be a key issue in this context. Although much work has been, and continues to be, done through trade organisations and market consultations to reach a consensus on the adjustments that will be required to minimise the economic differences between LIBOR and replacement RFRs, the risk that transition will create commercial "winners" and "losers" remains. Some parties may seek to draw comparisons between the interest payable by them under the replacement RFR and the synthetic LIBOR published after end-2021 for "tough legacy" transactions, or between the history of the transaction before transition and their interest payments thereafter, which could in turn lead to disputes.

Mis-selling type claims

Even where parties have agreed to replace LIBOR with a RFR, there remains a risk of disputes arising post-transition. For example, some counterparties may attempt to pursue mis-selling type claims if they contend that they did not receive clear, accurate and complete information about the transition prior to agreeing the variation.

Key to mitigating this risk will be compliance with the FCA's Conduct Risk Guidance highlighted above. It is important for firms not only to take active steps to engage with their customers in good time and provide the appropriate level of information for their customer's level of sophistication, but to keep robust records of those communications, so that they can demonstrate their communications were clear, fair and not-misleading if this is challenged.

Disputes may also arise in relation to LIBOR referencing transactions that were entered into after the FCA's announcement in 2017 regarding the discontinuation of LIBOR. While the majority of these transactions should contain mechanisms to enable a transition away from LIBOR, some parties may contend that they were not provided with sufficient information about LIBOR discontinuation or the way that any transition mechanism might operate prior to entering into the transaction.

The scope of the legislative solution

Although a legislative solution for "tough legacy" contracts is a welcome development, there may, depending on the detail of the FCA's final Policy Statements, be scope for disputes about the ambit and operation of the regime.

For example, depending on the definition of "tough legacy" and the methodology for calculating synthetic LIBOR, counterparties to transactions that were treated as falling under the regime may later claim that they should not have done (and vice versa).

Furthermore, the legislative solution proposed in the UK differs from the wider proposal put forward in the US for New York law governed financial transactions referencing USD LIBOR and the European Commission's proposed legislative solution for LIBOR referencing contracts. This may result in related LIBOR referencing contracts transitioning to different benchmarks under the various different legislative solutions and raises the spectre of complex conflict of laws disputes arising.

Fallback provisions

Disputes may also arise as to how and when fallbacks in some contracts operate. For example:

- **Intention vs commercial effect**: The operation of some fallback provisions could result in a disconnect between the intention of the parties at the time they entered a transaction and its commercial effect after transition. For instance, a contractual fallback to a "Historic Screen Rate" could result in a floating rate being converted in practice into a fixed rate, which may fundamentally change the nature of the transaction to the advantage or disadvantage of one of the parties.
- **Where a contractual fallback rate cannot be calculated**: In some cases, it may not be possible to calculate a fallback rate, as envisaged in the contract. In those cases, a party may seek to persuade the courts to fill the gap by substituting an alternative rate to LIBOR. However, in the limited cases in which the courts have been willing to substitute alternative machinery for a contractual mechanism that has broken down, it has been in circumstances where there was a contractual objective standard which they could work towards by different (and non-essential) means. The central question for the courts in the context of LIBOR transition would be the extent to which LIBOR is essential to the contract. In many cases, use of LIBOR is likely to be deemed an essential feature of the contract and not merely a mechanism of reaching an otherwise agreed objective interest standard.
- **Market disruption**: The ultimate fallback rate in many loan agreements is cost of funds, expressed in the LMA loan agreements as being the "percentage rate per annum of the cost to the relevant lender of funding its participation in the loan from whatever source it may reasonably select". There may be disputes as to when and how this fallback would operate in the context of the permanent cessation of LIBOR, which may be intensified if the lender is invoking the clause shortly before the interest payment date.
- **Exercise of contractual discretion**: In cases where fallback provisions require a party to make an assessment or exercise contractual discretion (for example, in certain bonds an Issuer must determine a Successor Rate "acting in good faith and in a commercially reasonable manner"), this may be challenged subsequently by counterparties. It is advisable for firms to consider carefully to what extent their discretion is subject to any express or implied constraints and keep records to enable them to demonstrate,

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if challenged, that they took into account the appropriate considerations.

Termination, force majeure and frustration

If no variation is agreed, there are no effective fallback provisions, and the legislative solution does not apply, disputes may arise as to what should happen to the contract once LIBOR is discontinued.

For example, parties may try to persuade the courts to interpret references to LIBOR in a legacy contract as references to an alternative rate (possibly synthetic LIBOR) or to imply a term to this effect.

Parties seeking to escape what they perceive to be a bad deal may argue that the permanent discontinuation of LIBOR triggers a contractual force majeure clause (which in many cases requires performance to become "impossible" or "impracticable") or a contractual event of default, giving rise to a right to terminate the contract. Alternatively, they may contend that the contract is terminated by operation of law due to the doctrine of frustration, although this is a very high hurdle to surmount in practice.

Variation risk

The huge volume of contractual amendments required before the discontinuation of LIBOR, together with the changes to back office processes required to calculate interest by reference to the new RFRs, will themselves give rise to a risk of disputes if contractual formalities are not complied with or operational errors occur that result in incorrect calculations. These risks are amplified when, as will often be the case, there are connected transactions or where transactions involve multiple jurisdictions and laws.

ESTABLISHING LOSS

Establishing recoverable losses in disputes arising out of LIBOR transition is likely to be particularly challenging. As noted above, parties might seek to prove they have suffered a loss by reference to synthetic LIBOR, some other RFR, or to the history of the transaction, but there will remain significant scope for dispute about the quantification of any losses. Much may turn on the nature of the specific transactions, the mechanisms that were available to the parties to transition away from LIBOR, and the actions of the parties in relation to transition.

MITIGATING THE RISKS

Financial institutions should continue with transition processes so difficult legacy contracts can be identified quickly and, where possible, transitioned to replacement RFRs in good time before December 2021. The FCA has been clear that firms should not wait to find out whether these legacy contracts will fall within the definition of "tough legacy" and that a synthetic LIBOR will only be available to those contracts where there is genuinely no realistic ability to renegotiate or amend.[2] Where parties can practicably agree to convert on fair terms they should do so.

A systematic approach and clear customer communications strategy will be needed, and all decisions and communications should be clearly documented and preserved. Staff responsible for communicating with customers about the transition process to a replacement RFR should be alert to the conduct requirements and disputes risks involved. Training sessions for customer-facing staff as well as guidance on the types of mis-selling claims that could arise will help to minimise the risks. ■

1 https://www.fca.org.uk/markets/libor/conduct-risk-during-libor-transition

2 https://www.fca.org.uk/news/statements/fca-statement-planned-amendments-benchmarks-regulation

Further Reading:

- Syndicated loan market and LIBOR: pathway to the end of 2021 (2021) 2 JIBFL 106.
- LIBOR: keeping the loan market moving towards the end of 2021 (2020) 6 JIBFL 397.
- LexisPSL: Banking & Finance: running a LIBOR transition project.