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LIBOR TRANSITION FOR THE INFRASTRUCTURE SECTOR

– THOUGHT LEADERSHIP

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LIBOR TRANSITION FOR THE INFRASTRUCTURE SECTOR

With 2020 set to be a critical year for LIBOR transition, the infrastructure market will face some significant challenges as it transitions towards the use of risk-free rates (RFRs). We look at some of those challenges and the steps market participants should be taking now to ensure a smooth transition before the end of 2021.

> In most products, market participants have made impressive progress in moving away from LIBOR. The time has come to draw to a close its remaining use.
>
> —**CHRISTOPHER WOOLARD,** Executive Director of Strategy and Competition at the FCA

What does 2020 hold for LIBOR transition?

Although much progress has been made to date, regulators have made it clear that they expect the pace of LIBOR transition to accelerate this year.

The main areas of focus in 2020 will be as follows.

Cessation of new LIBOR-based cash products

In the sterling market, the Working Group on Sterling Risk-Free Reference Rates has recently reiterated its target that after the end of Q3 2020, there will be no new issuances of LIBOR-based cash products which mature beyond 2021.

Development of forward-looking term reference rates (TRRs)

TRRs are expected to be available before Q3 2020 for sterling but not until the end of 2021 for USD (as sufficient liquidity needs to develop in the SOFR derivatives market to produce a robust rate).

Regulators have, however, made it clear that they expect the vast majority of market participants to use compounded overnight rates rather than TRRs. In the UK, the Working Group on Sterling Risk-Free Reference Rates reported in January that it considered SONIA compounded in arrears to be appropriate and likely to be operationally achievable for c.90% by value of the sterling LIBOR loan market. This includes all sponsor driven loans as well as project finance and real estate transactions (although they did note that export finance and emerging markets may require alternative rates).

Increased use of compounded overnight rates

Whilst the FRN market has been quick to adopt compounded overnight rates, progress in the loan market has been much slower. The hope is that the publication by the LMA of exposure drafts based on compounded SONIA and compounded SOFR rates, as well as the circulation by the LSTA among its members of a draft concept credit agreement based on SOFR compounded in arrears, will lead to market participants coalescing around conventions for loans referencing compounded overnight rates.

> **Compounded overnight rates**
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> Compounded overnight rates involve the production of a 'term' rate by compounding overnight RFRs over an interest period or a reference period to produce a backward-looking rate.

Legacy contracts

In addition to the focus on increasing the number of new transactions referencing RFRs, there will also be increased attention on how best to transition legacy LIBOR products. The Working Group on Sterling Risk-Free Reference Rates has said that it wants to significantly reduce the stock of LIBOR referencing contracts by Q1 2021.

Increased regulatory pressure

Regulatory pressure will continue to grow as the 2021 deadline approaches. The Bank of England has said that it is "keeping the potential use of supervisory tools under review", indicating that it may move from the 'carrot' to the 'stick' approach if it feels insufficient progress is being made by regulated firms by mid-2020.

How will the infrastructure market be affected?

Whilst LIBOR transition is an issue that affects the financial markets generally, the challenge is particularly acute in the infrastructure market. Factors such as the multipartite nature of the transactions, the often long-dated tenor of the debt and the wide variety of contracts involved which reference LIBOR (directly or indirectly), all increase the complexity of the transition.

The key areas where the infrastructure finance market will be impacted are as follows.

Updating financial models

Economic assumptions in financial models around interest rates will need updating to take account of the relevant RFR as well as any credit spread adjustments. These will then factor into forward-looking debt service and interest cover projections. Depending on the terms of the particular transaction, finance parties may have a consent right or the right to challenge changes to the economic assumptions used in the model. On some transactions the agent may have the right to approve a replacement benchmark rate for the purposes of the economic assumptions, although it cannot be guaranteed that, in practice, they will be willing to exercise such discretion.

Hedging mismatch

Ensuring any floating rate debt is effectively hedged is of central importance on infrastructure transactions where changes in interest rates may materially affect cashflow. Market standard fallback provisions for derivatives transactions differ from those used in legacy contracts for bonds and loans (see *Fallbacks used in legacy contracts*). Given this lack of alignment, basis risk may arise if transactions are not amended before fallbacks come into play.

ISDA is expected to publish a protocol this year which will enable parties who adhere to it to amend legacy contracts so as to incorporate fallbacks to RFRs which would apply in the event of the permanent discontinuation of LIBOR. By contrast, in the loan market, each loan agreement will need to be amended individually and such amendments could potentially have earlier triggers than those used in the ISDA protocol. Sponsors and borrowers will therefore need to coordinate the timing of any amendments across products carefully to avoid any mismatch between interest rate swaps and the underlying cash products.

Layering of LIBOR

On many infrastructure transactions, LIBOR is not only used as a benchmark rate in finance documents, but is also embedded into the project contracts themselves. For instance, tariffs payable under offtake agreements often include a portion sized on assumed project costs which will include interest costs. Changes to benchmark rates could mean that tariffs no longer reflect actual costs to the project. Similarly, termination payments under concession agreements may embed assumptions as to interest costs based on the finance documents in force at closing.

Any changes to project contracts to ensure the tariffs/compensation payments continue to align with the debt once it references a new RFR would need to be agreed with the relevant counterparties, which may include governments or public authorities, and potentially also regulatory bodies.

Consents to amendments

Infrastructure financings often involve many sources of debt and complex intercreditor arrangements – a single deal could involve commercial banks, development finance institutions, export credit agencies, infrastructure funds and bondholders. Coordinating the consent process for any change in benchmark rate will require careful planning and coordination and may present significant challenges, especially where all lender consent is required or where certain parties have entrenched rights (for instance, export credit agencies or credit insurers).

Where any loans include multiple currencies within the same instrument, rates for those different currencies may well transition at different times. Parties may wish to wait until there is sufficient clarity in relation to all relevant currencies before making such amendments. For new contracts, there may need to be a

Fallbacks used in legacy contracts

Product	Ultimate fallback on cessation of LIBOR
European LMA-style legacy loan	Individual lender's cost of funds (either on a lender-by-lender basis or weighted average of rates supplied)
Legacy floating rate notes (FRNs)	Interest rate from the previous interest period
Derivatives (2006 ISDA definitions)	Arithmetical mean of the rates quoted by four major banks in the relevant market (e.g. London, New York, Eurozone) for loans advanced by such banks in the applicable currency to leading European banks

transition period where LIBOR is used for some currencies and RFRs for others.

Any financings which include a New York-law governed indenture will have additional complexities to deal with as it is likely that unanimous noteholder consent will be required to make the necessary benchmark-related amendments. The ARRC has been considering a potential legislative solution to address this issue. The legislative solution would involve applying an ARRC-recommended SOFR rate and spread adjustment to LIBOR-linked contracts governed by New York law where such contracts do not contain fallbacks or where the fallbacks are to a LIBOR-based rate (such as the last-quoted LIBOR rate). It is currently unclear whether a legislative solution will be sought or passed, and in what form. Until a satisfactory legislative solution is adopted, parties to these types of legacy contracts will need to consider other means to address permanent LIBOR cessation, such as refinancing, redemption, tender offers or exchange offers.

Role of Agents

The role of agents (facility agents or intercreditor/global agents) as part of any transition to RFRs will need to be considered carefully. This includes questions around how the finance parties will be managed in the context of negotiations relating to the rate change and the extent of an agent's authority to implement amendments.

The LMA's exposure draft Reference Rate Selection Agreement enables the finance parties to agree the replacement rate and its terms and then authorise the facility agent to make the various consequential amendments to a facility agreement that would be necessary at the time of LIBOR cessation. It remains to be seen whether agents are willing to exercise this discretion.

Additional complications will arise where there are multiple agents, common on infrastructure transactions, particularly those involving export credit agencies (ECAs) who will each have their own agent acting as liaison between the ECA and the other finance parties.

Action to take now – new transactions

Communications from regulators in the UK and the US have become increasingly direct as the 2021 deadline draws closer: the only way to 'future-proof' today's contracts against the end of LIBOR is to use RFRs rather than LIBOR. However, while ISDA, the LMA and the ARRC have all been developing industry-level documentation to ease market participants towards the necessary changes, the market has not yet settled on conventions for the calculation of interest for RFR-based cash products.

LIBOR transition provisions

For parties entering into new LIBOR-based funding agreements, it remains imperative to ensure maximum flexibility to transition to RFRs once the ongoing industry-level work on the technicalities of rate determination are settled.

To date, industry riders have fallen into two general categories:

- 'soft-wired amendment' or 'European-style amendment' approach – the contractual terms provide for the parties to agree on a new rate in the future (usually involving a lower consent threshold than would otherwise have been the case)
- 'hard-wired' approach – the parties agree upfront to a hierarchy of specified alternative rates.

US and European amendment approaches

- **US:** the ARRC has published wording for both soft-wired and hard-wired approaches. The use of the hard-wired mechanic has, to date, been fairly limited given the lack of certainty around conventions and systems.
- **Europe:** the LMA Replacement of Screen Rate rider follows the 'European-style amendment' approach and is now commonly used on new financings in the European market.

While neither approach is capable of eliminating all of the challenges which the parties may encounter at the time amendments are effected (including, in the case of the 'European-style amendment' approach, what happens if no agreement is reached), informed negotiation on the appropriate approach can go a long way to minimising the disruption of a later change in the benchmark rate.

For transactions with multiple sources of debt, parties should consider carefully which finance parties should have consent rights in relation to benchmark-related amendments.

The same principles can be applied where other contracts – such as offtake or concession agreements – embed interest rate assumptions. In such cases, tariff-setting mechanisms or termination payment provisions could provide for a review mechanism which is triggered by LIBOR cessation, rather than being set for the duration of the agreement.

Hedging/loan mismatch

Parties may wish to build in termination or refinancing rights, including the ability to novate hedging transactions or enter into additional hedging arrangements to guard against any potential mismatches. In addition, market participants may wish to address upfront the consequences of any 'under-hedge' position which arises if such hedging transactions are terminated in accordance with their terms in circumstances where the parties are unable to agree on a replacement rate or adjustment spread.

Action to take now – legacy transactions

Internal due diligence and risk analysis

The first crucial step is to review existing deals to determine which are scheduled to mature after the end of 2021.

For deals which mature one or two calculation periods after LIBOR is expected to cease, parties might decide it is simpler to use existing fallback provisions rather than embarking on an amendment exercise.

For deals with a longer remaining tenor, it will be necessary to review the transaction documentation to determine, among other things:

- what fallback provisions (if any) have been agreed in the finance documents and associated hedging documents in relation to the unavailability of the relevant reference rate
- whether a change of the current reference rate impacts wider project documentation and if so, whether there is scope to amend current contractual terms (for instance whether there is scope to re-open tariffs in offtake agreements)
- any interconnected products in the capital structure, for example, derivative transactions and the underlying debt
- what consents are required for a change to the finance documents and, if applicable, the project documentation.

This information can then be used to formulate a transition plan. Ultimately there is unlikely to be a 'one-size-fits-all' solution and each transaction will need to be considered on the basis of its own terms.

Conclusion

The scale and complexity of LIBOR transition cannot be underestimated. Parties should start taking action to prepare for this change as soon as possible. Those who ready themselves through due diligence and the formulation of their own transition plans will strengthen their position at the negotiation table.

"2020 will be a pivotal year in the transition journey, with critical focus on enabling the flow of new business away from sterling LIBOR."

— **TUSHAR MORZARIA,**
Chair, Working Group on Sterling Risk-Free Reference Rates

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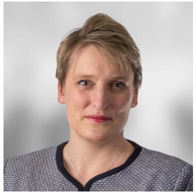

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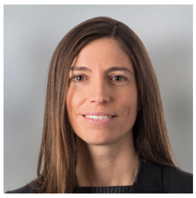

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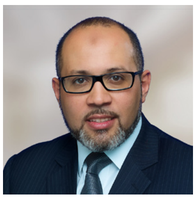

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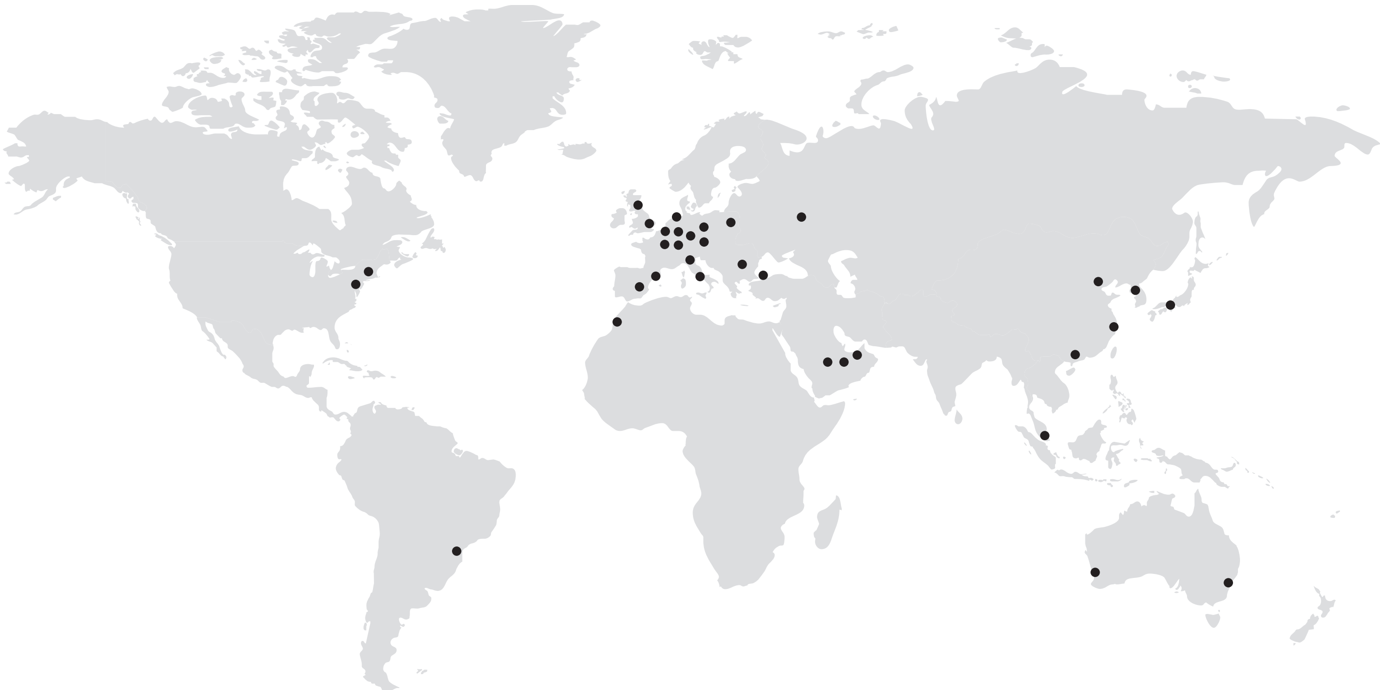

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