



LIBOR Transition Progress Note: Impact on the BAFT Master Participation Agreement (MPA)

February 2021

Following recent announcements by regulators and commentary by working groups on the importance of completing the transition to risk-free rates ("RFR"s) by end of 2021 (or in some cases earlier), BAFT and ITFA issue this joint statement as an update to the Guidance Note¹ published May 2020.

The Impact of LIBOR transition on the BAFT MPA

The latest BAFT Master Participation Agreement (MPA) forms under English (2018) and New York (2019) law and other documents based thereon² currently include the possibility of using an alternative interest rate within the definition of "Reference Interest Rate" (underlining added):

"Reference Interest Rate" [means in relation to any period, currency and amount for which an interest rate is to be determined, the reference rate specified as such for that currency and for that period in the Offer or subsequently agreed by the Parties in writing or, if no reference rate has been so specified or subsequently agreed:

- (a) *if the currency is euro, EURIBOR;*
- (b) *if the currency is US dollars, Japanese yen, GB sterling or Swiss francs, LIBOR until such time as LIBOR ceases to be available for that currency or the relevant period; and*
- (c) *in all other cases, the reference rate selected by the Party claiming the interest (acting reasonably) and having regard to market practice in the principal financial centre for that currency or, if different, in the financial market the claiming Party customarily uses to obtain funding in that currency for a comparable amount and period,*

provided that, if in any case the rate is less than zero, the Reference Interest Rate shall be deemed to be zero.]

¹ Links to respective announcements by ITFA and BAFT in May 2020:
<https://itfa.org/itfa-baft-guidance-on-accommodation-of-libor-transition-in-mpas>
<https://www.baft.org/policy/current-issues/2020/05/13/baft-itfa-guidance-on-accommodation-of-libor-transition-in-mpas>

² Including: BAFT 2018 English law MPA, BAFT 2019 New York law MPA (<https://www.baft.org/policy/document-library>)
ITFA Surety MPA (<https://itfa.org/wp-content/plugins/download-attachments/includes/download.php?id=10456>)

The previous BAFT MPA forms (2008 and 2010) have provisions for the replacement of LIBOR only, and not reference rates, and are therefore not as flexible as the above.

Whilst reference to LIBOR in the MPA will be replaced in due course with an alternative benchmark, this will not happen until such time as there is clarity on the constitution of an alternative rate for each relevant currency, taking into account the possible continued use of USD LIBOR until the end of 2021 or later³. In the interim, the current MPA wording as highlighted above will continue to be effective. Please note that Sterling LIBOR replacement is required sooner than it is for USD LIBOR. Additionally the requirement to change EURIBOR, if at all, is even later than for USD LIBOR or other currencies. At the moment the European Central Bank is still reviewing development and/or adoption of a possible RFR for Euros.

It should be noted that the Reference Interest Rate in the MPA forms relates predominantly to the charging of default interest (see Clause 12.5), as this is a situation where the parties will not have agreed in advance what the applicable rate would be. It is possible that use of the new RFRs may be appropriate in such a situation as interest will only need to be calculated at the end of the default period, and a backwards-looking rate will not therefore be inconvenient. Given the potential complexity of the drafting it is nevertheless possible that use of a central bank rate may be more suitable. BAFT and ITFA are therefore assessing the extent of any required changes.

Parties using the MPA should also consider the impact on Participated Transactions where the transition to an RFR has not yet taken place but may do so over the life of the Participation. The Seller may wish to consult with the Participant as use of an RFR may affect the economics of the transaction and provisions about how changes are agreed.

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Market participants are able to reference RFRs for certain loans and transactions. However, RFR compounded in arrears, a central bank base rate, forward swap curves or futures rates may not be well suited for certain types of trade transactions. This is especially true for discounted transactions where the rate must be known in advance in order to calculate what percentage of the face value will be paid to a counterparty. Here a forward-looking term rate is needed. The use of cost of funds has also been considered but may be unpopular with regulators. It is also difficult to validate, and thus remains a controversial area that is unlikely to be adopted.

Efforts have progressed toward the creation of forward-looking term rates, with various jurisdictions moving closer to issuing term rates prior to the demise of LIBOR. In the case of the Sterling Overnight Index Average (SONIA), after a 6 month initial 'beta' period, on January 11, 2021 the ICE Benchmark Administration Limited and Refinitiv began live production of forward-looking term SONIA rates (TSRR). FTSE Russell, is also expected to make its TSRR available. The Sterling Risk Free Rate Working Group has recommended the market adopt a broad-based transition to SONIA compounded in arrears, with use of a TSRR being limited but inclusive of trade finance. At present, the Sterling Working Group will not select an administrator among the providers and will leave it to industry participants to make the appropriate determination. This is in contrast to the U.S. approach where the Alternative Reference Rates Committee (ARRC) plans to select a term rate administrator among the providers that responded to the RFP. Provider interviews are currently underway by the ARRC and we expect that a consultation on permissible use cases is forthcoming. The ARRC has stated that it plans to recommend a term rate by the end of the first half of 2021, contingent on there being sufficient liquidity to produce a robust rate.

³ The ARRC issues guidance on USD LIBOR Session
https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Endgame_USD_LIBOR.pdf

In the likely scenario that all LIBOR tenors, with the exception of the USD LIBOR (Overnight and 1, 3, 6, and 12 months) cease at the end of 2021 or earlier, below are the proposed timelines for LIBOR transition to SONIA and SOFR.

SONIA

Q1 - 2021	Q2/Q3 - 2021	Q4 - 2021
<ul style="list-style-type: none"> By end-Q1 2021, cease initiation of new GBP LIBOR-linked loans, bonds, securitizations and linear derivatives that expire after the end of 2021 By end-Q1 2021, complete identification of all legacy GBP LIBOR contracts expiring after end 2021 that can be actively converted, and progress active conversion where viable through to completion by end-Q3 2021 	<ul style="list-style-type: none"> Progress active conversion of all legacy GBP LIBOR contracts expiring after end 2021 where viable and, if not viable, ensure robust fallbacks are adopted where possible 	<ul style="list-style-type: none"> Be fully prepared for the end of GBP LIBOR, by the end of 2021 Proposed cessation of all GBP LIBOR panel settings, subject to IBA consultation

SOFR

H1 - 2021	Q4 -2021	Q2- 2023
<ul style="list-style-type: none"> Creation of a SOFR term reference rate based on SOFR derivatives markets. The ARRC's goal for completion is 2021 H1. 	<ul style="list-style-type: none"> <u>ARRC supervisory guidance calls for no new LIBOR as soon as practicable (and no later than the end of 2021)</u> Proposed cessation of 1 week and 2 month USD LIBOR panel settings, subject to IBA consultation Legacy contracts using other USD LIBOR tenors will have time to mature through mid-2023. 	<ul style="list-style-type: none"> Proposed cessation of remaining USD LIBOR panel settings (Overnight and 1, 3, 6, and 12 months) subject to IBA consultation.

Our associations are actively monitoring developments, engaging with rate working groups to advocate that forward-looking rates are the more appropriate rates for trade finance and other working capital transactions using discount rates. BAFT and ITFA acknowledge that the time frames set by the regulators may not coincide with the timeline to establish such term rates. It is for this reason that members are encouraged to find other ways of pricing their assets during a potential period during which term rates are not available after the relevant LIBOR ceases to operate in a particular member jurisdiction.

In other countries, different, and maybe no, deadlines will apply to the continued use of USD LIBOR. It is therefore possible that, in certain countries, use of USD LIBOR will continue right up to cessation. This is tempting but, in the view of BAFT and ITFA, those banks that could benefit from longer deadline should not stop work on understanding, developing and integrating the new alternative rates into their processes as we recommend below.

Recommended Actions

To date, larger industry players have set up internal working groups within their institutions to address the transition away from LIBOR and are working with industry bodies to provide practical feedback and to be appraised of developments and timeframes. There is also a recognition that smaller institutions driven mainly by published term rates do not have the same capabilities and are waiting for further updates from the market. Whilst BAFT and ITFA understand this 'wait and see' approach, we encourage members to set up internal working groups to conduct a gap analysis as to whether their systems, operations, and documentation could smoothly adapt to new practices when LIBOR is discontinued, and alternative rates are in place without creating unnecessary complexity to their business model.

The associations also understand that members may need to send notifications to their clients in order to inform them that the use of IBOR will cease. Beyond the high-level disclaimer previously provided in the May 2020 Guidance Note, neither BAFT nor ITFA are in a position to endorse any specific wording, and it will remain for the member institutions to determine suitable wording according to their internal requirements. The recommendation is, nevertheless, to not implement new or updated clauses in the MPA until an update is made available by BAFT and/or ITFA, as applicable.

Members will continue to be updated with any material and tangible developments, notably when there is more certainty around the implementation and methodology of the alternative benchmark rates to be adopted.

Disclaimer

This additional note is not complete or exhaustive and does not constitute any advice or recommendation nor is it assuming a responsibility to provide advice. Where relevant, institutions will engage with their customers to transition to a new benchmark/ rate in due course. In the meantime, if institutions wish to receive advice, they should seek independent professional advice on the matters contained herein.