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Libor transition – buckle up for a rough ride

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The infrastructure industry is bracing for a storm of monumental proportions as the market readies itself for the transition away from established inter-bank lending rates that underpin many billions of dollars of loans across this global sector.

As the market works its way towards transition away from established base rates to replace them with alternative reference rates (ARR) – also known as risk-free rates (RFR) – before the end of 2021, the lending community is taking stock before launching into a tsunami of work.

Replacement of the London inter-bank offer rate (Libor), the reference rate for so many long-tenor loans in the infrastructure and energy space is leaving many lenders weak at the knees.

In such an environment, it was heartening that the scene was set last month by Associated British Ports (ABP) which became the first borrower to secure bondholder consent to amend £65 million ($82.5 million) in floating-rate debt (due December 2022) to reference an alternative benchmark rate to Libor.

These bonds now pay interest by reference to the Sterling overnight index average rate (SONIA), the benchmark rate being championed by UK regulators.

In one fell swoop, ABP – the UK's largest port operator – not only laid out a roadmap for others to follow, in a fit of philanthropy not usually espoused by big business, it has made all documentation relating to the deal open access. It can (for now) be accessed here…

And that's just the very tip of an exceedingly large iceberg. According to the Federal Reserve Bank of New York, an estimated $1.8 trillion gross notional value of USD Libor legacy notes and bonds exist globally (as at end February 2019).

While infrastructure and energy debt represents but a fraction of that vast sum, it is not an inconsiderable amount – many billions of dollars.

However, every dark cloud has a silver lining. In a world where mandates are few and far between, the transition to risk-free rates is being welcomed gleefully by an advisory community as specialists jockey to carve a niche.

On the ABP deal, kudos – and indeed first-mover advantage – goes to Deutsche Bank, Linklaters and Clifford Chance. Bravo to you three. This time next year you'll be buying new formal wear to replace the outfits you will have worn out going to all the awards nights (buyer beware: taking a table does not guarantee awards).

What's it all about?

Let's not dwell on the mundane – at times somewhat murky and, on occasion downright, illegal – history of Libor and its

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fall from grace. Rather, let's look at the shift from the static instruments that were ultimately deemed unfit for purpose and their shiny, new replacements boasting an array of interesting names.

Taking a glance around the globe, ARRs (in no particular order) are already in place in:

- UK: Sterling overnight index average (SONIA) – administered by Bank of England
- Europe: European short-term Euro rate (ESTER) – European Central Bank
- US: secured overnight financing rate (SOFR) – Federal Reserve Bank of New York
- Japan: Tokyo Overnight Average Rate (TONAR) – Bank of Japan
- Switzerland: Swiss average rate overnight (SARON) – SIX Exchange
- Canada: Canadian overnight repo rate average (CORRA) – Refinitiv Benchmarks Services
- Australia: interbank overnight cash rate – Reserve Bank of Australia

Taking all those abbreviations together, it rather puts one in mind of an invite list to a millennial birthday party… one you'd really hope not to be invited to.

By the end of 2021, it falls to these ARRs to mitigate the risks of manipulation, interruption and uncertainty in the use of benchmarks as we usher in a brave new world.

How does it impact us?

There's a lot of tooth-sucking going around the market at the moment, as wise heads bow knowingly and noble brows furrow – all trying to hide a distinct scent of unease.

Talking this week to sources in the industry, it's clearly not going to be a painless transition as risk-free rates do away with long-term – say 3-6 months – visibility on interest rates.

RFRs all have one thing in common… they have no term-rate fixing in advance, relying instead on overnight rates and fixing in arrears, based as they are on the average of overnight deposit transactions from the previous 24 hours.

As such, the borrower does not know in advance what interest payment is due for the entire period, leaving financial wizards to come up with a mechanism by which they can use this overnight rate, turning it into one rate that can cover a longer investment period. It is – of course – not feasible for organisations to borrow on an overnight basis.

Libor was intended to be a representation of unsecured inter-bank lending – rate at which a bank can borrow funds in an inter-bank market, taking an unsecured loan in the relevant currency.

This is not without issues. As was seen in stark relief during the stresses of the credit crisis, Libor includes an implicit bank credit premium which is directly impacted by the state of the market. RFRs, on the other hand, do not include this feature meaning they will price lower than Libor typically would.

Sources in the market say this could end up with, say, SONIA pricing 12-15bp lower than Libor…. which is surely going to result in lenders seeking to negotiate pricing upwards – a feat that will be all the more challenging on thinly-financed structures like project finance deals with long tenors. It is not clear who will bear this cost at this stage, but the bargaining power likely lies with the lenders.

For the client, the concern remains that they will have limited visibility on the rate they will be paying, forecasting a pricing through aggregation and compounding.

This is all manageable, if slightly uncertain (and thanks go out now to JCRA and Travers Smith, in particular, for feeding in to this piece which would have been impossible without numerous calls with industry specialists).

For long-tenor debt – and that takes in pretty much all infra/energy – that runs on beyond the end of 2021, these packages will either have to be renegotiated so that they reference SONIA, or counterparties will have to confirm they are happy with the fall-back provision that already exists.

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And that's pretty unlikely as those fall-back provisions are the clauses that refer to what rate will be used should Libor be unavailable… which, by any reading of the situation, is a stop-gap measure to cope with a temporary discontinuation of Libor and will unlikely be adequate.

Where the true pain in this transition lies is the wading through all the existing pieces of documentation and researching the reference rates in them to identify a system that keeps everyone – borrower, lender, counterparties and derivatives – are happy with.

And we will be here all night if we start delving into whether derivative documentation is amended in the same way as lending documents…

On that point, we hear that some of the more tech-savvy lenders are deploying artificial intelligence to wade through vast documentation to assess their exposure to Libor.

Why does it feel like that has merely scratched the surface of this issue and that the industry is at the bottom of a very high and steep mountain…?

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