International Capital Market Services Association

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ICMSA BULLETIN - Benchmark replacement and fallback provisions - Key principles and guidelines for Agents and Trustees

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As reported in ICMSA Bulletin 190118/45 "The discontinuation of LIBOR/IBORS - implications for English-law agency roles" published in January 2019 (the "**January 2019 Bulletin**"), the FCA announced that it would no longer compel banks to submit quotes to LIBOR from the end of 2021 and therefore that it was not advisable to rely on LIBOR being available after 2021. Since that time, market participants have developed forms of wording which enable issuers in the European DCM and covered bond markets to replace LIBOR (or any other relevant benchmark) in specified circumstances with a successor or alternative rate without bondholder consent ("**benchmark replacement provisions**"). In an effort to move away from IBOR-linked securities, there has also been an increasing number of issuers coming to market with floating rate issuances which reference the new risk-free rates ("**RFRs**"), in particular the Sterling Overnight Interest Average ("**SONIA**") and Secured Overnight Financing Rate ("**SOFR**") but also more recently the Euro Short Term Rate ("**€STR**").

As such provisions have become more commonplace, in particular in the EMTN and covered bond programme markets, this bulletin considers the implications for paying, fiscal and/or calculation agents (together, "**Agents**") and bond trustees ("**Trustees**"). It suggests present best practice guidelines and principles that should be taken into account by issuers and arrangers when drafting: (i) benchmark replacement and other fallback provisions for bonds which are linked to IBORs; and (ii) interest determination mechanics for bonds which are linked to SONIA and SOFR.

1 Benchmark replacement provisions

Whilst the introduction of benchmark replacement provisions is a positive development for the market generally, the market continues to develop and there is not yet a consistent, standard form provision across the industry. In addition, the operation of such provisions has not yet been tested. From an operational standpoint, Agents will need to be comfortable that once the successor or alternative rate has been determined, together with any applicable benchmark amendments and/or adjustment spread, they are able to operate those provisions in practice. This is particularly the case where the issuer or an independent adviser (an "**IA**") has a wide discretion to determine the successor or alternative rate and/or applicable adjustment (such as choosing a new methodology, obtaining a successor/alternative rate or introducing an adjustment spread). Once those determinations have been made by the issuer or IA, it is the Agent that would need to apply those determinations and perform the resulting calculations.

The following protections are therefore appropriate for inclusion in a benchmark replacement provision (and, where relevant, the underlying agency agreement):

(a) A clear statement that neither the Trustee nor any of the Agents are responsible for making a determination that a "benchmark event" (or its equivalent) has occurred or monitoring whether such an event will, or is likely to, occur. The responsibility for making such a determination should lie with the issuer or an IA on its behalf or, where the events are objectively certain, the obligation should be for the issuer promptly to notify the Agent of a benchmark event in order that it knows to expect to receive details of new rates and adjustments once determined.

(b) A requirement that after having made a determination under the benchmark replacement condition, the issuer/IA gives notice to the Agent of the successor/alternative reference rate, any benchmark amendments and any adjustment spread. The notice period is recommended to be ten business days prior to the first date on which a calculation is required to be made by the Agent. This is critical to give the Agent sufficient time to: (i) ensure that it is able to stress test the updated wording and mechanics; (ii) update its operational systems (and confirm with the issuer that the Agent's outputs match those of the issuer's own treasury systems, or where applicable, resolve differences); (iii) co-ordinate with the clearing systems on updating their own systems; (iv) distribute notices[1]; and (v) generally confirm it will be able to operate the revised interest provisions on a periodic basis. It is worth noting that a benchmark event will affect debt issuers throughout the capital markets and not just the given issuer on a particular transaction. Therefore, whilst a ten-business day notification period may seem a long time when considering a single set of issue documents, Agents will be conscious to ensure they can administer the large volume of such changes across the breadth of transactions they service.

(c) Most benchmark replacement provisions will provide for the issuer to give certain certifications as to the occurrence of a benchmark event and the nature of any changes to the interest calculation provisions. This certificate should be addressed not just to the Trustee (if any), but to all of the Agents involved within the interest determination and payment process.

(d) A statement to the following effect, to clarify the Agent's liability position in the event of uncertainty regarding the operation of the benchmark provisions:

"*Notwithstanding any other provision of this Condition [●], if [following the determination of any Successor Rate, Alternative Rate, Adjustment Spread or Benchmark Amendments,] in the Agent's opinion there is any uncertainty between two or more alternative courses of action in making any determination or calculation under this Condition [●], the Agent shall promptly notify the Issuer thereof and the Issuer shall direct the Agent in writing as to which alternative course of action to adopt. If the Agent is not promptly provided with such direction, or is otherwise unable (other than due to its own gross negligence, wilful default or fraud) to make such calculation or determination for any reason, it shall notify the Issuer thereof and the Agent shall be under no obligation to make such calculation or determination and (in the absence of such gross negligence, wilful default or fraud) shall not incur any liability for not doing so.*"

Without limiting the generality of the text above, situations where it might be relevant include:

(i) where the IA's advice provides for a "menu" of choices for the issuer and Agent to apply to the deal depending upon the nature of the securities, the relevant maturity dates

[1] Issuers should note that whilst an Agent will distribute notices through the clearing systems, the Issuer should provide the Agent with the agreed form of the notice (which has been approved by the Trustee). The notice should specify that any investor queries regarding the amended interest rate provisions should be directed to the Issuer and not to the Agent or the Trustee.

and/or other commercial factors. The Agent should not be required to make such choices given that they could have a direct impact on the economics of a transaction, so it would seek instructions from the issuer; and

(ii) if the amended interest determination wording is unclear as to whether a rate which is used in the calculations for a particular date, is the rate for transactions which are undertaken on such date or the rate which is published on such date (for transactions which have taken place on a prior date).

(e) Inclusion of wording, similar to that on which Trustees can rely, which ensures that the benchmark amendments to documents do not, without the prior consent of the relevant Agent, have the effect of exposing the Agent to additional liabilities, increasing the obligations or duties, or decreasing the rights or protections, of such Agent under any of the terms and conditions, the applicable agency agreement or any other transaction document. In all cases, it should be clear that where Trustees and Agents are obliged to give effect to benchmark amendments, they should incur no liability for the consequences of such amendments.

2 IBOR fallback considerations

2.1 Reference Banks

It is common for floating rate interest on Eurobonds to be determined by reference to one or more quotations provided on a specific screen page at a specified time. If the relevant screen page is not available at such time, or no quotations are provided, customary fallback wording will provide that the Agent approaches one or more reference banks to provide a quotation for the relevant reference rate at the relevant time. However, in light of increased regulatory scrutiny regarding the administration and operation of benchmarks following the LIBOR crisis, the number of reference banks which are willing to provide reference rate quotations has significantly declined. Agents are therefore unwilling to agree to obligations in fallback provisions which require them to poll reference banks when it is widely expected that such reference banks will not provide quotations when requested. Although the new style benchmark replacement provisions envisage a process which is expected to minimise the likelihood that this provision would be relied on, it may still be relevant for determination of interest unless and until the process of implementing successor/alternative rates and adjustments is completed. If an issuer wishes to retain reference bank fallback wording, the onus should be on the issuer (perhaps by appointment of a relevant agent at such time) to source the necessary quotations from the relevant reference banks and to provide any quotations obtained to the Agent for the purposes of calculating the relevant interest rate.

2.2 Legacy fallback provisions

2.2.1. **Calculation Agent discretion:** Some legacy MTN and covered bond programmes include provisions which provide that the ultimate interest rate fallback (or interpolation methodology) is the rate that is "*determined by the [Calculation Agent] in its sole discretion, acting in a commercially reasonable manner*". The obligations performed by a calculation agent role are expected to be limited to mathematical determinations – i.e. to calculate the payments due on the basis of pre-determined terms (including the benchmark to be used). The very wide ambit of legacy fallback provisions, however, gives the calculation agent much greater discretion and commercial influence over the terms of an instrument than is appropriate for the nature of its role. Critically, by agreeing to perform such wide discretionary duties, there is a risk that the calculation agent is considered as a "user" under the provisions of the EU Benchmarks Regulation (the "**BMR**").

Whilst ESMA has issued FAQs which clarify that a calculation agent that does not set the terms of the financial instrument and does not decide which benchmark is referenced would not be regarded as "using a benchmark" for the purposes of the BMR, the wide discretionary determinations required by legacy fallback provisions, could call into question whether a calculation agent has decided the relevant benchmark and therefore acted as a user. An entity which is treated as a user under the BMR is obliged to comply with certain additional regulatory requirements which are not typically considered to be commensurate with the commercial basis on which calculation agents accept their role or the risk profile thereof (see the January 2019 Bulletin for further details).

It is for this reason, amongst others, that Agents require the protection of a comprehensive illegality clause in the agency agreement pursuant to which they are appointed. Under such a clause, an Agent may refrain, without liability, from taking any action to the extent that the Agent believes that such action would be contrary to applicable law and/or regulation (e.g. bringing itself within scope of BMR user reporting obligations or does not currently comply).

2.2.2 **Trustee determination:** A further provision commonly seen in MTN and covered bond programmes requires that if the Agent has failed to calculate interest in accordance with the conditions, the Trustee may (or in some older examples, will) either step in to make that calculation itself, or appoint an agent to do so on its behalf. Notwithstanding that this is typically framed as a discretionary power (and not a duty) of the Trustee, it is neither appropriate nor possible for a Trustee to make such calculations or determinations (especially complex compounding calculations required under more recent SONIA- and SOFR-referencing FRNs). In addition, as the issuer would ultimately be responsible for the fees, acts and/or omissions of any agent appointed by the Trustee, it is preferable for the issuer to make the agency appointment directly without the Trustee's involvement. In practice, many programmes allow the issuer to appoint a replacement agent upon the incumbent Agent's failure to act, which should negate the Trustee having to intervene. Any such provision requiring the Trustee to make interest calculations should be carefully considered and removed where possible.

2.2.3 **Consent solicitations:** Whilst the matters addressed in paragraphs 2.2.1 and 2.2.2 arise most frequently at the time of an update of an EMTN or covered bond programme, the same concerns are equally relevant to standalone transactions which include similar language. Therefore, if an issuer launches a consent solicitation exercise to amend the terms of the relevant securities (e.g. for the purpose of amending the reference rate from LIBOR to SONIA), it is to be expected that Agents and Trustees will request the issuer to include these changes within the package of amendments to be approved by holders. In both cases, the language is outdated and not in line with the commonly assumed role of third-party service providers in the current regulatory and commercial environment.

2.3 Other market precedents

In addition to the generic benchmark replacement provisions which have been developed in the European market, in the US, the Alternative Reference Rates Committee (the "**ARRC**") has been active in publishing its recommendations for robust contractual fallback wording for various forms of debt including new issuances of USD LIBOR floating rate notes. It should be noted that although there may be demand to use an unmodified form of ARRC's suggested wording, certain amendments may be necessary to address the legitimate commercial and operational concerns of the Agents and the Trustee and to implement the wording into the context in which it is proposed to be used.

3 Risk Free Rates

With increasing pressure from regulators to move away from floating rate debt which references the IBORs, the market has seen a number of issuers (particularly financial institutions) issuing FRNs under which the interest rate is determined by reference to SONIA,SOFR and now €STR. Unlike the IBOR market which is forward-looking, interest determinations using risk free rates are calculated on a backward-looking basis and subject to a mechanism to provide cashflow certainty prior to the interest payment date (typically a "look-back", "lag" or "lock-out" basis). Different market conventions as to whether the interest rate is calculated on a compounded or an averaged basis adds further complexity. With these markets still in their developmental stages (albeit with greater homogeneity of drafting in the SONIA market), the challenge for Agents is two-fold – (i) to develop systems capable of calculating interest on a fundamentally different basis to traditional IBOR-linked products; and (ii) to ensure the legal drafting of risk-free rate interest mechanics provides a basis on which Agents can properly service the risk-free rate market. Many of the principles discussed above in this bulletin will also be relevant in the risk-free rate context, but some specific concerns relating to the drafting of SONIA,SOFR and €STR interest rate provisions are examined below.

3.1 SONIA: Bank of England guidance

In broad terms, the legal drafting for SONIA interest rate provisions includes the primary interest determination mechanics using a compounding formula into which the relevant SONIA rates are inputted, together with fallback options if the relevant screen page for SONIA is not available. A further provision is often included which provides that if the Bank of England publishes guidance as to: (i) how the SONIA reference rate is to be determined; or (ii) any rate that is to replace the SONIA reference rate, the Agent shall follow such guidance in order to determine SONIA for so long as the SONIA reference rate is not available or has not been published.

Whilst the commercial intention behind such wording is to be welcomed, from an Agent's perspective, it will need to clear that any such Bank of England guidance contractually overrides its existing obligations under the bond conditions and/or the agency agreement. The following two amendments address these concerns:

3.1.1 **Agent instructions**: the drafting should clarify that the Agent should be given clear written instructions by the issuer that it should determine interest by reference to the Bank of England's guidance and not the existing contractual provisions; and

3.1.2 **Contractual amendments**: a provision should be included to require that if any amendments or modifications to the bond conditions or any other transaction documents are required in order for the Agent to follow the Bank of England's guidance to determine SONIA, the Agent shall have no obligation to act until such amendments or modifications have been made.

3.2 SONIA: Observation Look-back[2] Period

[2] Sometimes also known as a "lag"

As SONIA is an overnight rate rather than a forward-looking term rate, market precedents to date have included a mechanic whereby interest is determined by reference to an "Observation Period" (i.e. the period during which SONIA rates are observed) which is off-set to the corresponding interest period to which it relates. In the early SONIA issuances an Observation Period of five business days was hardwired into documents. Market practice on programme issuances evolved to include (with certain limitations) optionality on this period. The number of days by which the Observation Period is off-set vis-a-vis the interest period (often defined as "p" in MTN and covered bond programmes) is important from an operational standpoint to ensure that Agents have sufficient time to make the necessary calculations without the help of the sophisticated systems which have been developed over many years for forward-looking IBOR-referencing products.

The broad market consensus with which most Agents have become comfortable is for the look-back period to be five London business days, albeit other acceptable formulations might include a proviso that the look-back period can be less than five London business days with the relevant Agent's consent (which may be provided in the future once systems are updated and market conventions coalesce and/or if there were to be an officially published source of compounded SONIA), but in any case, not less than three London business days. Draft documentation will often provide for the interest determination date to be the day which is "p" London business days prior to the next interest payment date ("**IPD**"). However, in order to give the Agent time to determine the relevant rate and amounts payable by the issuer (c.f. the two-day period which is commonly used when calculating LIBOR-based rates), it is preferable to allow for the Agent to make its determinations as soon as possible on or after the date which is "p" London business days prior to the next IPD, and in any event, no later than three London business days prior to the next IPD.

3.3 SOFR

As at the date of this bulletin, practice in the SOFR market continues to develop and the contractual provisions for the determination of interest in respect of SOFR-referencing instruments varies between transactions. From the perspective of the Agent and the Trustee however, the general themes raised in this bulletin will be equally relevant to SOFR transactions as they are for those referencing SONIA. Specifically, from an Agent's standpoint, it is important that the Agent should be acting without discretion on the basis of clear written instructions and that it is given the opportunity to review and comment on any provisions which it will be required to operate in order to determine periodic interest amounts.

In particular, the same timing concerns discussed above for SONIA apply to Agents when making calculations and/or determinations on the basis of SOFR. However, since the observation period / "lag" methodology is only one of the options seen alongside the "lock-out" and/or "payment delay" and/or "weighted average" methodologies, the drafting can be more complex. For example, "p" may be defined as being zero when a "lock-out" or "payment delay" approach is used. In that case, the definitions of "Interest Determination Date", "Interest Payment Date" or the minimum "lock out" / "suspension" or "payment delay" period, will need to be adjusted in order to ensure that the Agent is given sufficient time to perform the necessary calculations and operational steps.

Typically, there are also extensive provisions setting out fallbacks in case of unavailability of SOFR. As noted in paragraph 1 above, the Agents should not be responsible for monitoring or determining a benchmark event. There should also be similar clarity within the SOFR fallback wording so that the primary responsibility is for the issuer to notify the Agent as to occurrence of a relevant event or determination of a successor or replacement rate by any of the named authorities.

Issuers should also be mindful of operational differences applicable to payments made on securities which are cleared through DTC and those which are cleared through Euroclear and Clearstream, Luxembourg (together, the "**ICSDs**"). Payment and pre-advice timelines are likely to be more compressed for DTC-cleared issuances, so it may not be possible for e.g. the terms of a DTC-cleared SOFR instrument to be replicated fully when cleared through the ICSDs. An early dialogue with the Agents and the ICSDs regarding any such proposals is encouraged in order to eliminate the operational risk of late payments to holders through the ICSDs.

3.4 €STR and other RFRs

As at the date of this bulletin, there have only been three issuances of floating rate notes referencing €STR and these have followed very similar market conventions and contractual drafting to the SONIA referencing transactions. The future development of this market and applicable conventions cannot be predicted. As with SOFR transactions from the perspective of the Agent and the Trustee however, the general themes raised in this bulletin will be relevant to €STR transactions, and indeed for future transactions based on other overnight RFRs, as they are for those referencing SONIA.