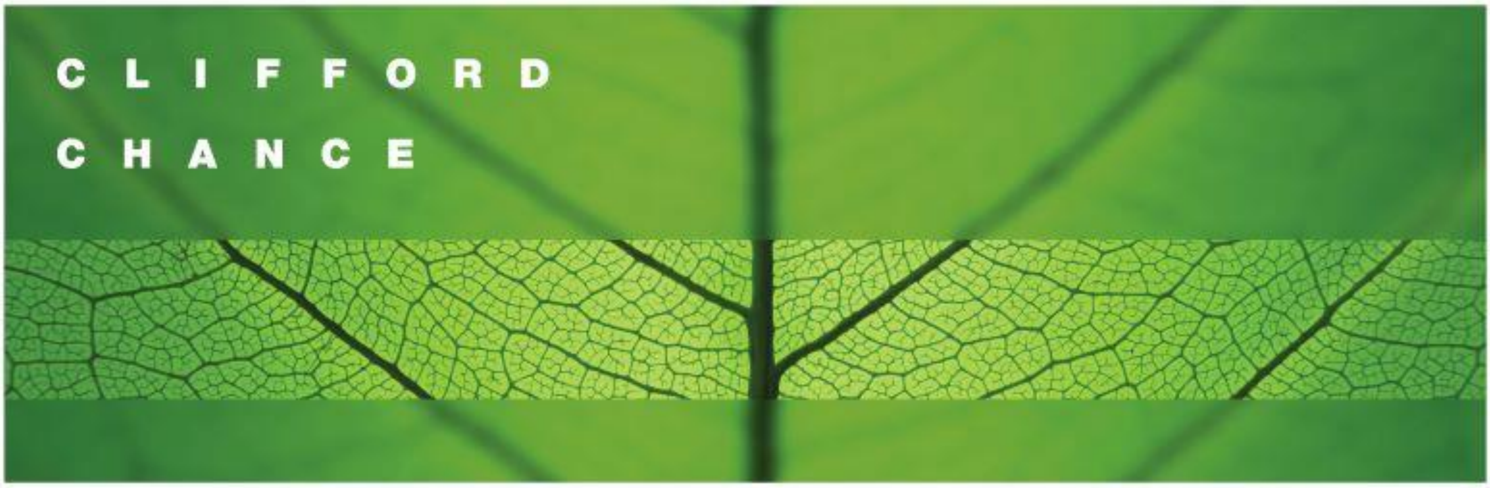


LIBOR TRANSITIONING – NAVIGATING THE IMPACT FOR TRUSTEES IN THE CAPITAL MARKETS

Corporate trustees ("trustees") for notes that mature after the end of 2021 should brace themselves for LIBOR being phased out. While trustees have been closely monitoring benchmark replacement terms since the FCA signalled that it would no longer compel banks to submit LIBOR submissions, LIBOR transitioning will increase as 2021 draws closer and trustees will need to be prepared for the impact on their role.

This briefing considers the impact of LIBOR transitioning for trustees. For more information about reference rate transition and risk-free rates generally please see our website here. Many of the themes will be relevant to the transition of other reference rates and to other counterparties with an interest in capital markets transactions.

The Financial Stability Board recently urged markets to employ "significant and sustained efforts" to transition, particularly in light of the relatively slow progress made in securitisation (and lending) transactions. While trustees are likely to adopt a position that is reactive to that taken by issuers and originators, they will be expected to be supportive of efforts by commercial parties to ensure an orderly transition, and may be more proactive than might typically be expected to ensure the transition process is managed across their entire book of business.

In dealing with what The Bank of England has categorised as a key threat to financial stability, there is not a 'one size fits all' approach to LIBOR transition and trustees may be involved in varying strategies to assist their counterparts in bringing transaction documentation in line with new standards. While the industry could reach a consensus on the replacement of reference rates, trustees will inevitably remain a focal point in any transition strategy.

Key issues

- Corporate trustees need to be prepared for the transition away from LIBOR.
- If transactions are not amended, trustees will want to consider the effect of LIBOR discontinuation for its existing duties and discretions.
- Widescale amendments and repapering could have a material impact on how trustees manage their day to day business.

Trustees should therefore be conscious of assessing any discretion or obligation to calculate interest rates post-LIBOR and will also want to understand the cost and administrative impact of any associated amendment and repapering project.

DUE DILIGENCE

Recent documentation has placed a greater emphasis on ensuring that robust fallbacks are included in documentation to ensure that an alternative method of calculation will continue to be available.

While existing transactions may need to be amended to allow floating rate interest rates to reflect the commercial intentions of the parties after LIBOR is phased out, it is important for trustees to understand their current obligations in relation to interest rate calculation, particularly if such documents are, for whatever reason, not amended prior to LIBOR being phased out.

Fallback provisions in capital markets documents are likely to vary, but due diligence will help identify obligations so that they can be analysed, and where relevant, adjusted. AI technology can also help identify and categorise legacy transactions. We envisage that there will be five broad categories identified as part of a typical due diligence process:

1. Trustee with no duty or residual discretion; change requiring noteholder consent.

The terms of the trust deed will identify the trustee's specific powers or duties. As a replacement interest rate can impact the sums due or paid to noteholders (or the method of calculating those sums), a change to the interest rate will commonly be excluded from the trustee's powers to agree to amend documents without noteholder consent. Some transactions may entitle the trustee to exercise a discretion if it is satisfied that there is no material prejudice to noteholders notwithstanding that the change is a reserved matter, but this will be unusual in practice.

2. Trustee with residual discretion.

In the absence of the issuer (or its agent) calculating the interest rate, the trust deed may entitle the trustee to do so. Where the trustee is entitled, but not obliged, to determine the rate, it will need to consider whether it would be appropriate for it to make that determination. It is likely to be difficult for a trustee to determine how the changes to the rates compare economically particularly if such calculations involve complex compounding calculations. It is also likely to be more appropriate for the issuer to appoint a replacement agent to make calculations if the relevant agent has failed to comply with its obligations and the transaction documents contemplate such alternate appointment.

3. Trustee with the duty to calculate where it can divest itself of the obligation.

Where the trustee has a duty to calculate the interest rate, the trustee will understandably seek to mitigate any potential liability. A trust deed would typically allow the trustee to appoint an agent or delegate to perform its obligations and where the trustee is able to divest itself of this duty without taking responsibility for the actions of such agent or delegate, this is likely to be its preferred option.

4. Trustee with duty to calculate where it has to perform the calculation.

If the trust deed does not entitle the trustee to appoint an agent or delegate, the trustee is unlikely to want to rely on its statutory rights to do so. The trustee may instead wish to take financial and legal advice to ensure it can perform its duty without exposing itself to liability to the issuer, noteholders or both. The cost of taking expert financial and legal advice (which would ordinarily be at the issuer's cost) will need to be assessed by the issuer against the cost of amending the transaction. The trustee will also need to understand any potential implications under the Benchmark Regulation and be able to record and justify its decision-making with appropriate governance to manage the risk of liability over its actions (or inaction).

5. Issuer (or issuer's agent) has a duty to set the rate as a fallback.

If an agent is unable to calculate an interest rate with reference to the formula prescribed in the conditions of the notes, the rate may have to be calculated in a commercially reasonable manner. What is objectively reasonable will be fact-specific and while trust deeds ordinarily empower the trustee to determine all questions and doubts arising in relation to the trust deed (including the conditions), a trustee would not expect to take responsibility for the issuer's agents in a pre-default scenario nor for the effectiveness or adequacy of the document terms. The trustee may however need to consider the implications of a breach of obligations in this regard.

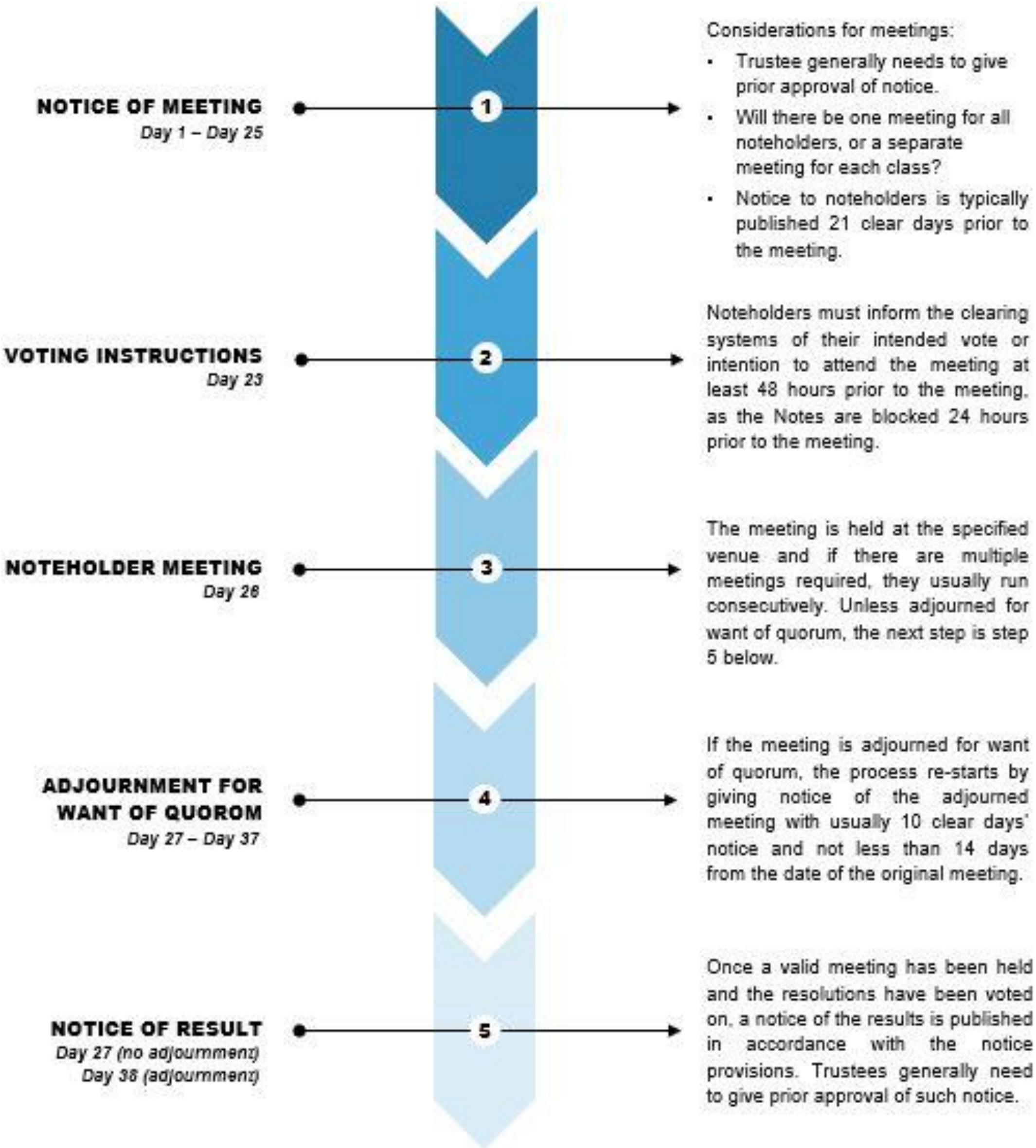
AMENDMENTS AND REPAPERING

Regulated entities will face increased scrutiny regarding their transition efforts and this may result in commercial pressure to amend documentation to ensure that floating rates of interest can still be calculated and interest calculation provisions operable while also reflecting the originally intended economics of a transaction. This may be easier said than done, particularly on structured deals, where LIBOR or similar benchmark rates could be present in the underlying asset portfolio, in the transaction documentation setting out the calculation of the interest rate and in related swap documentation, all of which may need to be amended concurrently.

As mentioned above, the vast majority of such amendments will require the consent of a given proportion of noteholders (often of each class voting separately). Similarly, it is likely that most amendments will need the written consent of the transaction counterparties involved and a simple notice to market will not suffice. While trustees would not expect to be involved in preparing the detail of the proposed amendments, they will need to actively engage with issuers and other counterparties as part of the implementation process.

Noteholder Meetings

For most transactions, a change of reference rate will require a noteholder meeting. Below we set out the typical requirements and timings for meetings.



Noteholder meetings require a notice of meeting to be prepared in line with the meeting provisions, a meeting venue to be booked, quorum and voting procedures adhered to and personnel to be available to prepare for, and attend the meetings.

It may be prudent for trustees, their agency counterparts and advisors to be involved in devising a strategy to manage the overall impact on their normal business operations to ensure they are not adversely impacted by a glut of meetings in a given period, particularly as the deadline for LIBOR transition approaches.

Similarly, there may be efficiency gains by having pre-prepared packs of benchmark transition meeting documentation and sample amendments that can be readily adapted to meet the specific requirements of a given transaction. Nevertheless, the administrative burden on trustees could be significant, and exacerbated in a structured context where separate meetings of each class of noteholders may be necessary to approve amendments and coordination across products.

Electronic Consents

For notes held through the clearing systems, transactions may include provisions for electronic noteholder consent in lieu of a physical noteholder meeting. The process is generally the same as for noteholder meetings, save that it can be more efficient since the trustee is directed to enter into the amendments as soon as the requisite electronic noteholder consent is obtained, and the need to wait for a meeting date is thus eliminated.

Written Resolutions

For certain transactions with a single noteholder or a small number of identifiable noteholders, it may be possible to agree amendments by way of written resolution. This is a far more efficient process than conducting noteholder meetings but will not be suitable for widely held notes. Trustees would require proof of holding to accompany such written resolutions and would expect the resolutions to include standard exculpation language.

Consent Solicitations

There is a risk that noteholders may not engage with noteholder meetings or electronic consents without an incentive to do so, which could force issuers to use some sort of consent solicitation, whereby noteholders might be offered a cash or other incentive in exchange for responding to the request for consent. The first consents of this type for LIBOR amendments were launched in early 2019 and passed successfully without the offer of any such incentive.

The process typically involves a consent solicitation memorandum which is used to solicit the consent of noteholders, followed by a standard meeting or electronic consent process to direct the trustee to effect the amendments. The process may involve the appointment of a solicitation agent to manage the process and calculate the votes.

Negative Consent

Some transaction documentation provides for noteholders to agree modifications by way of negative consent. This typically involves the issuer notifying noteholders of the proposed amendments and provides that they have a set period of time by which to object to the proposed amendments. If an insufficient proportion of noteholders object, then the amendments may be made regardless of the effect on noteholders. The trustee may be involved in receiving such objections from noteholders and reviewing the notices to holders. This process has the benefit of allowing amendments to be made where noteholders may be apathetic to the nature of the amendments proposed. However, trustees would not expect to engage in a negative consent process where this was not originally disclosed in the original documentation due to concerns of noteholder disenfranchisement.

Mandatory Modifications

Many recent transactions include mandatory modification provisions which oblige the trustee to agree to modify the interest rate and related amendments without the need for noteholder consent provided that certain certifications and other supporting evidence is provided to the trustee, and such modifications are expressly carved out of the definition of reserved matters.

This is usually derived from the language prepared by AFME, but the wording used does vary from transaction to transaction, so trustees will want to check that the appropriate mitigants are adopted, including that the modifications do not increase its obligations and duties or decrease its rights and protections.

Refinancing

Where the issuer is unable to achieve the necessary noteholder consent or other form of repapering, or where this could prove too costly, the issuer may consider whether a refinancing would be a better alternative. All applicable notes would be redeemed or exchanged by the issuer, and the issuer would then re-issue new notes with appropriate replacement interest rate provisions. To do this, the issuer may rely on existing call options in the note conditions that permit early redemptions or may launch an exchange offer to exchange the existing notes for new notes.

Frustration

A small minority of transaction documents may not include workable fallback provisions, which may ultimately result in the existing interest rate being impossible to calculate. Similarly, issues could arise where the duty to calculate the interest rate falls on the trustee or another agent, but prior to the transaction documents being amended, the interest rate proves impossible to calculate under the current drafting. In such circumstances, the parties may argue that the contracts which reference LIBOR are frustrated by the rate being discontinued. This is likely to be a last resort where no other remedy is available. It may also be difficult for the parties to argue that the doctrine of frustration applies, as bringing the arrangement to an end is likely to result in significant economic consequences for the parties.

SUMMARY

While it may seem some time away, LIBOR transition will necessitate significant oversight by trustees, in addition to managing their ordinary course of business. Individual responses will depend on the proactivity of the parties involved, but trustees will wish to assess the potential effect of transitioning on their personnel, fees and costs, regulatory implications and internal governance across the totality of the issuances on which they act.

In recent years, documentation for capital market transactions started to prepare for LIBOR transition by including mandatory modification wording and more recently, transactions have been linked to alternative risk-free rates such as SONIA. However, it is clear that participants will need to accelerate efforts to prepare for LIBOR cessation by the end of 2021. On 16 January 2020, the Working Group on Sterling Risk-Free Reference Rates published their roadmap for LIBOR transition, which urged market participants to establish a framework for LIBOR transition of legacy transactions by as early as Q1 2021 and encouraged the promotion and widespread use of SONIA compounded in arrears.

Having a coordinated approach and an appropriate engagement strategy will no doubt result in easing the burden for all parties involved. Whether the market, as a whole, is quick enough to respond however, remains to be seen.

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