SONIA and the 'Tough Legacy' of LIBOR

By Jack Castle

At the end of 2021 the London Interbank Offered Rate (LIBOR) will be discontinued. In its place the Financial Conduct Authority is proposing a different rate to become the market standard, the Sterling Overnight Index Average (SONIA). What is the impact of LIBOR's discontinuance on regulated credit agreements? How might regulated lenders approach a transfer to SONIA? Will the Government legislate to assist with the change?

Goodbye, LIBOR

1. LIBOR (London Interbank Offered Rate) is a benchmark interest rate referenced in an estimated US$350 trillion outstanding contracts.[i] It is renowned for its ubiquity, notorious for the manipulation scandal, and is being discontinued at the end of 2021.

2. The discontinuance of LIBOR was announced by the Financial Conduct Authority ('**FCA'**) in July 2017, which came to that decision not because of any controversy but '*because the underlying market that LIBOR seeks to measure – the market for unsecured wholesale term lending to banks – is no longer sufficiently active*.'[ii] The FCA is proposing instead that market participants use a different rate: SONIA (Sterling Overnight Index Average). It has set a target for no new LIBOR-linked loans from Q1 2021.

Hello, SONIA?

3. SONIA is fundamentally different from LIBOR. LIBOR is the average of what each of the submitting panel banks considered the interest rate will be to borrow

money from another bank (in a reasonable market size) just prior to 11am London time. It is forward looking. LIBOR comes in US Dollar, Euro, Pound Sterling, Japanese Yen, and Swiss Franc flavours.

4. SONIA, however, is based on actual transactions and reflects the average of the interest rates that banks have paid to borrow sterling overnight from other financial institutions and other institutional investors. As its name suggests, it is a rate for sterling only; other LIBOR currencies have their own suggested replacements.

5. As SONIA is backward-looking, its rate on the date that interest falls due for a given period cannot be known until the period is (nearly) complete. For example, if a contract stipulates quarterly payments at "SONIA + x%", SONIA will not be available until the completion of that quarter. In contrast, 3-month LIBOR is the rate for the coming period, so interest payments based on it can be known at the beginning of each quarter.

6. Further, because most LIBOR rates are based on interbank loans over a long period of time, they can include a premium for credit/liquidity risk. SONIA, being based on rates that occurred and using only transactions of one business day maturity, is a risk-free rate. The result is that SONIA is likely to be always lower than LIBOR.

7. These differences give rise to two main practical issues: uncertainty as to interest that will become payable at the end of a given period, and the possibility of a kind of "LIBOR top-up fee" being levied by lenders. In addition, changing the reference rate raises the issue of whether the lender is able to introduce a new reference rate under the contract terms.

Impact on existing agreements

8. Many agreements, not just credit agreements, use LIBOR as a reference rate. Unfortunately, SONIA is not a direct replacement of LIBOR. It is a different and distinct rate that has existed parallel to LIBOR since its inception in 1997, which has now been given FCA's support as a benchmark. The position is not as simple as "for LIBOR, read SONIA".

9. Certain agreements will include a fall-back position, whereby if LIBOR is not available (which it will not be from the end of 2021), an alternative rate is to be used. Whether SONIA is the appropriate alternative may depend on the wording of the contract term. But some contracts will only mention LIBOR, with no alternative provision. In those cases, there may be a power to alter terms in certain circumstances. This power may allow the substitution of SONIA, or it may be possible to imply a term, or perhaps (if the other party does not agree to a variation), the rate will become fixed by reference to the last LIBOR rate that there was.

10. Although these issues may arise wherever LIBOR is referenced, the impact on credit agreements is particularly significant and for regulated credit agreements even more so, being further complicated by the statutory consumer protection regime. In the absence of a fall-back rate the problems are particularly acute.

The transition from LIBOR for regulated firms

11. The FCA is likely to be astute to the conduct of financial institutions during the transition from LIBOR, whether that is in managing its own business risk or seeking to amend or replace LIBOR in existing credit agreements. It has already given some indication of this, noting in particular the need for firms to have clear internal apportionment of responsibilities among its directors and senior managers (SYSC

4.4.3R), and to consider whether LIBOR-related risks can be addressed within existing risk frameworks or whether a dedicated program is needed.[iii]

12. Regulated firms will need to also to comply with their FCA obligations to treat customers fairly, and to pay regard to their information needs.

13. Lenders will want to examine whether there is a provision in their credit agreements that allows unilateral variation: if there is, the lender can give notice under s.82(1) Consumer Credit Act 1974 ('**CCA**'). They need to be astute to the power the agreement actually allows them: does it allow variation of the manner by which the rate is calculated, or is it restricted to variation only of the actual rate payable? The former may be necessary to unilaterally adopt SONIA or another substitute rate.

14. If a term is relied on to change the way the rate is calculated, it must also be fair under the Consumer Rights Act 2015 or its predecessor regulations.

15. Although the FCA has indicated it does not expect firms to give up the margin difference between LIBOR and SONIA, there will need to be fairness in how this difference is calculated, considering that LIBOR will cease to be published. Any unilateral increase in interest rate must be for a 'valid' reason (CONC 6.7.14R), which includes (a) recovering the genuine increased costs of funding the provision of credit under the agreement and (b) a change in the risk presented by the customer which justifies the change in the interest rate (CONC 6.7.15G), neither of which appear exactly to cover providing for the difference between SONIA and LIBOR rates. Firms may want to consider how they will demonstrate that any LIBOR "top-up charge" would not be an increase in interest rate, considering that from 2022 the 'true' LIBOR-based interest rate will be a matter of speculation.

16. If unilateral variation to terms is not available, lenders will be faced with attempting to secure 'modifying agreements' under s.82(2) CCA. Such a modifying agreement would be subject to the requirements of the CCA as to form and formalities, as well as, more significantly, obtaining the consent of the borrower.

17. There is a risk that changes may be said to treat customers unfairly, giving rise to potential claims to the Financial Ombudsman Service, or a claim for an unfair relationship under ss.140A–140C CCA. Care will certainly have to be taken in explaining what the discontinuance of LIBOR (and the substitution of SONIA) means for borrowers, and with ensuring that any action taken by lenders does not substitute inferior terms as far as the consumer is concerned.

'Tough Legacies'

18. On 23 June 2020 the Chancellor made a statement announcing that the FCA were to be given powers relating to benchmarks in order to manage the transition from LIBOR.[iv] He seemed, however, to be avoiding an approach that would legislate directly to make changes to contracts that reference LIBOR. Rather, the government's apparent preference is to encourage the market to shrink LIBOR-referencing contracts to an '*irreducible core*' of '*only those contracts that genuinely have no or inappropriate alternatives and no realistic ability to be renegotiated or amended*', which it calls '*Tough Legacy*' contracts.

19. To deal with these Tough Legacy contracts, it seems legislation will give the FCA powers to direct changes in methodology of a benchmark rate '*in circumstances where the regulator has found that the benchmark's representativeness will not be restored and where action is necessary to protect consumers and/or to ensure market integrity*.' The same legislation will also '*prohibit use of an individual critical benchmark where its representativeness will not be restored, whilst giving the regulator the ability to*

specify limited continued use in legacy contracts.' Quite how this Delphic indication will work is unclear, but might the Oracle be saying that some form of LIBOR could be allowed to live on, a shadow of its former self, but unable to be used in new contracts?

20. The problems of legacy contracts are indeed "tough" and will be very much contract-specific. Existing contracts with LIBOR references need careful consideration now, well in advance of LIBOR's discontinuance, to establish whether there is a problem and if so how best to resolve it.

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[i] https://www.theice.com/publicdocs/LIBOR_evo_summary.pdf
[ii] https://www.fca.org.uk/news/speeches/the-future-of-libor
[iii] https://www.fca.org.uk/markets/libor/conduct-risk-during-libor-transition
[iv] https://questions-statements.parliament.uk/written-statements/detail/2020-06-23/HCWS307