ITFA AND SULLIVAN & WORCESTER ISSUE JOINT GUIDANCE ON THE USE OF RISK-FREE REFERENCE TERM RATES IN TRADE AND EXPORT FINANCE

SEPTEMBER 2021

ITFA and Sullivan & Worcester joint guidance to ITFA members on the use of Risk-Free Reference Term Rates in Trade and Export Finance
September 2021

Regulators have long promoted, as a replacement for LIBOR, compounded risk-free rates (RFRs), where the interest rate and amount of interest payable are only known at the end of the interest period. However, in both the UK and the US, regulators have also recognised the need for forward-looking RFRs in sectors such as trade finance. While it is expected that 90% of market transactions will use RFRs compounded in arrears, the need for certainty at the outset of a transaction in the trade finance sector will undoubtedly lead to the use of forward-looking RFRs in loan documentation, as well as for the calculation of discount rates applicable in relation to, for example, receivables financing transactions where the rate must be known to determine the final amount to be paid to the customer.

This guidance note looks at Term SOFR[1], the ARRC recommended RFR term rate available for US dollars, and Term SONIA[2] and Term SONIA Reference Rate (TSRR), the RFR term rates for Pounds Sterling, highlighting issues to consider when entering into new transactions, including a reminder on timing for each. The Schedule sets out key facts for each of the RFR term rates for US dollars and Pounds Sterling in turn. This guidance note does not cover RFR term rates for euros in any detail as these are at a much earlier stage in the process of reform.

For more information contact info@itfa.org at ITFA or Geoffrey Wynne at Sullivan & Worcester UK LLP gwynne@sullivanlaw.com and see the TFG and ITFA hub on LIBOR Transition LIBOR Transition (tradefinanceglobal.com)

COMMON ISSUES

1. Regulatory Approval

Given the prioritisation of compounded rates over term rates, it is critical that members are comfortable that their regulators will permit the use of RFR term rates.

In the US, the Alternative Reference Rates Committee (ARRC), which was set up by the banking industry to cooperate with the US authorities on LIBOR transition, "supports the use of SOFR Term Rate in addition to other forms of SOFR for business loan activity —particularly multi-lender facilities, middle market loans, and **trade finance loans**—where transitioning from LIBOR to an overnight rate has been difficult and where use of a term rate could be helpful in addressing such difficulties"[3]. It may also be useful for certain securitisations.

[1] SOFR is the Secured Overnight Financing Rate - see the Schedule for Key Facts on Term SOFR.

[2] SONIA is the Sterling Overnight Index Average - see the Schedule for Key Facts on Term SONIA and Term SONIA Reference Rate.

[3] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Scope_of_Use.pdf and https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Press_Release_Term_Rate_Scope_and_Conventions.pdf 21 July 2021

The ARRC does not support the use of Term SOFR rates for the majority of the derivatives market. It does, however, support the use for end-user facing derivatives to hedge cash products referencing Term SOFR rates. It has recommended the use of the term rate published by CME Group[4] (see key facts for US dollars in the Schedule).

In the UK, the Bank of England has accepted that banks and other users can follow the lead of the ARRC in relation to US dollars, even though the ARRC is not a regulator in the UK. For products using Pounds Sterling, it has, however, been noticeably stricter. The Working Group on Sterling Risk Free Reference Rates (Sterling Working Group) recognises the need for a forward-looking term rate for trade finance and trade and working capital transactions amongst others, which need certainty to know the interest rate at the beginning of the interest period.[5]

The FICC Markets Standards Board's "Standard on the use of Term SONIA Reference rates"[6] published 28 July 2021, recommends that its members assess if there is a "robust rationale" for using a SONIA term rate. Its core principles state that banks and dealers should track and retain records of volumes of deals; have adequate policies and procedures and controls in place for using term rates and have comprehensive risk disclosures. Therefore, whilst use of Term SONIA is acceptable for discounting, use could be more difficult for regulated lenders to justify for borrowers or transactions which could otherwise use an RFR compounded in arrears. Use of RFR terms rates is expected for some export finance and emerging market borrowers who may have systems or other local constraints which require up-front knowledge of the interest amount to be charged e.g. because an application must be made to a central bank for the use of foreign currency reserves which takes time to process.

2. Credit Adjustment spreads

Both RFR term rates for US dollars and Pounds Sterling are "risk free" and, therefore, do not include a credit premium as does LIBOR. An additional credit adjustment spread (CAS) could be added to the RFR term rate to maintain economic parity where parties are comparing pricing to the LIBOR equivalent.

On 5 March 2021, Bloomberg published the CAS as the five-year historic median to show the economic differential between LIBOR and SOFR for US dollars[7], and between LIBOR and SONIA for Pounds Sterling rates.[8] These rates were fixed on 5 March 2021 for each tenor.

---

[4] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC-Scope-of-Use-FAQ.pdf published 27 August 2021

[5] Use Cases of benchmark rates- compounded in arrears, term rates and further alternatives Jan 2020 https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/use-cases-of-benchmark-rates-compounded-in-arrears-term-rate-and-further-alternatives.pdf

[6] https://fmsb.com/

[7] https://assets.bbhub.io/professional/sites/10/IBOR-Fallbacks-LIBOR Cessation_Announcement_20210305.pdf Published by Bloomberg

[8] Credit adjustment spread for active transition for GBP LIBOR referencing loans Dec 2020 https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/credit-adjustment-spread-methods-for-active-transition-of-gbp-libor-referencing-loans.pdf

Using a historic median has the advantage of simplicity and makes sense in relation to legacy loans based on LIBOR which now have to be transitioned to RFRs. There is some debate as to whether the same logic should apply to new transactions.

It is possible to use a forward-looking CAS (which will need to be recalculated periodically and for which there is no agreed methodology) or exclude it altogether building the spread into the margin to be used with the RFR term rate. Whether to use a CAS is a commercial decision for the parties and this guidance note does not make any recommendation either way. The need to treat customers fairly and remain economically neutral after the transition away from LIBOR should underpin any such decisions. For many trade finance products, it is the overall cost that will be critical. Where a CAS is added, this could be built into the benchmark as an adjusted benchmark rate or added to the calculation as a separate element. The LSTA[9] Term SOFR Concept Document of 25 August 2021 shows how this could be done for US Dollars. [10]

ISSUES TO CONSIDER - US DOLLARS

1. Fallbacks

Shorter tenor: Term SOFR for US dollar transactions is available for 1, 3 and 6 months however, as yet there are no rates published for shorter periods, as with LIBOR. So, if there is a stub period either at the beginning or end of a transaction which is less than one month what alternative rate could be used? One option could be to use Daily SOFR overnight rate from the day before and apply it forward on a daily basis, or opt for interpolation as with LIBOR, or opt for a rate and apply it forward for a slightly longer period. A fixed rate or a rate based on the US central bank rate published by the Federal Reserve Bank of New York could be used.

Temporary unavailability: The LSTA and the ARRC have suggested using Daily SOFR or SOFR compounded in arrears on a temporary basis, however other forward-looking options have also been suggested including, SOFR in advance or SOFR average applied in advance. Similar methods could be used for temporary unavailability of Term SOFR as have previously been used in respect of LIBOR including, the historic rate or interpolated rate for the next interest period adapted from the LIBOR wording. The LSTA has published drafting to give the borrower the option to revoke a utilisation if Term SOFR is not available. The Agent is also given a degree of discretion to amend the terms of the agreement to accommodate the changes in the availability of tenors. At the end of August 2021, the LSTA Term SOFR Concept Document adopted the ARRC recommendation for use as a temporary fallback, Term SOFR for the first preceding US Government Securities Business Day, as long as this is no more than three such consecutive days before the determination date.

---

https://assets.bbhub.io/professional/sites/10/IBOR-Fallbacks-LIBOR-Cessation_Announcement_20210305.pdf Published by Bloomberg

[9] Loan Syndications and Trading Association https://www.lsta.org/

[10] As set out in the LSTA Term SOFR Concept Document 25 August 2021. LSTA documentation is available to LSTA members through their website.

Permanent replacement of RFR: Where Term SOFR is to be replaced permanently, the ARRC recommends that parties consider using either a hardwired option or an agreement to negotiate, agree and document an alternative benchmark within a certain timeframe. Alternative benchmarks could either be from the family of SOFR benchmarks including, Daily SOFR, SOFR compounded in arrears, SOFR in advance, SOFR average applied in advance, or, if at the time there is a replacement administrator for CME Group which is recognised as the "ARRC recommended Term SOFR" administrator (as there will only be one recommended Term SOFR at any given time, we understand) the *ARRC recommended Term SOFR* could be used. Other forward-looking rates, including AMERIBOR[11] (although it must be noted that private alternative rates have not met with much enthusiasm from regulators) or the US central bank rate published by the Federal Reserve Bank of New York could also be options to replace Term SOFR on a permanent basis.

2. Cost of funds

Lenders will also have to consider whether these methods will give them an adequate return to cover their cost of funds using the RFR term rates. Questions have been raised about whether cost of funds should still be an appropriate measure to use as a fallback as it is linked to the credit of the particular lender rather than to an external objective measure, for example, the central bank rate published by the Federal Reserve Bank of New York as the ultimate fallback. Lenders have to consider whether break costs and market disruption clauses, which for LIBOR work on the premise that LIBOR would represent an approximation of a lender's cost of funds, are still appropriate when a transaction is based on Term SOFR for US dollar transactions. That said, the recent LSTA Concept Document does include cost of funds provisions similar to those currently used in LIBOR based transactions.

3. Business Days

CME Term SOFR is calculated on each day that the Federal Reserve Bank of New York calculates and publishes SOFR. The business day for US dollar Term SOFR is quoted as US Government Securities Business Days which means any day except Saturday and Sunday or any other day on which the Securities Industry and Financial Markets Association recommends fixed income departments are closed for the entire day. Note, this is a new definition and needs to be taken into account for all Term SOFR and multicurrency transactions involving US dollars. The convention for both Term SOFR and SOFR Averages is to use the rate published two US Government Securities Business Days before the first day of the interest period.

4. A reminder on timing of reform of US dollar LIBOR

In relation to US dollar LIBOR, the ARRC in the US has launched its SOFR First initiative and is encouraging the market to transition away from US dollar LIBOR to use the SOFR family of benchmarks.

---

[11] Overnight, 1 and 3 month tenors. 6 and 12 month tenors are expected to follow.

From now until the end of 2021, the regulators are expecting parties to include in contracts either (i) hardwired alternative rates which will kick in on certain trigger events to replace US dollar LIBOR; or (ii) a contractual mechanism to negotiate, agree and document the adoption of an alternative benchmark rate within a stated time period.

After 31 December 2021, the US dollar LIBOR tenors for one week and 2 months will no longer be published. US supervisory guidance encourages no new US dollar lending from that date so that SOFR Term Rates or SOFR compounded in arrears are used from the first interest period in 2022. There is some uncertainty over whether utilisations under pre-existing LIBOR denominated *uncommitted a*greements would constitute new lending, although there is an emerging view that "pure" bilaterals, where both the commercial terms and the obligation to lend are subject to the lender's discretion, should be considered as new loans. The ultimate answer will depend on the wording of the agreement itself and whether there are already fallback provisions either hardwired or by agreement built into the agreement. The cautious approach for regulated lenders would be to review the wording of any agreement, consider using RFRs for any utilisations after 1 January 2022 and make any necessary amendments to the underlying financing documentation.

From 1 January 2022 to 30 June 2023, there will be US dollar LIBOR for the following tenors, overnight and 1, 3, 6 and 12 months for tough legacy contracts where it has been impractical or impossible to amend.

On 30 June 2023, publication of rates for overnight and 1-, 3-, 6- and 12-month US dollar LIBOR will end. After this date, it is unclear if there will be any synthetic US dollar LIBOR rates. The ARRC has suggested not to expect these, however, the UK's Financial Conduct Authority is looking into this with possible providers.

ISSUES TO CONSIDER - POUNDS STERLING

Once parties have satisfied themselves that they are eligible to use a forward-looking RFR term rate, then they should look at the practicalities of how to access the rate and what happens if they cannot get the rate for the period they need to cover.

1. **Fallbacks for Sterling term rates**

Shorter tenor: SONIA term rates for Sterling transactions are available for 1, 3, 6 and 12 months however, as yet, there are no rates published for much shorter periods, as with LIBOR. So, if there is a stub period either at the beginning or end of a transaction which is less than one month what alternative rate could be used? One option could be to use SONIA, overnight rate from the day before and apply it forward either on a daily basis, or opt for interpolation as with LIBOR, or opt for a rate for a slightly longer period than the period for which the rate is to apply. A fixed rate or a rate based on the Bank of England Bank Rate for that period could also be used.

Temporary unavailability: Similar methods could be used when there is temporary unavailability of Term SONIA published by Refinitiv Benchmark Services (UK) Limited

(Refinitiv) or TSRR published by ICE Benchmark Administration Limited (IBA)[12]. However, as there are two providers, the first step could be to use the term rate from the other provider, (use TSRR instead of Term SONIA and vice versa) as long as parties can access the rate on the day of publication. Methods used until now, including the historic rate or interpolated rate for the next interest period, could still work.

Permanent replacement of RFR: Where the Sterling RFR term rate is to be replaced altogether, the LMA[13] lists a number of options for parties to consider as replacements: for example, "Bank of England Bank Rate; SONIA compounded in advance (compounding the previous period's SONIA and then applying this calculation on a forward basis); SONIA compounded over the week prior to the interest period to determine the interest to be applied on a forward basis; Bond index yields (referencing the closest coupons adjusted maturity bond yield at the relevant time (for example, UK gilts); Fixed rate; and an Alternative TSRR" [14]. Lenders and borrowers will need to consider what will work operationally for both parties.

2. Cost of funds

Lenders will also have to consider whether these methods will give them an adequate return to cover their cost of funds using the RFR term rates. Questions have been raised about whether cost of funds should still be an appropriate measure to use as a fallback as it is linked to the credit of the particular lender rather than to an external objective measure, for example, the Bank of England Bank Rate, suggested by the LMA, as the ultimate fallback. Lenders have to consider whether break costs and market disruption clauses, which for LIBOR work on the premise that LIBOR would represent an approximation of a lender's cost of funds, are still appropriate when a transaction is based on Term SONIA or TSRR.

3. Business Days

SONIA term rates are likely, similar to LIBOR, to be quoted at T+2, days before the start of an interest period. LMA terminology for RFRs refers to "RFR Banking Day". For Sterling this should be a day other than a Saturday or Sunday when banks are generally open for general business in London. Parties should double check that the "RFR Banking Day" matches the Business Day needed for the transaction.

4. A reminder on timing of reform of Sterling LIBOR

By **31 March 2021**, regulated entities were not to engage in any new lending using Sterling LIBOR as the benchmark for loans ending after 2021. Since then, attention has been focussed on amending legacy contracts which use Sterling LIBOR tenors.

---

[12] See the Schedule for key facts on Term SONIA and TSRR.

[13] Loan Market Association

[14] Extracts from the LMA's table in its paper "Considerations in respect of the use of forward-looking term SONIA reference rates" 26 March 2021

The **end of Q3 2021** is the deadline given by the Sterling Working Group for parties to amend legacy contracts to replace Sterling LIBOR so that amendments take effect in 2022, using an alternative rate or RFR from the first interest period in 2022.

During Q4 the aim of the Sterling Working Group is for all to "be fully prepared for the end of GBP LIBOR loans". [15]

On 31 December 2021, Sterling LIBOR tenors for overnight, one week and 2 and 12 months will cease to be published. Tenors of 1, 3 and 6 months will no longer be representative.

From **1 January 2022**, it is expected that IBA will publish 1-, 3- and 6-month Sterling LIBOR under the auspices of the FCA using powers under the Financial Services Act 2021 under a different methodology to be known as "synthetic LIBOR". More details on use and methodology are expected from the FCA in the autumn. However, synthetic LIBOR is only intended to be used for tough legacy contracts where it has been impractical or impossible to amend. The provision of synthetic LIBOR is also likely to be time limited, so parties will also have to consider what other options they could adopt.

Commercial and market developments

Other international term rates are also being reformed on slightly different timetables to SONIA and SOFR. EURIBOR is still available as a forward-looking benchmark rate for transactions in euros. Recent consultations containing proposals for reform of euro LIBOR and EURIBOR have taken advantage of the work and thinking involved in the reform of Sterling LIBOR and US dollar LIBOR so that the euro RFRs can meet similar market standards and similar operations methodology more quickly. EONIA is being replaced by the Euro Short Term Rate, €STR, as the RFR for euros. When dealing with euros or any other currency, parties will need to consider the terms of the transaction, whether the RFR for the currency involved has been launched and whether there is an appropriate RFR term rate which will be available for the trade finance sector during the life of the transaction. This guidance note does not cover euros or currencies other than Pounds Sterling and US dollars in any detail.

Members will also need to transition potentially a large number of LIBOR denominated agreements. Most of the issues raised above are equally relevant to "legacy" agreements. How these legacy agreements should be transitioned is outside the scope of this guidance note but it is worth noting that the use of RFR term rates will make the task considerably simpler than would be the case if transitioning to RFRs compounded in arrears. Market participants should be looking at how to implement the necessary amendments, which may be done either (i) by bespoke amendment agreements[16], or (ii) by override amendment agreements where replacement terms are "superimposed" on the agreement to adopt an alternative benchmark specifying the

[15] Priorities and roadmap for transition by end 2021 (May 2021) https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfr-working-group-roadmap.pdf?la=en&hash=92D95DFA056D7475CE395B64AA1F6A099DA6AC5D

[16] As seen by Sullivan & Worcester UK LLP

reference rate terms[17]. Clearly, market participants will need to consider what is most appropriate for them, take the necessary legal and operational advice and look at the costs involved for their portfolio of legacy documents to be transitioned away from LIBOR.

ITFA and BAFT are planning to amend the BAFT Master Participation Agreements (2007 and 2018) to use central bank rates in place of LIBOR. (Note that LIBOR is only used to calculate default interest in the master agreement itself). ITFA and BAFT will announce when the amendment is available to the market.

In trade finance transactions using RFR term rates, the parties will be looking for a profitable and operationally functioning interest and discount rate with suitable fallbacks, which may be needed to keep the transaction and the market running smoothly. Whichever methods are chosen, it is prudent for parties to consider the practical issues of (i) access to the RFR term rate, (ii) whether operationally the Lender or Agent can work with the chosen alternative RFRs, and (iii) whether there should also be the option for the parties to decide that the RFR is no longer appropriate and agree an alternative benchmark which they will document at the time. We will be keeping an eye on how the market develops and will be interested to hear from you on what you have found works well using RFR term rates.

[17] As seen by ITFA and adopted by some regulated lenders

SCHEDULE

KEY FACTS: US dollar RFR term rates

US Dollars	**Replacement rate for US dollar LIBOR is the Secured Financing Overnight Rate (SOFR)**
Term Rate RFR	CME Group's forward-looking SOFR Term Rates. Selected by the ARRC[18] on 21 July 2021 and recommended by the ARRC on 29 July 2021. There is no other ARRC recommended SOFR term rate or provider.
Administrator	CME Group Benchmark Administration Limited
Supervisor	UK Financial Conduct Authority
Access	Real-time data via CME Market Data Platform and Smart Stream on Google Cloud Platform. Delayed and historical data via CME DataMine and CME website[19]. Licenced through data redistribution partners, Bloomberg and Refinitiv.
Tenor	1-, 3- and 6-month Term SOFR CME Group expects to launch 12-month Term SOFR before the end of 2021.
Publication time	On each day the New York Fed publishes SOFR. Term SOFR is published at 5.00am US Central Time
Republication time if errors	Validation checks and recalculations are done during the calculation process. Once published there is no republication.
Best practice	ARRC Best Practice Recommendations to Scope of Use of the Term Rate[20] recommends overnight SOFR and SOFR averages but recognises the need for SOFR Term Rates. ARRC FAQs on Best Practice Recommendations to Scope of Use of the Term Rate [21] published after recommendation of CME Group Term SOFR as the ARRC recommended Term SOFR.
Methodology if rate is temporarily unavailable	ARRC recommends using Daily SOFR if Term SOFR is not available. If there is market volatility CME Group will check the day-on day changes against the underlying market, and if not consistent, it will publish the previous day's Term SOFR rates, pending investigation. Where (i) there is a technical failure in calculating the rate, (ii) SOFR futures data is not available, or (iii) the NY Fed Overnight SOFR rate is not available for the calculations, the rates will be calculated using the previous day's Term SOFR rates for (i) and (ii) and Overnight SOFR rate for (iii) for all tenors. If

[18] Alternative Reference Rates Committee https://www.newyorkfed.org/arrc

[19] https://www.cmegroup.com/market-data/cme-group-benchmark-administration/term-sofr.html?redirect=/termsofr#

[20] See Use Case information.

[21] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC-Scope-of-Use-FAQ.pdf published 27 August 2021

	this occurs for more than three such consecutive business days, then CME Group must convene the Oversight Committee to assess remedial action.[22]
Published Definitions and documentation	ARRC definition LSTA Concept Document August 2021 for Term SOFR. LMA is working on a recommended document for developing markets sector which may include US dollar forward-looking term rates. [23]

KEY FACTS - Sterling RFR term rates

Pound Sterling	**Replacement rate for Sterling LIBOR is the Sterling Overnight Index Average (SONIA)**	
Term Rate RFR	Refinitiv Term SONIA[24] – Term Rate (Term SONIA)	ICE Term SONIA Reference Rate[25] (TSRR)
Administrator	Refinitiv Benchmark Services (UK) Limited (Refinitiv)	ICE Benchmark Administration Limited (IBA)
Supervisor	Bank of England[26]	
Access	Refinitiv Eikon, Refinitiv Real Time and Refinitiv Data Scope	ICE Term Risk Free Reference Rates Portal
Tenors	1-, 3-, 6- and 12-month Term SONIA	1-, 3-, 6- and 12-month TSRR
Publication time	11.50am London time	11.55 am London time
Republication if errors	Yes: cut off time 12.50 republication on date of error	Yes: cut off time 14.00, republication 14.45 on date of error
Best practice / market standards	Best Practice Guide for GBP loans published Feb 2021, updated July 2021- relates to SONIA compounded in arrears[27]. FICC Markets Standards Board's "Standard on the use of Term SONIA Reference rates" published 28 July 2021	

---

[22] Extracts from the CME Term SOFR Reference Rates Benchmark Methodology 2021 https://www.cmegroup.com/market-data/files/cme-term-sofr-reference-rates-benchmark-methodology.pdf

[23] Available to LMA members on www.lma.eu.org

[24] Refinitiv Term SONIA https://www.refinitiv.com/en/financial-data/financial-benchmarks/term-sonia-reference-rates

[25] ICE Benchmarks https://www.theice.com/marketdata/reports/244

[26] Term SONIA Reference Rate publication summary- updated July 2021 https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfrwg-term-sonia-reference-rate-summary.pdf

[27]https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor/working-group-on-sterling-risk-free-reference-rates

Methodology if term rate is temporarily unavailable	Refinitiv's 3 tier waterfall methodology enables publication in "the most challenging market conditions" so it provides Term SONIA even during periods of "extreme volatility". [28]	IBA's 3 tier waterfall methodology enables publication. IBA would publish the previous day's rate until the TSRR can be calculated using the waterfall (level 3). [29]
Published and recommended documentation	LMA[30] Illustrative definition for Refinitiv Term SONIA	LMA Illustrative definition for ICE TSRR
	LMA is working on RFR SONIA term rate facility documentation for the developing markets sector (expected later in 2021).	

[28] https://www.refinitiv.com/content/dam/marketing/en_us/documents/methodology/term-sonia-methodology.pdf

[29] https://www.theice.com/publicdocs/data/TSRR_-_Calculation_Methodology.pdf

[30] Loan Market Association's paper "Considerations in respect of the use of forward-looking term SONIA reference rates" March 2021. LMA members can access illustrative definitions on the LMA website.