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PFI Guidance Note

# Discontinuation of London Interbank Offered Rate – applied to PFI Projects

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# Discontinuation of LIBOR

1. The purpose of this note is to make procuring authorities aware of a forthcoming change in the UK finance markets resulting from the discontinuation of LIBOR that will impact the vast majority of PFI projects. It also makes procuring authorities aware of a possible PFI market consultation exercise to occur in the first half of 2021.

# What is LIBOR?

2. In the UK, LIBOR is expected to cease to exist after the end of 2021, as required by the Bank of England and the Financial Conduct Authority (FCA). LIBOR stands for the London Interbank Offered Rate. It is a forward looking interest rate that UK banks charge other financial institutions for short-term loans. The loan maturities vary from one day to one year. LIBOR acts as a benchmarking base for short-term interest rates for various types of variable rate loans, and also forms the basis for interest rate, floating to fixed swap hedging arrangements.

3. In PFIs LIBOR is often used as the base cost of private sector debt finance that is loaned by banks to PFI Special Purpose Vehicles (SPVs), to which is then added the financier's credit (profit) margins and other fees. This base cost of debt finance then forms part of the Unitary Charge that the procuring authority pays to the PFI SPV to enable the SPV to cover its finance costs. LIBOR is not used for PFI projects that are financed by bonds so this issue may not be relevant for those projects. Although LIBOR is not mentioned in most PFI Project Agreements, it will be relevant when referencing financing agreements, especially for variations, refinancings, termination provisions and other finance related provisions.

4. For most sectors in the UK it is proposed that LIBOR will be replaced by a new benchmark interest rate called SONIA.

5. For interest rate derivatives the proposed change also involved interdealer brokers (IDBs) moving the primary basis of their pricing screens and curve construction for interest rate swaps from LIBOR to SONIA. At present, SONIA swaps are priced by reference to a LIBOR swap adjusted by the LIBOR-SONIA basis. In future, SONIA swaps would be the primary pricing point.

6. It should be noted that from **1 October 2020**, it is a recommendation from the UK Industry Working Group that lenders should offer non-LIBOR alternatives for new loans and from **1 April 2021** lenders should not offer new LIBOR loans.

# What is SONIA?

7. SONIA stands for the Sterling Overnight Index Average. Unlike LIBOR, SONIA is based on actual historic transactions and reflects the average of the interest rates that

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banks pay to borrow sterling overnight from other financial institutions and other institutional investors. The main differences between LIBOR and SONIA include:

a. **Backward vs forward-looking**: SONIA is a measure of overnight borrowing costs rather than a forward-looking expectation of rates (LIBOR);

b. **Term**: LIBOR rates are published at several different maturities (for example overnight/spot, one week, two months, three months, six months and one year), whereas SONIA is currently only published as an overnight or spot rate without incorporation of a term element; and

c. **Bank credit risk**: LIBOR is unsecured and includes an element of bank credit risk. Whilst SONIA is also an unsecured rate, because it is a measure of overnight borrowing costs and does not incorporate bank credit risk, it operates as a near proxy for a risk-free rate.

8. As SONIA does not include the credit risk component of LIBOR, it would usually be expected to be lower than its LIBOR equivalent. However, the spread has been quite volatile over the last 12 months and may go up or down in the future. The spread is currently only one basis point, although SONIA has been up to 20 basis points lower than 6 month LIBOR at certain times in the last 12 months.

9. Although it is expected that SONIA will replace LIBOR for the vast majority of UK lending transactions, there may be some instances for what the FCA refers to as "tough legacy contracts" (discussed below) where SONIA may be adjusted to provide a synthetic (alternative) benchmark rate. The expectation, in accordance with Bank of England and Financial Conduct Authority (FCA) guidelines, is that SONIA will be implemented for PFI transactions as an appropriate and robust alternative to LIBOR, and this should be approached as a straightforward, largely administrative process. However, ultimately it is up to the PFI private sector investors and their financiers to determine the most appropriate alternative benchmark interest rate for PFIs.

## How might a switch to SONIA affect Procuring Authorities?

10. If LIBOR is replaced with SONIA, then in the first instance it should not convey any contractual obligations on procuring authorities. For example, although the switch may constitute a general change in law, it is not a qualifying change in law for which the procuring authority may be liable. In addition, the switch would not constitute any type of compensation or relief event.

11. The switch from LIBOR to an alternative benchmark interest rate such as SONIA under some PFI contracts may meet the definition of a Refinancing under the financing documents, and thereby could theoretically give risk to a Refinance Gain or loss. However, despite SONIA probably being at times (depending upon market conditions)

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a slightly cheaper rate than LIBOR, it is not anticipated that there will be any Refinance Gain to be shared with the procuring authority. This is because any gains for the SPV from a reduced SONIA rate should be countered by equivalent losses under the SPVs existing interest swap arrangements. Further, the SPV will have to pay certain administrative costs required as a result of the change – including legal costs for the amendment of some contractual documents.

12. It is not anticipated that there should be any changes to the Project Agreement required due to this switch from LIBOR. However, there will be some contractual drafting changes required in the financing documents including the interest swap agreements. Any administration costs driven by these changes should be solely for the account of the private financiers and the SPV. Procuring authorities should not contribute to meeting any SPV costs in respect of the discontinuation of LIBOR.

## Why do procuring authorities need to know about this?

13. There is a possibility that the occurrence of a refinancing event may crystallise liabilities that the SPV owes under its existing swap arrangements. In the unlikely event that these liabilities are material and may threaten the solvency of the SPV, then obviously the procuring authority will need to understand this as soon as possible. Additional guidance will be provided by the Infrastructure and Projects Authority (IPA) later in 2021 once this issue has been investigated further, and accepted market protocol has been developed.

14. Due to the fact that there is no direct liability or obligation for procuring authorities as a result of the switch away from LIBOR, there is no immediate need for procuring authorities to do anything other than be aware of the issue and how it may impact the SPV. However, procuring authorities may wish to find out from the SPV what their plans are in this respect to help ensure that the SPV and its financiers are taking appropriate steps to manage any residual SPV risk.

15. In respect of the discontinuation of LIBOR, procuring authorities should **NOT** mandate or direct any particular course of action to the SPV. This is because if such a direction is considered to be project specific, it may lead to the change being considered as a qualifying change of law, rather than a general change in law, and it may then confer some liabilities onto the procuring authority. It is for the private sector equity and debt financiers to resolve this issue between them.

16. However, procuring authorities should assist the private sector in minimising administrative costs, and making the LIBOR transition as efficient as possible, whilst ensuring that they do not take on any risks or liabilities arising from the switch away from LIBOR.

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## Synthetic LIBOR for tough legacy contracts

17. Under new powers under the Financial Services Bill (October 2020), the UK's Financial Conduct Authority (FCA) has outlined that after 2021 it may provide certain market sectors with more direct interest benchmark substitutes (in the case of LIBOR the market is calling this possible new benchmark rate 'synthetic LIBOR'). The FCA will only do this where it decides that the market sector in question has 'tough legacy contracts' and the application of SONIA would cause a 'disorderly cessation' from the existing benchmark rate. This may be the case where counterparties cannot agree on a way to transition away from LIBOR, and if publishing the synthetic LIBOR benchmark will contribute to 'protecting consumers or preserving market integrity'.

18. If PFIs are determined by the FCA to be tough legacy contracts, then the application of some type of synthetic LIBOR may reduce any SPV costs associated with the switch away from LIBOR. However, the FCA guidelines say that the new benchmark would only be published for up to 10 years, and would be re-assessed by the FCA every year for continuing applicability. If so, even if PFIs are deemed by the FCA as tough legacy contracts, it may only delay the process of switching from LIBOR to SONIA as many PFI finance arrangements have more than 10 years remaining.

19. There is no indication yet whether PFIs would meet the criteria to be considered to be tough legacy contracts. There will be a market consultation exercise for the PFI industry during the first half of 2021 which the IPA as well as other UK Government departments with large PFI portfolios may contribute to. If, as a result of this market consultation exercise, it is decided that PFIs may be a tough legacy contract, then the FCA will be approached for their final determination.

## Next Steps

20. The IPA will continue to coordinate Government consultation with PFI private financiers. Currently, the PFI private financiers have not worked out in detail what their approach will be in respect of the discontinuation of LIBOR for PFI projects. It is expected that this will become better known during 2021.

21. If any Government entity wishes to participate in any market consultation exercise (e.g. to determine whether or not PFIs will qualify for synthetic LIBOR as tough legacy contracts) then they should contact IPA in the first instance.

22. IPA will update this technical note as necessary later in 2021 once more is known of the PFI markets approach to the discontinuation of LIBOR. This will include the results

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of the market consultation exercise in respect of the possibility of using synthetic LIBOR rate for PFIs instead of the proposed SONIA rate.[1]

[1] More information on the transition from LIBOR to SONIA can be found on the Bank of England website - https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor

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