CLIFFORD CHANCE

LIBOR 2021

FRANCIS EDWARDS AND DAUWOOD MALIK
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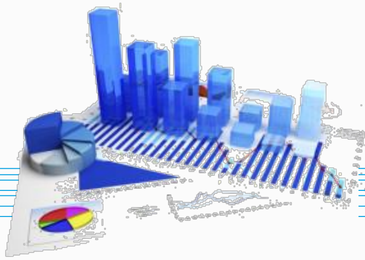
OVERVIEW

- LIBOR currently a key interest rate benchmark for global financial system for a large volume ($350 trillion or more?) and broad range of financial products and contracts – corporate loans, corporate bonds, derivatives, mortgages, consumer loans, structured debt products, regulatory capital
- Since LIBOR scandal broke in 2012 has been under pressure
- Andrew Bailey, Chief Executive of UK's Financial Conduct Authority gave speech on 27 July 2017 making clear that market should anticipate LIBOR may not be available post 2021
- Why might LIBOR cease to be available? Will it cease to be available?

- What will replace LIBOR?
- What does this mean for legacy transactions?
- What does this mean for documenting current transactions?
- Is there a the way forward now?
- "The Asian perspective".

WHY MIGHT LIBOR CEASE TO BE AVAILABLE?



2012
Wheatley Report on LIBOR.

2013
G20 asks Financial Stability Board (FSB) to look at fundamental review and reform of key interest rate benchmark rates.

1 January 2018
EU Benchmarks Regulation.

Since 2012
Since 2012 confidence in reliability and robustness of interbank benchmark interest rates ("IBOR"s) has been undermined due to:

- cases of attempted market manipulation and false reporting
- post financial crisis decline in liquidity of interbank funding markets
- …. has resulted in Governments, regulators and central banks looking to review and reform key benchmark rates.

2014
FSB recommends

- strengthening existing IBORs by underpinning them to greatest extent possible with transactions data ("**IBOR+**")
- developing alternative nearly risk free reference rates for certain financial transactions such as derivatives ("**RFRs**")
- IBOR benchmark rates to reflect IOSCO Principles for Financial Benchmarks.

REFORM OF LIBOR SINCE 2012

- BBA implemented Wheatley recommendations to stop publishing LIBOR for less common currencies (AUD, CAD, NZD, DKK and SEK) and less common maturities

- ICE Benchmark Association (IBA) takes over as administrator of LIBOR
- IBA introduced reforms, including:
  - "waterfall" for LIBOR submissions standardised and
    aimed at to greatest extent possible basing submissions on actual transactions
  - standardised parameters for type of transactions relevant for submission
  - adding to eligible counterparties – including transactions with corporates
  - extending approved funding locations
  - developing submission methodology

… and reform ongoing, BUT ...

WILL REFORM BE ENOUGH?

- FCA study indicates there is an insufficient volume of transactions in the unsecured wholesale bank borrowing and related markets to enable the determination of LIBOR to be based on actual transactions
- … meaning LIBOR panel banks forced to resort to "Expert judgement" in submitting rates

- Uncomfortable position which FCA/Banks want to transition away from but in an orderly transition – hence Andrew Bailey's July speech
  - currently, FCA's active encouragement has been significant factor in encouraging panel banks to continue to provide quotes to enable ICE LIBOR to be published
  - FCA actually has powers to compel submission under Benchmark's Regulation
  - after 2021 FCA intends not to encourage such submission or use any power to compel submission
  - not necessarily end of LIBOR – but reality is likely to be beginning of the end: 4 year "runway" (unless market cannot determine an alternative ....).

ALTERNATIVES TO LIBOR?

Onus on market participants to:

- develop alternative benchmark rates
- ensure new contracts which go beyond 2021 have sufficiently robust fallbacks to deal with LIBOR ceasing to be published.

“Risk Free Rates” for relevant currency?

- for sterling, working committee set up by Bank of England has recommended SONIA (Sterling Overnight Index Average) – the unsecured overnight rate which is now administered by the Bank of England and is in the process of being reformed.
- for USD, the Alternative Reference Rates Committee has announced a broad Treasuries repo financing rate (an overnight rate based on the interest paid on overnight loans collateralised by US Government debt) as the appropriate rate for certain USD derivatives and Fed seeking public comment on 3 new reference rates based on this
- for Swiss Francs, working group has recommended the overnight secured benchmark rate (SARON)
- for Euro it is still being considered
- for Japanese Yen, the study group has announced its chosen RFR as the uncollateralised overnight call rate calculated and published by Bank of Japan.

ALTERNATIVES TO LIBOR?
(CONTINUED)

Challenges of RFR's

- "Backward Looking rate" rather than "forward looking"
- Borrower/Issuer – won't know rate until end of interest period (and then aggregated/ compounded (?) interest rate over the period)
- Does not include "risk" elements which LIBOR does – both counterparty risk and temporal risk – so RFR rates historically less than LIBOR
- Re-think fundamental terms of loan documentation ("cost + margin" approach)?

Solutions

- Introduce a "term" RFR? How? Who calculate?
- Will solutions lead to similar concerns to LIBOR?
- Issues with transition
- Needs to be inter-relationship which works
- Market efficiencies if widespread use of same benchmark/reference rate
- Trade associations considering and co-ordinating – ISDA, ICMA, LMA, AFME.

Cart before horse?

- Derivatives solution adopted by loan/bond markets counter-intuitive?
- Derivatives used to hedge interest rate exposures in loan/bond markets.

WHAT IS THE SITUATION UNDER LEGACY TRANSACTIONS?
FALLBACKS

- Most documents have some provisions allowing for fall-backs should Screen Rate LIBOR not be available but they are really designed to address short-term unavailability
- LMA style syndicated loans:
  - interpolation [only works if is a rate but just not for the period required]
  - historic rate [only works if is a recent rate]
  - average of quotes of borrowing rates of Reference Banks in wholesale markets [only works if Reference Banks willing to quote]
  - self-certificated Lenders costs of funds (individual or weighted average) [unwieldy/impractical]
  - provision allowing Agent to specify another information source as the applicable Screen Rate unlikely to be of assistance when the underlying rate itself (as opposed to the information source) of that rate has changed ("relevant rate").
- ISDA
  - alternative screen rate
  - reference banks.

WHAT IS THE SITUATION UNDER LEGACY TRANSACTIONS?
FALLBACKS (CONTINUED)

- DCM – FRNs
  - Most floating rate notes bear interest on the basis of a screen rate
  - If the relevant screen rate is unavailable, the agent should request a number of reference banks to provide a quotation for the applicable LIBOR rate
  - As a secondary fallback, the agent is required to obtain quotations from a number of major banks for loans of equivalent tenor to the interest period
  - Where the rate of interest cannot be determined at all, the parties default to the most recently calculated rate for prior interest periods, in effect fixing the rate
  - Structured debt – more sensitive to ensuring matching adjustments across both assets and liabilities.
  - Satisfactory from regulatory viewpoint? – EU Benchmarks Regulation.

WHAT IS THE SITUATION UNDER LEGACY TRANSACTIONS?

IF FALLBACKS NOT SATISFACTORY?

If fallbacks not satisfactory, amendment / liability management process

Possibly

Contract frustrated? – Extremely unlikely?

- consent levels?
- LMA style syndicated loans – likely at least Majority Lenders and Borrower. If prospect of reducing overall return then likely all Lender and Borrower unless amendment option selected
- ISDA – protocol mechanism
- felt to be impractical in public bonds due to inflexibility of amendment procedures and timing considerations.

- use tools of contractual interpretation/implied terms to construe contract so that it is read as referring to the "new rate" (whatever that is) – might work but the more different the "new rate" the more difficult.

WHAT DOES THIS MEAN FOR CURRENT TRANSACTIONS?

- How do I cater for LIBOR ceasing to exist?
- Difficult for current transactions to specify an alternative rate which does not yet exist and which does not yet have market acceptance
- Likely LIBOR continued to be used until clear what alternative rate will be accepted
- To extent commercially acceptable, in multi-party transactions (such as syndicated loans and FRNs) consider making the document more flexible in terms of amendments to the reference rate
  - e.g. LMA option for syndicated loans – Majority Lender and Borrower can amend if Screen Rate not available to provide for another benchmark rate to apply
  - changes to interest rate determination would usually be reserved matters in eurobond documentation requiring high approval thresholds – carve-out changes due to cessation of benchmark?
  - Index linked bonds have concept of an indexation adviser in the event of fundamental changes to index. Hard to see that working in a high-volume, high-risk context.
  - Structured debt – Discussion of allowing servicer or cash manager to propose change in the basis rate via "negative consent" mechanism. See AFME Model Wording for Benchmark Rate Modification
  - ISDA protocol mechanism?

ISDA'S WORK ON IBOR FALLBACKS AND TERM STRUCTURE DEVELOPMENT

IBOR Fallbacks

- work led by ISDA at request of the FSB OSSG
- ISDA established a number of working groups (USD; GBP/EUR/CHF; JPY; AUD/SGD/HKD)
- selection of a fallback rate that would apply in the event that the applicable IBOR is *permanently* discontinued
- amendments to the 2006 ISDA Definitions to add selected fallbacks that would apply upon any such *permanent* discontinuation
- development of a proposed plan to amend legacy contracts referencing the applicable IBORs (including potential protocol mechanism)
- fallbacks anticipated to be based on the relevant RFR with an adjustment to minimise any value transfer at the point at which the fallback is triggered
- WGs developing a list of potential calculation methodologies for credit spreads
- anticipated poll of derivatives market participants to identify most appropriate adjustment mechanism

Term structure

- Challenge of using an overnight rate for longer interest periods (for LIBOR typically one, three, six or twelve months)
- Forward v backward looking rates
- If compound RFR in arrear to create term structure, only available at end of the period
- Work on possible term structures on-going

ISDA'S DOCUMENTATION WORK

ISDA Benchmark Supplement

- compliance with Article 28(2) EU Benchmark Regulation - robust written fallback plans
- amending the ISDA Definitional booklets in order to ensure robust fallbacks exist in the event that benchmark ceases to exist or materially changes
- separate work stream to the IBOR Fallbacks initiative
- Interaction with ISDA IBOR Fallbacks

  - fallbacks under ISDA Benchmark Supplement to apply for an interim period, until IBOR Fallbacks finalised

  - once finalised, IBOR Fallbacks at top of fallback waterfall
- Work still on-going

IBOR Fallbacks

- As described above

GBP-SONIA-COMPOUND

- April 2016 Bank of England took over the administration of SONIA from the Wholesale Market Brokers' Association ("WMBA")
- From 23 April 2018 the BoE will take over the end-to-end administration of SONIA, including its calculation and publication
- Amendments to Floating Rate Option GBP-WMBA-SONIA-COMPOUND
- References to WMBA removed
- a rate *"..as provided by the administrator of SONIA to, and published by, authorized distributors of the rate.."*

ISDA’S DOCUMENTATION WORK (CONT.)

ISDA SONIA FAQs

- published March 2018

Other ISDA initiatives

- "IBOR Global Benchmark 2018 Transition Roadmap“ (published by ISDA, AFME, ICMA, SIFMA and SIFMA AMG) on 1 February 2018
- Global IBOR survey questionnaire by ISDA (in partnership with AFME, ICMA, SIFMA and SIGMA AMG) - launched on 26 February

THE ASIAN PERSPECTIVE

Approach regionally to IBOR

Reform since 2012

Will local IBORs also cease to be available?

Approach to documentation

FUTURE

1 Market participants should be (and are) contemplating life when LIBOR in its current form ceases to be available

2 Need for industry-wide co-operation to agree on alternatives and support transition (borrowers/lenders/arrangers/issuers/ underwriters; front/back/middle offices; loans/DCM/derivatives/ structured debt)

3 Equally, need to be joined up with approach for alternative benchmarks for individual LIBOR currencies and other IBOR rates

4 Countdown to 2021

CLIFFORD CHANCE CONTACTS

FRANCIS EDWARDS
Partner, **Hong Kong**

T +852 2826 3453
E francis.edwards
@cliffordchance.com

DAUWOOD MALIK
Partner, Hong Kong

T +852 2826 3485
E dauwood.malik@
cliffordchance.com

C L I F F O R D

C H A N C E

Clifford Chance, 27th Floor, Jardine House, One Connaught Place, Hong Kong

WWW.CLIFFORDCHANCE.COM

516444-4-12057