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LIBOR – THE BEGINNING OF THE END?

Although a bedrock of the financial markets for over 30 years, LIBOR has been under pressure ever since the Wheatley Review, and a speech by Andrew Bailey, Chief Executive of the UK's Financial Conduct Authority (FCA)[1] on 27 July heralds its potential demise. Market participants need to prepare for the likelihood that LIBOR will cease to exist by the end of 2021. This briefing explains why and assesses the practical and documentary implications.

Key issues

- LIBOR is likely to cease to exist by the end of 2021.
- The development of suitable alternatives for financial products is now a priority.
- The fallback provisions in existing market standard documentation have practical limitations in the absence of agreed alternatives to LIBOR.
- For now, the most prudent change to multilateral documentation is likely to be to provide for easier amendment in the future.

What did the speech actually say?

There were four key points for users of LIBOR:

- Market participants should not rely on LIBOR being available after 2021.
- The FCA's active encouragement has been a significant factor in persuading LIBOR panel banks to continue providing quotes and has been an important element in enabling the continued publication of LIBOR. After 2021, the FCA will no longer encourage LIBOR panel banks to provide quotes and will not exercise its powers to compel them to do so.
- An FCA study indicates that 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.
- The onus is on market participants to (a) develop alternative benchmark rates; and (b) ensure that contracts entered into now which go beyond 2021 have sufficiently robust fallbacks to allow for a smooth transition if publication of LIBOR ceases.

What does this mean for LIBOR?

Mr Bailey stressed that the FCA is not mandating the end of LIBOR and that IBA, LIBOR's administrator, would be free to continue to produce LIBOR after 2021 if it can do so. However, the practical reality is that, in the current environment, the production of LIBOR is unlikely to be sustainable in the absence of the FCA encouraging or compelling panel banks to provide quotations.

> "I cannot entirely discount the risk of earlier panel degradation, or having to fall back to use of our powers to compel, with all the costs and risks of a messier and more costly transition that this might crystallise."
>
> **Andrew Bailey**
> Chief Executive, FCA, 27 July 2017.

What will replace LIBOR?

That is the $300 trillion question. There is no ready-made replacement rate in place, and the FCA has made clear that, although it is ready to support and coordinate them, it is market participants themselves that must take primary

[1] https://www.fca.org.uk/news/speeches/the-future-of-libor

responsibility for the development of, and transition to, alternative reference rates.

The speech notes that there has been progress in the development of alternative reference rates (often dubbed "*risk free rates*") in the context of derivatives, and suggests that these could be adapted for other purposes:

- In the US, the Alternative Reference Rates Committee has recently announced a broad Treasuries repo financing rate (an overnight rate based on the interest rate paid on overnight loans collateralised by US government debt) as the appropriate reference rate for certain USD derivatives and other contracts as an alternative to USD LIBOR.
- In the UK, the working group on sterling risk-free reference rates has recently recommended SONIA (an overnight rate in the process of being reformed and administered by the Bank of England and to be based on the interest rate paid on wholesale unsecured overnight loans) as an alternative to GBP LIBOR in the derivatives market.

Both of these rates are at an early stage of gestation and market consideration. Both are verifiable overnight benchmark rates and are "*backward looking*" in that they report what the rate was for past transactions. By contrast LIBOR is a term benchmark rate which is "*forward looking*" in that it reports what the rate is today for a forward-starting term. The extent to which overnight rates of this type could be used as a basis for the construction of a new forward looking benchmark for a variety of terms, who might produce and publish such a benchmark and the extent to which such a rate would be commercially acceptable to LIBOR users in all contexts, are matters that market participants need to address.

Any new forward looking benchmark for the debt markets will have to be closely linked to the development of benchmarks for the derivatives markets given the interrelationships involved.

What does this mean for current transactions and documentation?

In the recent past, the financial markets have needed to address the discontinuance of interbank rates for specific currencies and maturities (for example, through the amendment of market standard forms to provide for interpolation).

However, in the context of a future complete discontinuance of a rate like LIBOR, it is difficult for current transactions sensibly to specify the use of a future alternative reference rate which does not yet exist and which does not yet have market acceptance. In the near term, it is likely that transactions will continue to be based on LIBOR as documentation can be adapted only when market thinking is more developed on the alternative(s) to LIBOR in the context of the markets in question.

To the extent commercially acceptable, a step to consider in the context of multi-creditor transactions such as syndicated lending or bonds and other securities, is likely to be to provide for the flexibility to make any subsequent amendment to interest rate determinations that may be required further down the line as a result of the discontinuation of LIBOR. For example by incorporating a lower creditor consent threshold than might otherwise have applied to such a fundamental amendment: referring to majority lenders instead of all lenders in the context of lending documentation; and making it a low quorum matter at a bondholder meeting, rather than a high quorum

> "[I]n one currency–tenor combination, ... [panel] banks, between them, executed just fifteen transactions of potentially qualifying size in that currency and tenor in the whole of 2016. LIBOR is sustained by the use of “expert judgement” by the panel banks to form many of their submissions."
>
> **Andrew Bailey**
> Chief Executive, FCA, 27 July 2017.

"*reserved matter*" in the context of bonds and other securities. The Loan Market Association (LMA) recommended forms of loan documentation have included such provision as an option since 2014. Whilst it is important to note that future amendment is no panacea (in securitisations and other structured transactions, for example, it will be crucial that a number of interrelating products continue to reference the same rate at all times) the flexibility to make such changes with a lower creditor threshold may prove useful. For the structured markets, parties should also consider "hard wiring" the ability to make amendments needed as a result of the discontinuation of LIBOR. Such provisions could easily be adapted from existing ones used in respect of amendments expected to be needed to deal with rating criteria and legislative change.

In the context of bonds and other securities, issuers and dealers will need to consider how to disclose the risks associated with possible discontinuation of LIBOR as a rate. In most instances, transactions that reference LIBOR will in any case have had a LIBOR risk factor relating to the unpredictability of future LIBOR levels and the reforms of LIBOR that have been ongoing for some time. In general, we would expect that the language of future risk factors could be relatively easily adjusted to refer to the FCA's announcement and the possible discontinuation of LIBOR entirely. It is important, however, to recognise that the uncertainty as to the final position – especially regarding replacement benchmarks – means that risk factors cannot be too specific at this stage

What does this mean for legacy transactions and documentation?

The key question is how these transactions deal with LIBOR not being available. This is considered below in the context of market standard lending, bond and derivatives documentation.

As a precursor, it is important to note that, although the possibility cannot be entirely discounted, there will be challenges in construing references to LIBOR in existing English law documentation (whether by reference solely to a rate displayed on a specified screen or in more descriptive terms) as including any future alternative reference rate, since it will likely be very different in nature to LIBOR, even if, to take an extreme example, that alternative reference rate was carried on the same screen that previously carried LIBOR.

Corporate lending

- The Agent's power, in the recommended forms of LMA loan documentation, to specify an alternative information source as a screen rate for an interest rate benchmark will likely be of no assistance in the scenario where the underlying benchmark itself, as opposed to the referenced information source, no longer exists.
- Instead, those forms contain a number of contingency measures which apply in the event of an interest rate benchmark itself being unavailable.
- In the context of a discontinuation of LIBOR, the floating element of the interest rate will sometimes be determined by reference to the average of quotes of borrowing rates in the wholesale markets supplied by Reference Banks. Failing that, the floating element will be determined by reference to each lender's self-certified cost of funds (either on a lender-by-lender basis or on the basis of the weighted average of rates supplied, depending on the option included at signing).

"There is a very important question here to which we need a robust answer, namely whether the better approach to transition would be to amend contracts to reference an alternative rate, or amend the definition of LIBOR through the fallback protocol to replace the current methodology with alternative reference rates."

Andrew Bailey
Chief Executive, FCA, 27 July 2017.

- The market's experience of the discontinuation of BBA LIBOR for a number of currencies in 2013 suggested that neither of these fallbacks is practical on a large scale or for long periods of time. Since 2014, LMA loan documentation has, as an option, facilitated subsequent replacement of an unavailable benchmark by providing for suitable amendments to be made with the consent of the borrower group and the majority lenders only. It is this provision which is likely to be the most useful if LIBOR ceases to be available and alternatives emerge. In its absence, it is likely that amendments to documentation to replace LIBOR with any alternative reference rate will require the consent of the borrower group and ***all*** the lenders. As noted above, on a structured loan transaction any such amendment would need to be considered in the context of any interrelating product, such as an interest rate swap.

Bonds, securitisations and other securities

- Most Eurobond and Medium Term Note Programme documentation provides for floating rate notes to bear interest either on the basis of an observed reference rate (plus or minus a margin) (the "**screen rate approach**"), or on the same basis as the floating leg of an interest rate swap for the relevant designated maturity determined on the basis of the relevant ISDA Definitions (itself a LIBOR based definition).
- In general, the screen rate approach is the more commonly followed and will usually provide for the determination agent to adopt the LIBOR rates quoted on the relevant Bloomberg/Reuters page specified in the documentation a few business days prior to commencement of the relevant interest period. Typically bond documentation provides that if the relevant screen rate is unavailable, the agent shall request a number of reference banks to provide a quotation for the applicable LIBOR rate. In the event of a discontinuation of the benchmark, this initial fallback would not be workable. As a secondary fallback, the agent is required to obtain quotations from a number of major banks in the principal financial centre of the relevant currency for loans to other European banks for the relevant interest period.
- As noted above in relation to corporate lending however, it may not be practicable to rely on bank quotations for prolonged periods in the absence of an appropriate reference rate. Further, although most bond documentation provides that, in a worst case scenario where the rate of interest cannot be determined at all, the parties default to the most recently calculated rate for prior interest periods, it would clearly be commercially unsatisfactory if floating rate bonds in fact became fixed rate instruments as a result of a practical inability to operate the determination provisions.
- Unlike LMA loan documentation, typical Eurobond documentation has not specifically contemplated the substitution of an unavailable benchmark and so if formal amendments are required these will likely need to be undertaken by way of consent solicitation.
- For securitisations, it is essential to ensure that the issuer is not left with unhedged mismatches between the asset basis, bond interest basis and related derivatives. Accordingly, any amendment to matched LIBOR-based floating rates in the transaction will need to be changed simultaneously and in an identical manner. Typically this will mean amending the bond documentation and the floating leg of any interest rate swap at the same time and in the same way – for example coordinating the changes to the bond interest rate and the floating leg of the swap on a

standalone retail mortgage-backed security. Where the underlying assets contain LIBOR-based floating rates (as, for example, a securitised small-to-medium enterprise loan would likely have), these will similarly need to be amended in concert with the associated leg of the relevant swap.

- There will, however, be a range of complexity to this coordination, depending largely on the type of securitisation. At the simple end of the spectrum, credit card securitisations would not typically have an interest rate swap at all, so the bonds can be amended without regard to the rest of the documentation (assuming any cross-currency swap is also unaffected). At the more complicated end, managed collateralised loan obligations (CLOs) would normally have a series of asset-specific swaps. For CLOs, therefore, it is important to make sure that each individual swap confirmation is amended at the same time and in the same way as the relevant asset. This may present particular challenges given that the CLO will in many cases only be a small minority lender in respect of each asset and therefore not in a position to control the timing or substance of any changes to that asset.

OTC derivatives

- Certain of the relevant ISDA Definitions contain a Reference Bank type fallback, which would suffer from the kind of practical challenge mentioned above in relation to corporate lending.
- As noted above, work has been undertaken in developing alternative rates in the form of risk free rates, and while these may well be a starting point for an alternative rate they do not currently address the forward looking element for specified terms.

Relevance of EU Benchmarks Regulation

From 1 January 2018, the new EU Benchmarks Regulation will impose new obligations on banks and other supervised entities that use benchmarks such as LIBOR as a reference in securities and derivatives, consumer loans and investment funds falling within the scope of the regulation. They will be required to produce and maintain robust written plans setting out the actions that they would take in the event that the benchmark materially changes or ceases to be provided.

Where feasible and appropriate, these plans must nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives. Supervised entities must also, upon request, provide their regulators with those plans and any updates and must reflect them in the contractual relationship with their clients.

These requirements present a number of practical challenges for firms. In particular, firms have been seeking confirmation that this does not require changes to contracts entered into before 1 January 2018. In addition, the extent to which firms can reference substitute benchmarks will be constrained by the terms of market standard documents, the fallbacks they provide and the difficulty of identifying, in advance, a fallback which does not yet exist or does not yet have market acceptance.

Wider significance

Interest rate benchmark administrators and regulators around the world have been striving to meet the recommendations of the Financial Stability Board

that benchmark rates be anchored in transactions and objective market data as far as practicable. Whilst the potential discontinuation of LIBOR may be the most high profile consequence to date of this process, it is unlikely to be the last.

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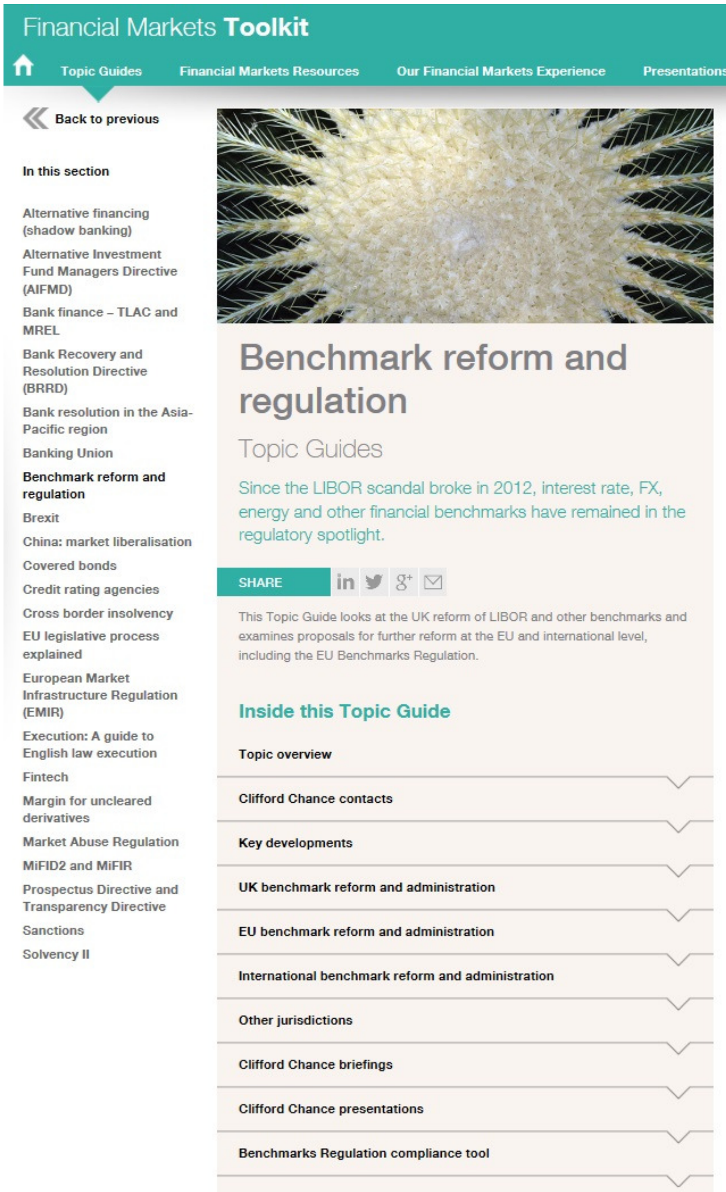

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