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US CONSIDERATIONS FOR TRANSITION AWAY FROM LIBOR

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

The following are four key takeaways from Mr. Bailey's July 27th speech:

- 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 LIBOR's administrator, ICE Benchmark Administration (IBA),[2] 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

Key Points

- UK regulatory support for LIBOR is likely to be withdrawn by the end of 2021.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.

"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, July 27, 2017

[1] https://www.fca.org.uk/news/speeches/the-future-of-libor
[2] Since February 2014, the IBA has been administering the production of ICE LIBOR (formerly known as BBA LIBOR) as a benchmark rate quoted for five currencies and seven maturities, resulting in the production of 35 rates each business day.

be sustainable in the absence of the FCA encouraging or compelling panel banks to provide quotations.

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

There has been progress in the development of alternative reference rates (often dubbed "risk free rates") in the context of derivatives, and Mr. Bailey suggested that these could be adapted for other purposes:

- In the US, the Alternative Reference Rates Committee (AARC)[3] recently announced a **broad Treasuries repo financing rate (BTRF)**, which is an overnight rate based on the interest rate paid on overnight loans collateralized 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 the **Sterling Over Night Index Average (SONIA)** as an alternative to GBP LIBOR in the derivatives market. The Bank of England became the administrator of SONIA in April 2016 and is currently taking steps to reform this benchmark.[4]

The BTRF rate and the SONIA rate are both at an early stage of gestation and market consideration. The Federal Reserve Bank of New York announced that it plans to begin publishing BTRF quotes during the first half of 2018.[5] The Bank of England anticipates SONIA will move to a new basis by April 2018. Both are verifiable overnight benchmark rates and are "backward looking" or "observed" rates in that they report what the rate was for past transactions. By contrast LIBOR is a term benchmark rate which is "forward looking" or "estimated" in that it reports what the rate is today for a forward-starting term and which relies on the judgment of submitters. Observed rates are generally considered to be less susceptible to manipulation than estimated rates, especially with respect to short-term maturities for which a highly liquid market exists. 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.

"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, July 27, 2017

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[3] The US Federal Reserve tasked the ARRC with identifying a set of alternative reference interest rates that are more firmly based on transactions from a robust underlying market. The ARRC's June 22, 2017 announcement of its selection of a preferred alternative reference rate is available at https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Jun-22-2017.pdf. As next steps, the ARRC is refining its proposed transition plans and developing implementation options, and it plans to publish a final report before the end of 2017.
[4] Information about SONIA reform is available at http://www.bankofengland.co.uk/markets/Pages/benchmarks/soniareform.aspx
[5] The Federal Reserve has announced that it will seek public comment on rate composition and calculation methodology before it adopts a final publication plan for overnight treasury repo rates. *See* Federal Reserve Bank of New York, Statement Regarding the Publication of Overnight Treasury Repo Rates, May 24, 2017, *available at* https://www.newyorkfed.org/markets/opolicy/operating_policy_170524a.

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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.

Build-in flexibility to amend

To the extent commercially acceptable, a step to consider in the context of multi-creditor transactions (such as syndicated lending or debt securities), is to provide for flexibility to make amendments to interest rate determination provisions that may be required as a result of the discontinuation of LIBOR. Transaction parties will want to consider whether to permit unilateral amendment or incorporate a lower standard for approval of an amendment to specify a replacement reference rate than might otherwise apply to an amendment affecting interest rate determination provisions. For example:

- credit agreements could refer to a majority of the lenders instead of all of the lenders in the context of required consents for these types of amendments;
- indentures could specify that the issuer and the trustee could enter into a supplemental indenture to specify a reference rate to replace LIBOR when it is discontinued without requiring the consent of the holders of floating rate notes; and
- parties to documentation for structured products could "hardwire" the ability to make amendments needed as a result of the discontinuation of LIBOR (such provisions could easily be adapted from ones already in use for amendments that may be needed to deal with rating criteria and legislative change).

In addition, companies with effective shelf-registration statements that register ongoing of future offers and sales of floating rate notes with the SEC will want to consider whether to amend existing base prospectuses and indentures to clearly provide for this type of flexibility to amend.

While it is important to note that future amendment is no panacea (in transactions involving a number of interrelated products, it may be important to continue to reference the same reference rate in all relevant documents at all times), the flexibility to make such changes may prove useful.

Subsequent replacement of an unavailable benchmark may be addressed by providing for suitable amendments to be made with the consent of the borrower and the majority lenders only.

Identify and disclose risks

In the context of bonds and other debt securities, issuers and underwriters will need to consider how to disclose the risks associated with possible discontinuation of LIBOR as a rate. Many floating rate note prospectuses recently filed with the SEC have included a risk factor concerning LIBOR related reforms. These could be expanded to refer to the FCA's announcement and the possible discontinuation of LIBOR entirely. In doing so, it will be important to disclose the uncertainty as to the nature of any replacement reference rate and whether it will gain widespread market acceptance may present additional risks. Issuers and underwriters will want to consider which additional risks to disclose, which could include any of the following:

- the effect of uncertainty regarding the interest rate calculation before a replacement benchmark is published regularly and gains widespread market acceptance;
- the risk that differences in the administration or determination methodology of the replacement benchmark may affect the amount of interest payments or the price or liquidity of the securities; or
- The potential need to amend existing documentation to specify a replacement reference rate via a consent solicitation, and whether necessary consents may be obtained at an acceptable cost or at all.

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 corporate lending, bonds and other floating rate securities and interest rate swap documentation.

There could be challenges in construing references to LIBOR in existing New York law governed 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.

Corporate lending

- An agent's power 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.
- In the context of a discontinuation of LIBOR, existing loan documentation may provide that the floating element of the interest rate will 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 would 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).

- The market's experience of the discontinuation of BBA LIBOR for a number of currencies in 2013 suggests that neither of these fallbacks is practical on a large scale or for long periods of time. Instead, subsequent replacement of an unavailable benchmark may be addressed by providing for suitable amendments to be made with the consent of the borrower and the majority lenders only.[6] This type of provision is likely to be the most useful if LIBOR ceases to be available and alternatives emerge. In the absence of such a provision, it is likely that amendments to documentation to replace LIBOR with any alternative reference rate will require the consent of the borrower and all the lenders.

Bonds and other floating rate securities

- New York law governed indentures typically provide for floating rate notes to bear interest on the basis of a published reference rate (plus or minus a margin) (the "screen rate approach"). In general, the screen rate approach provides for a calculation 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, if the relevant screen rate is unavailable, the agent is instead required to request a number of reference banks to provide a quotation for the applicable LIBOR rate. In the event of a discontinuation of LIBOR, 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 center 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.
- New York law governed indentures do not typically contemplate the substitution of an unavailable reference rate. If an amendment is required to specify a replacement reference rate, it could require investor consent (via a consent solicitation). Indentures do traditionally permit amendment without noteholder consent to cure ambiguity or to make other provisions which do not adversely affect the interests of the noteholders in any material respect. Consequently, issuers, trustees and their respective advisers may need to consider whether and to what extent the implementation of a replacement reference rate could adversely affect the interests of the noteholders. This concern could especially arise if more than one replacement benchmark rate

[6] Since 2014, LMA loan documentation has, for example, 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.

were available for selection or the replacement benchmark tends to result in lower rates than LIBOR under similar circumstances.

- Where an issuer has entered into interest rate swaps to hedge exposure under floating rate notes, to the effectiveness of the hedges will depend on the ability to amend the floating leg of any such swaps to conform to the amended rate on the securities.

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- Where it is applicable, Section 316(b) the Trust Indenture Act of 1939, as amended (the "TIA") prohibits the impairment of a holder's right to receive interest payments without consent of the holder. While it may be unlikely that specification of a replacement reference rate would result in the impairment of a holder's right to receive interest payments, issues could arise if more than one replacement reference is available for selection at the time of amendment and the one chosen tends to result in lower rates than the other available benchmark. It may take some time before market preference for one rate over other available alternatives becomes clear.
- Companies that have issued preferred shares that pay dividends using a rate calculated by reference to LIBOR will need to consider the extent to which they can amend the dividend calculation provisions to specify a replacement benchmark rate pursuant to their certificate or articles of incorporation, any relevant certificate of designation and relevant state corporate law.
- Significant changes in the nature of the interest calculation provisions could cause the amended security to constitute a "new security" for purposes of federal securities law.[7] Such an issue could arise if the nature of the replacement benchmark rate differs so significantly from LIBOR that it changes the nature of a holder's investment experience. In practice, issuers may be able to conclude that an amendment to specify a new benchmark rate as a result of the discontinuation of LIBOR would not result in the creation of a new security for federal securities law purposes, but this may depend on the extent to which the issuer follows general market practice.
- Parties should also consider whether a change in the interest calculations would constitute a "significant modification" of the debt, resulting in tax consequences for the issuer and holder of the debt and possible re-characterization of the debt for tax purposes.

[7] *See*, *e.g.*, American Bar Association, Committee on Trust Indentures and Indenture Trustees, Annotated Trust Indenture Act, 67 The Business Lawyer 977, 1002 (2012).

Interest rate swaps

- Certain of the relevant ISDA definitions contain a reference bank type fallback. The 2006 ISDA Definitions, for example, include a fallback in the definition of certain floating rate options providing that if the rate is unavailable at the initially specified source, the calculation agent is to poll reference banks for rates (e.g., USD-LIBOR-Reference Banks). An attempt to rely on the fallback for long-term purposes once LIBOR benchmark rates are no longer quoted would result in the kind of practical challenges mentioned above in relation to corporate lending and debt securities. When certain LIBOR maturities were discontinued in 2013, the ISDA 2013 Discontinued Rates Maturities Protocol specifically overrode the relevant definitions' fallback provisions, avoiding such difficulties.
- 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.
- ISDA may develop a protocol to replace LIBOR on legacy swaps, which would facilitate the amendment process. Adoption of the protocol will depend on parties' willingness to use any replacement rates specified in the protocol.

CONCLUSION

The Financial Stability Board recommended that benchmark rates be anchored in transactions and objective market data as far as practicable. The potential discontinuation of LIBOR may be the most high profile consequence of this recommendation to date. Market participants need to prepare for the possible transition away from LIBOR by the end of 2021.

For legacy transactions, parties will want to evaluate the fallback provisions in agreements that refer to LIBOR as the reference rate and how to efficiently and effectively amend those agreements to specify a replacement reference rate when necessary. Parties should be aware that 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.

In the context of current transactions, parties face practical difficulties in specifying 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 involving floating rates will continue to be based on LIBOR. In the longer term, documentation can be adapted once an appropriate replacement benchmark rate is regularly published and has gained market acceptance.

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