C L I F F O R D

C H A N C E

LIBOR – CROSS PRODUCT REVIEW

— THOUGHT LEADERSHIP

DECEMBER 2018

LIBOR – CROSS PRODUCT REVIEW

Following an announcement by Andrew Bailey, Chief Executive of the UK's Financial Conduct Authority (FCA) on 27 July 2017, it became evident that market participants would need to prepare for the very real possibility that LIBOR would cease to exist – or change very substantially – soon after the end of 2021. In essence, the thinness of the interbank lending market has given rise to severe misgivings as to LIBOR's continuing appropriateness and there is a desire to move to risk-free rates (RFRs).

Risk Free Rates

Risk Free Rates tend to be robust, overnight rates based on transactions in a liquid market. In contrast, reference rates such as LIBOR, which were originally developed to reflect interbank lending, now relate to a very thin market indeed as banks have turned to alternative funding sources.

Overview

Although the roots of LIBOR are in corporate lending, the rate is now ubiquitous and appears in a wide range of wholesale and even retail products. In the financial markets, its uses range across corporate and sovereign bonds, covered bonds, securitisations, derivatives and project, asset and trade financings. Many of these instruments, particularly in relation to derivatives, are interdependent. A corporate loan cannot be considered in isolation, for example, but must be viewed in the context of any linked derivative transaction or securitisation into which vehicle a lender has transferred its participation. This reflects the necessity for rates across the interlinked transactions to be based on similar frameworks, calculation periods and day count regimes, so that the funds flows match. For this reason, stakeholders from the different product areas are concerned to ensure that there is an appropriate replacement for LIBOR and that this works across all their transactions. This briefing contains a review of the comparative product challenges for the loan, bond (including securitisation) and derivatives markets to assist with your review of financing arrangements as a whole. In relation to each category, we consider (a) the existing documentary fallbacks in the event of LIBOR failing as the primary interest rate-setting mechanism, (b) the trigger for their application, (c) some potential documentary solutions and (d) challenges presented by LIBOR transition for that particular product.

Although this briefing focuses on LIBOR and does not discuss other IBORs, many of the points discussed below will equally be applicable to the potential discontinuation or reform of other IBORs.

Loans

Existing documentary fallbacks

Loan agreements can take many different forms depending on the product for which they are used. However, the Loan Market Association (LMA) recommended forms, designed for syndicated lending, tend to be used as the paradigm for the English law, LIBOR-based syndicated markets and so their approach is highly influential. The same is true of the Asia Pacific Loan Market Association (APLMA) recommended forms for transactions in Asia.

Based on those LMA and APLMA recommended forms, in the event of a failure of LIBOR as the primary interest rate-setting mechanism the ultimate fallbacks to determine the floating element of the interest rate are:

- First, by reference to the calculation of an average of the quotes of borrowing rates in the wholesale markets supplied by designated Reference Banks; or
- Failing that, secondly, 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 in the agreement at signing.

Neither of these options are seen as being attractive as long-term solutions to the absence of LIBOR but were more appropriate for the short-term absence of the LIBOR screen rate. If banks are no longer submitting rates for LIBOR screen rate calculations there is a real possibility that banks will be reluctant to submit a rate as a Reference Bank. For loans involving large syndicates of lenders it may also prove impractical from a purely administrative standpoint to calculate rates by reference to individual lenders self-certified costs of funds.

Triggers

The existing trigger for the application of fallbacks is the situation where "no Screen Rate is available for [*relevant benchmark*]". In the context of the potential discontinuance of benchmarks and new documentation, this will need to be re-examined once appropriate replacement benchmark(s) are determined to address scenarios which are not covered by the existing trigger. For example, where the Screen Rate continues but is felt no longer to be an appropriate rate to be used.

Potential current documentary solutions

At this stage, without being certain as to which rate(s) will replace LIBOR and other benchmark rates, it is difficult to build determinative optionality into the documentation to refer to such new rate(s) beyond including flexibility to amend terms as and when required with a lower consent threshold than would otherwise be required. The LMA recently published a revised version of their optional "Replacement of Screen Rate Clause". The original version of this clause (published in 2014) contemplated its use only where a Screen Rate became unavailable: the revised version allows the parties to extend the circumstances in which the clause is triggered (if the parties agree that trigger events other than just the unavailability of the LIBOR screen rate are appropriate). It allows amendments to be made to facilitate inclusion of a replacement benchmark which:

- is formally selected as a replacement for LIBOR by the LIBOR administrator or by an appropriate regulator; or
- is otherwise accepted by the relevant markets; or
- is deemed appropriate by the requisite majority of Lenders and the Obligors.

Interestingly, the Alternative Reference Rate Committee (ARRC) in the US has recently published its **consultation** on fallbacks for syndicated business loans and floating rate notes (the ARRC consultation). This suggests two options for the syndicated loans market: an "amendment approach" (which is not dissimilar to the approach in the LMA clause set out above) or a "hardwired" approach which, upon a trigger event, immediately looks to a waterfall of potential replacement rates and spread adjustments. One of the interesting points about the "hardwired" approach is that it would include references to a term SOFR rate and spread adjustments which are not available yet. Only time (and responses to the consultation) will tell whether this approach is acceptable to market participants in the US and whether participants in other markets could consider a similar approach.

Challenges for transition from libor to a new benchmark rate

Any move away from LIBOR will be a fundamental change for a market which has developed and depended upon LIBOR for over 30 years. There are a number of challenges to the adoption of a new benchmark rate in the loan markets, including:

- Challenges in determining an appropriate rate. Regulators are concerned to achieve a move to rates which are based on deeper markets with more robust RFRs. However, RFRs are backward looking: forward-looking term rates are the strongly desired preference for the loan markets for a number of reasons, including that they enable borrowers to establish their funding costs at the outset of the Interest Period and therefore provide advance visibility as to their financing costs so as to help with cash management. The Bank of England Working Group on Sterling Risk Free Rates **Consultation** on term SONIA reference rates (the Term Rate Consultation) highlights the appetite within the syndicated loan markets for a term reference rate and details options for the calculation of such a rate. Once the results of the Term Rate Consultation are known, there may be greater clarity on how any such term rate would be calculated.

- Contractual challenges in relation to how to manage legacy loan agreements which continue to reference LIBOR. Some of these may be refinanced but there will be many which need to be amended. Some of these legacy contracts may require all lenders to approve a change to the floating rate benchmark rate. Even for those agreements where a majority of lenders are able to agree such a change, obtaining the requisite majority for amendments may be challenging. Many syndicates include a range of lenders whose cost of funding is quite different – banks (with varying credit ratings), CLOs and numerous different types of funds – so selecting an alternative benchmark rate may not be an uncontroversial choice when the fallback ultimately is to a formulation based on lenders' costs of funds.
- Economic challenges including calculation of any spread to minimise value transfer on legacy transactions – if the replacement rate is seen as likely to reflect a lower rate than screen rate LIBOR – to avoid there being winners and losers on the transition to a new reference rate.
- Determining appropriate fallbacks to any replacement benchmark rate.
- Operational challenges such as systems and calculation methodologies – any move to a benchmark rate with a different calculation methodology would involve a wholesale change in systems, which will require time and expense to put in place.
- Competition concerns, particularly on pricing discussions.
- Cross product coordination of matching reference rates. For example, for those loans with interdependencies into other products (eg to derivatives or securitisations), parties will be keen to align the different products in terms of their reference rates, fallbacks and the timing of any transition to a new reference rate.
- Cross-currency coordination, particularly for multi-currency facilities. Potentially different approaches to different benchmark rates for different currencies and different timing of adoption of those new rates could significantly add to the complexity of the loan product.

Bond markets

Existing documentary fallbacks

English law bond documentation has no agreed market standards, whether wholly (such as derivatives and ISDA) or partially (such as loans and the LMA). In the event that the benchmark rate is unavailable, there are, however, fallbacks which would typically be seen in bond documentation:

- a "reference bank rate" calculation by the relevant agent on the basis of an average of rates supplied by selected banks;
- quotations obtained by the relevant agent from major banks in the principal financial centre of the relevant currency for loans to other European banks for the relevant interest period; or
- as an ultimate fallback, the rate would tend to default to the interest rate from the previous interest period.

This would effectively change a floating rate instrument into a fixed rate instrument which is clearly unsatisfactory from a commercial standpoint and could lead to mismatches in related transactions such as underlying derivatives or securitisations. Any such mismatch could be particularly sensitive in structured debt transactions where the match of adjustments across assets and liabilities is important.

As in the loans market, these fallbacks would only be useful or practicable in the short term; they were not drafted to be used over prolonged periods.

Triggers

Typically, the trigger for the application of fallbacks is the situation where the screen rate is unavailable. In the context of the potential discontinuance of benchmarks and new documentation and similarly to the loan markets (see above), this may need to be re-examined to address scenarios where the Screen Rate continues but is not an appropriate rate to be used, or indeed is not the only available rate.

Potential current documentary solutions

At this stage, where it is not possible to refer to benchmark rate(s) other than LIBOR in documents (although there are isolated examples of other rates such as SONIA being referenced in issued transactions), as for loan transactions, it is difficult to build optionality into the documentation to refer to such new rate(s). However, the following mitigants could be considered:

- including appropriate risk factors relating to LIBOR discontinuation and interest rate reform generally and examining how products are labelled and marketed;
- including new fallback provisions, particularly in the context of long – dated issuances to specifically address LIBOR discontinuation (or it becoming market practice to use another benchmark rate) and how a future replacement benchmark could be determined; and
- including flexibility to amend terms as and when required with a lower consent threshold than may otherwise be required.

These solutions are not without their problems: it is difficult to make future predictions, and arriving at solutions which give investors comparable rates of return may be a challenge. Also, litigation risk should not be discounted. Further details on the potential documentary solutions are set out in the **paper** prepared by the Bank of England Working Group on Sterling Risk-Free Reference Rates "New issue of Sterling bonds referencing Libor". In addition, it may be interesting to consider the ARRC Consultation which suggests fallback language for floating rate loans: the waterfall includes reference to a term SOFR rate and spread adjustment rates which are not yet available. The results of this consultation will indicate whether market participants can accept fallbacks containing rates which do not yet exist.

In the securitisation markets, AFME has published **model language** for a negative consent mechanism, some variation of which is being included widely on current transactions. In broad terms, this language permits the issuer (via an agent) to propose a new reference rate with a presumption of investor consent in the absence of investor objections. In order to make use of this provision, a number of conditions must be met. These might include conditions designed to ensure that any matched rates will remain matched after the change in reference rate. This wording has not yet been seen in the vanilla bond markets as fewer transactions use a trustee structure. In the absence of a trustee, there is no one able to consent on behalf of noteholders and therefore typically no ability to modify the terms and conditions of the notes without positive noteholder consent.

Challenges for transition from libor to a new benchmark rate

A move away from LIBOR will be a difficult change for the bond markets. There are a number of challenges to the adoption of a new benchmark rate, many of which are similar to those for the loan markets, as described above. However, in particular:

- Challenges in determining an appropriate rate – as noted above, regulators are looking for a move towards RFRs. In the Term Rate Consultation, it is noted that term rate structures may be appropriate for the bond markets as well as the loan markets, although the use case for vanilla floating rate notes is weaker than that for securitisation structures or corporate lending.
- Contractual challenges in relation to how to manage legacy bond transactions which continue to reference LIBOR and may need to be amended. Obtaining the requisite majority for amendments may be even more challenging than in the loan markets given the public nature of the instruments. For example, most bonds will require a process to be followed to obtain bondholder consent which may include holding meetings. These are subject to notice periods and it is difficult to engage the noteholders who remain anonymous. This can lead to issues with obtaining the necessary quorum to hold the meeting at all. Especially in complex deals, there may be multiple classes of bondholder or consent levels to achieve a binding vote

(often all bondholder consent would be required).

- Economic challenges including calculation of any spread to minimise value transfer on legacy transactions – as in the syndicated loan markets, if the replacement rate is seen as likely to reflect a lower rate than screen rate LIBOR – to avoid there being winners and losers on the transition to a new reference rate, which will make it more difficult still to obtain the requisite bondholder votes.
- Determining appropriate fallbacks to any replacement benchmark rate.
- Operational challenges such as systems and calculation methodologies – as in the syndicated loan markets, any move to a benchmark rate with a different calculation methodology would involve a wholesale change in systems and a long lead time.
- Competition concerns particularly on pricing discussions.
- Cross product coordination of matching reference rates – this is a key consideration for all bonds, but particularly significant for securitisation structures where matching rates is fundamental.
- Determining appropriate risk factors in light of the difficulties of predicting future developments and their impact on the relevant bonds.
- MiFID II product governance concerns.
- Disagreements amongst investors – particularly where all bondholder consent is required or where there may be a transfer of economic value upon any transition to a replacement benchmark rate.

Derivatives

Existing documentary fallbacks

In the derivatives market, transactions tend to be carried out on standard ISDA documentation terms, with parties incorporating the relevant set of definitions into their trade confirmations and selecting appropriate options as applicable. In certain ISDA documentation, there are fallbacks not dissimilar to those described above for both loans and bonds. The 2006 ISDA Definitions contain a fallback in the definition of certain floating rate options (eg GBP – LIBOR-Reference Banks):

- first, the calculation agent conducts a poll of rates that the "reference banks" would offer to prime banks in the London interbank market for deposits in the relevant currency (e.g. sterling, euro, US dollars) for the relevant interest period; and
- secondly, if fewer than two quotations are obtained pursuant to the first method, the relevant rate will be the arithmetical mean of the rates quoted by the major banks in the relevant market (e.g. London, Eurozone, New York) for loans in the relevant currency to leading European banks for the relevant interest period.

As for loans and bonds, these fallbacks are only practical solutions where there is a short-term absence of a LIBOR screen rate.

Triggers

The trigger for the current fallbacks is generally a rate being unavailable from the initially specified source.

Potential current documentary solutions

ISDA has been working on a number of initiatives to facilitate broad, market – wide amendments to relevant documents, including:

- a **Benchmarks Supplement** (published in September 2018) to facilitate compliance with Article 28(2) of the EU Benchmark Regulation and provide for robust written fallback plans;
- fallbacks based on risk-free rates for IBORs to be included in the 2006 ISDA Definitions. These fallbacks will apply to trades entered into after the fallbacks are incorporated into the 2006 Definitions following publication of the relevant Supplement; and
- mechanisms to amend legacy contracts referencing IBORs for which fallbacks have been revised and included in the 2006 ISDA Definitions after the date of the trade – including a protocol mechanism (by which the revised fallbacks will apply to all contracts with other parties which are adherents to the protocol).

ISDA have also recently published a public **consultation**: "Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW" (the ISDA Consultation). The ISDA Consultation seeks feedback on proposed amendments to the 2006 ISDA Definitions to address fallbacks to the applicable RFRs for derivatives in circumstances where an associated IBOR is not available. See our **briefing** "IBOR fallbacks for derivatives – ISDA consultation on term and spread adjustments for floating rates" for more detail on the proposals.

Challenges for transition from libor to a new benchmark rate

Although movement away from LIBOR has been considered for longer in the derivatives markets than those for bonds and loans, there are still considerable challenges that will need to be overcome. These include:

- Similarly to loans and bonds, challenges in determining the appropriate rate (although the Term Rate Consultation indicates a weak use case for term reference rates for most derivatives, and so transition to SONIA as the replacement benchmark rate for GBP LIBOR is likely to be the solution). However, the derivatives market is further advanced than other markets because the FSB charged ISDA with looking at benchmark reform in advance of other markets, particularly given their globally applicable documentary terms.
- Determining the appropriate fallbacks – as set out in the ISDA Consultation, there are questions on the identification of the appropriate credit spread methodology and term structure based on a risk-free rate as part of the fallback process to facilitate a transition away from the relevant IBOR whilst maintaining, as far as possible, an equivalent economic outcome for the parties.
- Operational challenges such as systems and calculation methodologies – in addition, fallback rates and credit spread methodology referred to in the ISDA Consultation would need publication by an administrator.
- Economic challenges including the minimisation of any value transfer at the time any fallback is applied (which may be achieved through the credit spread methodology referred to above) to avoid there being winners and losers on the transition to a new reference rate.
- Minimisation of market disruption upon discontinuation of a benchmark rate.
- Minimisation/elimination of potential manipulation of any replacement benchmark rate.
- Cross product coordination of matching reference rates across products – the Term Rate Consultation makes it clear there is a minimal use case for a term SONIA reference rate in the derivatives market save where those derivatives hedge loan and bond transactions which reference a term rate. Development of a liquid RFR futures market is necessary to support term reference rate setting.
- For derivatives transactions that form part of a wider financing or capital markets transaction, additional consents may need to be obtained before the associated documentation may be amended to incorporate the agreed fallback (e.g. lender, agent or noteholder consent in addition to that of the counterparty to the derivative transaction).

Finally

Although there has been progress since the Bailey Announcement, there is still significant work to be completed before any transition away from LIBOR can commence. As well as the market and regulator-led initiatives, market participants also need to consider their own population of contracts and products which reference LIBOR and their existing fallback language. It will be necessary to ascertain the scale of the problem, consider how solutions can be implemented in due course and consider how best to communicate the approach to clients. The importance of planning has been underlined by the FCA and PRA through their recent issue of "Dear CEO" **letters** to certain institutions asking them to confirm the steps they are taking to manage the transition.

See our **briefing** "LIBOR – the beginning of the end?" for a discussion of Andrew Bailey's 2017 announcement and what this means for transactions and documentation.

SCHEDULE – COMPARATIVE PRODUCT CHALLENGES

Issues	Derivatives	Loans	Bonds
Existing documentary fallbacks	ISDA Definitions – GBP/USD/ EUR/CHF/JPY- LIBOR: • reference banks • bank quotes	Loans documented on LMA standard terms: • reference banks • cost of funds	No uniform approach, but following: • reference banks • bank quotes the fallbacks are likely to result in rate becoming fixed at last available ICE LIBOR
Potential Documentary Solutions	ISDA is working on fallbacks for IBORs to be included in the 2006 ISDA Definitions. The ISDA consultation on certain aspects of the fallbacks was launched on 12 July 2018. These fallbacks will apply to trades entered into after the fallbacks are incorporated into the 2006 Definitions. ISDA is considering mechanisms to amend legacy contracts referencing IBORs for which fallbacks have been amended – including a protocol ISDA Benchmarks Supplement (published September 2018) – to facilitate compliance with Art 28(2) of EU Benchmark Regulation (robust written fallback plans)	Revised LMA "Replacement of Screen Rate" clause – optional provision which was recently expanded to extend the triggers which would allow amendments to be made with a lower consent threshold (majority lender only)	Some (not universal) attempts to include new fallback provisions and lower voting thresholds. In securitisation transactions, AFME negative consent mechanism, some variation of which is being widely included. In broad terms and subject to certain conditions (which may include matching of rates), the wording permits the issuer (via an agent) to propose a new reference rate with a presumption of investor consent in the absence of investor objections.

Issues	Derivatives	Loans	Bonds
Some Transitional Challenges	• challenges in determining an appropriate replacement benchmark rate • economic challenges including calculation of credit spread to minimise value transfer • determining appropriate fallbacks • operational challenges such as systems, calculation methodologies • minimisation of market disruption • minimisation/elimination of potential for manipulation • cross-product co-ordination of matching reference rates and development of a liquid RFR futures market to support term reference rate setting • consents from relevant third parties where derivative forms part of a broader financing or capital markets transaction	• challenges in determining an appropriate replacement benchmark rate • contractual challenges in how to manage legacy loan agreements referencing LIBOR • economic challenges including calculation of credit spread to minimise value transfer • determining appropriate fallbacks • operational challenges such as systems, calculation methodologies • competition concerns particularly on pricing discussions • cross-product co-ordination of matching reference rates • cross-currency co-ordination	• challenges in determining an appropriate rate • contractual challenges in how to manage legacy bond transactions referencing LIBOR • economic challenges including calculation of any spread to minimise value transfer • determining appropriate fallbacks • operational challenges such as systems and calculation methodologies • competition concerns particularly on pricing discussions • cross product co-ordination of matching reference rates • determining appropriate risk factors • MiFID II product governance concerns • disagreements amongst investors

CONTACTS

Andrew Bryan
Senior PSL
T: +44 20 7006 2829
E: andrew.bryan@
cliffordchance.com

Charles Cochrane
Partner
T: +44 20 7006 2196
E: charles.cochrane@
cliffordchance.com

Peter Dahlen
Partner
T: +44 20 7006 2716
E: peter.dahlen@
cliffordchance.com

Paul Deakins
Partner
T: +44 20 7006 2099
E: paul.deakins@
cliffordchance.com

Anne Drakeford
Partner
T: +44 20 7006 8568
E: anne.drakeford@
cliffordchance.com

Francis Edwards
Partner
T: +852 2826 3453
E: francis.edwards@
cliffordchance.com

Jeremy Elliott
Senior PSL
T: +44 20 7006 3442
E: jeremy.elliott@
cliffordchance.com

Thomas England
Partner
T: +65 6506 2782
E: thomas.england@
cliffordchance.com

Matt Fairclough
Partner
T: +852 2825 8927
E: matt.fairclough@
cliffordchance.com

Kate Gibbons
Partner
T: +44 20 7006 2544
E: kate.gibbons@
cliffordchance.com

Julia House
Senior Associate
T: +44 20 7006 2206
E: julia.house@
cliffordchance.com

Katie Hoyle
Senior Associate PSL
T: +44 20 7006 4528
E: katie.hoyle@
cliffordchance.com

Andrew Hutchins
Partner
T: +65 6661 2060
E: andrew.hutchins@
cliffordchance.com

Paul Landless
Partner
T: +65 6410 2235
E: paul.landless@
cliffordchance.com

Julia Machin
Managing Senior PSL
T: +44 20 7006 2370
E: julia.machin@
cliffordchance.com

Dauwood Malik
Partner
T: +852 2826 3485
E: dauwood.malik@
cliffordchance.com

OUR INTERNATIONAL NETWORK
32 OFFICES IN 21 COUNTRIES

Abu Dhabi
Amsterdam
Barcelona
Beijing
Brussels
Bucharest
Casablanca
Dubai
Düsseldorf
Frankfurt
Hong Kong
Istanbul

London
Luxembourg
Madrid
Milan
Moscow
Munich
Newcastle
New York
Paris
Perth
Prague
Rome

São Paulo
Seoul
Shanghai
Singapore
Sydney
Tokyo
Warsaw
Washington, D.C.

Riyadh*

*Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

C L I F F O R D

C H A N C E

J2018091018947