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TRANSITIONING FROM LIBORS AND IBORS – AN INTERNATIONAL OVERVIEW

– THOUGHT LEADERSHIP

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TRANSITIONING FROM LIBORS AND IBORS – AN INTERNATIONAL OVERVIEW

Before financial markets can be encouraged to move from using LIBOR (the London Interbank Offered Rate) or other interbank offered rates (IBORs) as reference rates in new financial contracts, there must be suitable alternatives in place. This briefing provides a snapshot of "risk-free reference rates" (RFRs) selected by different markets to replace LIBORs and IBORs for different currencies. It also highlights those RFRs for which "term" rates are being pursued and those for which Overnight Indexed Swaps (OIS) and futures have been developed.

Overview

Since 2014, the message from international regulators has been united and clear: phase out "expert judgement" LIBORs and IBORs; switch instead to robust RFRs. Further pressure came in July last year in a speech by Andrew Bailey, CEO of the UK Financial Conduct Authority. Nothing incentivises like a deadline, and the warning that LIBOR might cease at the end of 2021 (or, at least, that its continued existence could not be guaranteed after that date) resulted in an escalation of work by interest groups in various jurisdictions.

Alternative RFRs

LIBOR rates

Work on RFRs for LIBOR rates was well underway before Andrew Bailey's 2017 speech. National working groups had already selected alternative RFRs for Sterling, U.S. Dollars and Japanese Yen before July 2017. A recommendation for a replacement for CHF LIBOR was made shortly afterwards, in October 2017. A successor rate for Euro LIBOR was determined (out of a shortlist of three) in September 2018. In Hong Kong, the development of the Hong Kong Dollar Overnight Index Average (HONIA) into an IOSCO-compliant Hong Kong dollar RFR is also under consideration. A list of selected RFRs (SONIA, SOFR, TONA, SARON and ESTER), together with a brief commentary, is set out in the summary reference table in the Annex to this briefing.

IBOR rates

For completeness, there are also changes afoot with other IBORs – for example, EURIBOR and EONIA. A brief commentary on the status of these IBORS is also set out in the summary reference table on page 4.

RFRs: Overnight or term?

The choice of a potential RFR for each LIBOR rate represents only part of the story. RFRs do not represent a seamless replacement for LIBOR – although interests of the regulators and financial markets in finding robust RFR alternatives are somewhat aligned, they are not identical.

Regulators view robust RFRs, based on actual transactions, as optimal to ensure financial stability. Such rates are less likely to be open to manipulation and have significantly higher transaction volumes. For example, the paucity of representative LIBOR transactions cited by Andrew Bailey in his speech in 2017 (fewer than ten) contrasts starkly with the daily volumes of £50 billion for reformed SONIA. However, the issue is more than just volume. Overnight (or backward-looking) RFRs differ considerably from LIBOR (forward-looking) term rates. LIBOR exists in various tenors – such as three month and six month tenors – and embeds an element of credit risk in the overall figure.

An overnight RFR may prove suitable for some financial products (such as derivatives), but a forward-looking rate is still desirable for others (such as loans, bonds, securitisations and for swaps hedging those products). These differing needs are leading to pressure to consider more than one RFR for some currencies; that is, both an overnight rate and a term rate.

This is not due to reluctance to move away from the status quo of forward-looking LIBOR rates. There are valid economic and operational considerations at play not least timing considerations when ascertaining interest rates for the following interest period and the systems required to calculate new rates. It is imperative for corporates, for example, to identify funding costs in advance.

RFRs: One rate or two?

In July 2018, Andrew Bailey acknowledged that different products (such as, bonds, swaps and loans) may require different reference rates. He referred to the possibility of "two centres of gravity in interest reference rates" – both overnight and term. The July 2018 consultation on possible Term SONIA Reference Rates (TSRR) issued by the Working Group on Sterling Risk-Free Reference Rates also acknowledges this likely split by product. Similarly, the U.S. Alternative Reference Rates Committee (ARRC) consultations, closing on 8 November 2018, on possible fallbacks to be drafted into USD LIBOR contracts for loans and bonds reflect the likely demand for term rates for these products. The ARRC's first suggested fallback in the waterfall, should USD LIBOR cease, is a (yet to be created) "term SOFR". "Overnight SOFR" is the second fallback.

The summary reference table in the Annex to this briefing indicates those RFRs for which a term rate is planned.

Overnight RFR bonds: Trend-setting or bucking the trend?

Amidst the clamour for term rate RFRs for bonds, there are notable exceptions. A handful of bonds have been issued referencing overnight RFRs, including SONIA issuances by the EIB, RBC, Lloyds, Banco Santander and the World Bank, and SOFR issuances by Fannie Mae, the World Bank, MetLife and Barclays. A corporate issuer also announced plans to restructure two existing GBP LIBOR bonds, with a possible switch to SONIA.

The overnight (backward-looking) RFR bonds are noteworthy for various reasons. First, initial supranational issuance has been followed by corporates. Secondly (whilst acknowledging the limited pool), issuers are already referencing RFRs from other jurisdictions. Thirdly (and more importantly), they illustrate the lack of consistent market practice and demonstrate some concerns about backward-looking rates. The SONIA RFR bonds have referenced "Compounded Daily SONIA" with a five-day "lag" (calculating the rate five business days before the Interest Payment Date – a workaround to reflect the fact that accrued interest cannot be calculated with certainty in advance). The SOFR RFR bonds have referenced "averaged SOFR" with a four-day "lockout" (taking a SOFR rate from a few days before the reset date). The differing approaches may reflect the fact that the established, liquid SONIA swaps market uses a daily compounded rate for SONIA swaps - albeit with a shorter lag – but there is, in contrast, no established market for SOFR swaps. Once a SOFR swap market develops, it is likely that SOFR bond calculations will start to mimic these practices. There will also be pressure to mirror the number of days of "lag" or "lockout". Interestingly, the terms of one MTN Base Prospectus with a SONIA bond option envisage a reducing "lag" in the future. Finally, the concept of a compounded interest rate is potentially problematical in some jurisdictions – including Germany, Belgium, Luxembourg and France.

Term rates, OIS and futures markets

Notwithstanding the recent bond issuances in overnight RFRs, there now seems to be an acceptance that term rates will still have a role to play, particularly in the loan markets.

A question for regulators and practitioners then becomes how to ensure that any RFR-derived term rates (which seek to measure the market's forward expectation of an average RFR rate over a designated period) are robust. The UK July 2018 consultation on TSRR suggests that there is potential to create a term rate "on a stronger footing than LIBOR". It outlines suggested steps and ingredients required to achieve this – largely by "anchoring" the rate in Overnight Index Swaps (OIS) and futures transactions based on the RFR and specifying certain requirements for those derivatives markets (such as, healthy volumes, high liquidity, improved transparency and actionable quotes).

A further factor to consider in relation to the development of RFR term rates, therefore, is the existence of underlying RFR swaps and futures markets from which these term rates could be derived.

The summary reference table in the Annex to this briefing also indicates those RFRs for which OIS or futures already exist.

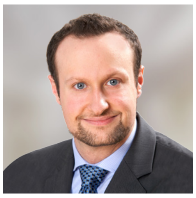
ANNEX – SUMMARY REFERENCE TABLE

LIBORs and IBORs – Replacement RFRs

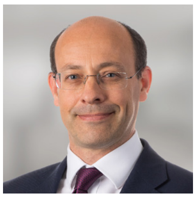
CURRENCY	RFR	Comments	Secured?	Term rate RFR yet?	Futures or OIS exist?
GBP	SONIA (Sterling Over-night Index Average)	• Administered by the Bank of England since April 2016 and reformed in April 2018 following consultation. • An unsecured overnight rate based on the rate at which interest is paid on sterling short-term wholesale funds where credit, liquidity and other risks are minimal. • Selected by the Sterling Working Group on Sterling Risk-Free Reference Rates.	No	Planned	Yes
USD	SOFR (Secured Over-night Funding Rate)	• Administered by the Federal Reserve Federal Reserve Bank of New York (Fed). • A secured rate based on transactions in the US Treasury repo market. • Selected by the Alternative Reference Rates Committee (ARRC).	Yes	Planned	Yes
JPY	TONA (Tokyo Overnight Average Rate)	• Administered by the Bank of Japan. • An unsecured rate based on uncollateralised overnight call rate market transactions. • Selected by the Study Group on RFRs.	No	Planned	Yes
CHF	SARON (Swiss Average Rate Overnight)	• Administered by the SIX Swiss Exchange. • A secured rate based on data from the Swiss repo market. • Recommended by the National Working Group on Swiss Franc Reference Rates.	Yes	Planned	Yes
Euro[1]	ESTER (Euro Short-Term Rate)	• To be administered by the ECB. • To be available October 2019. • An unsecured rate to reflect wholesale euro unsecured overnight borrowing transactions with financial counterparties. There are 52 reporting banks. • Selected on 13 September 2018, by the private sector working group.	No	Under consideration	No

1 **EONIA and Euribor reforms**	
EONIA (Euro Overnight Index Average)	Work to reform EONIA will not proceed. EONIA transition to ESTER is one of the workstreams of the Working Group on Euro Risk-Free Rates. EONIA may still be used as a reference rate until 31 December 2019; thereafter, regulatory approval will be required for its continued use in existing contracts. There is growing support for extending the transitional period to the end of 2021.
Euribor (Euro Interbank Offered Rate)	The European Money Markets Institute (EMMI) is in the process of reforming Euribor. In addition, from 3 December 2018, EMMI will publish five tenors, instead of eight, reflecting highest use. The Working Group on Euro Risk-Free Rates is exploring possible fallback arrangements for Euribor; including term structure methodology on RFR(s) as a fallback in Euribor-linked contracts in the case Euribor does not become registered with ESMA by end-2019. There is growing support for extending the transitional period to the end of 2021.

CONTACTS



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

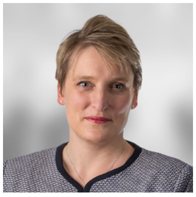


Charles Cochrane
Partner
T: +20 7006 2196
E: charles.cochrane
@cliffordchance.com

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

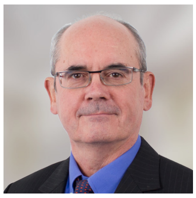
Paul Deakins
Partner
T: +20 7006 2099
E: paul.deakins
@cliffordchance.com

Laura Douglas
Senior Associate PSL
T: +20 7006 1113
E: laura.douglas
@cliffordchance.com



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

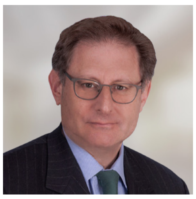
Francis Edwards
Partner
T: +852 2826 3453
E: francis.edwards
@cliffordchance.com



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

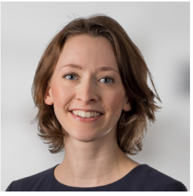
Thomas England
Partner
T: +65 6506 2782
E: thomas.england
@cliffordchance.com

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

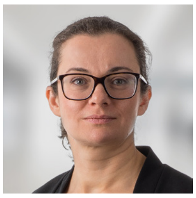


David Felsenthal
Partner
T: +1 212 878 3452
E: david.felsenthal
@cliffordchance.com

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



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



Katie Hoyle
Senior Associate PSL
T: +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: +20 7006 2370
E: julia.machin
@cliffordchance.com

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

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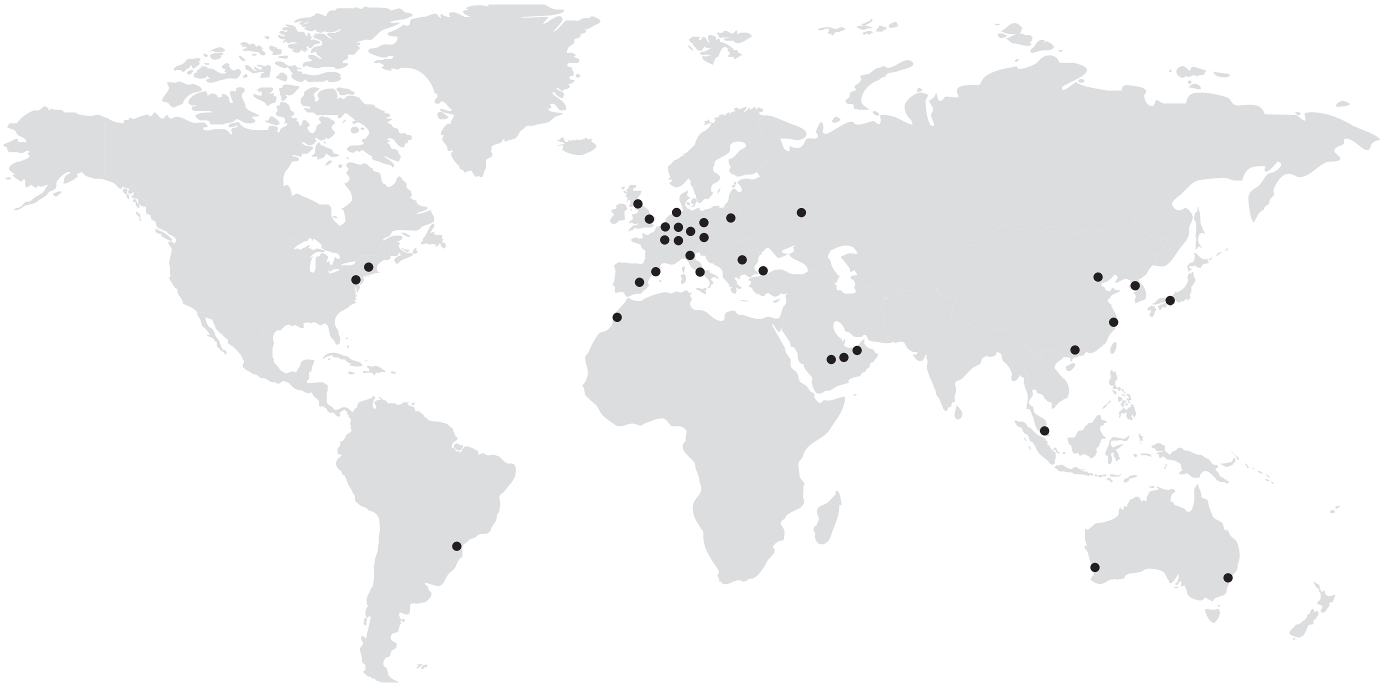

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Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

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