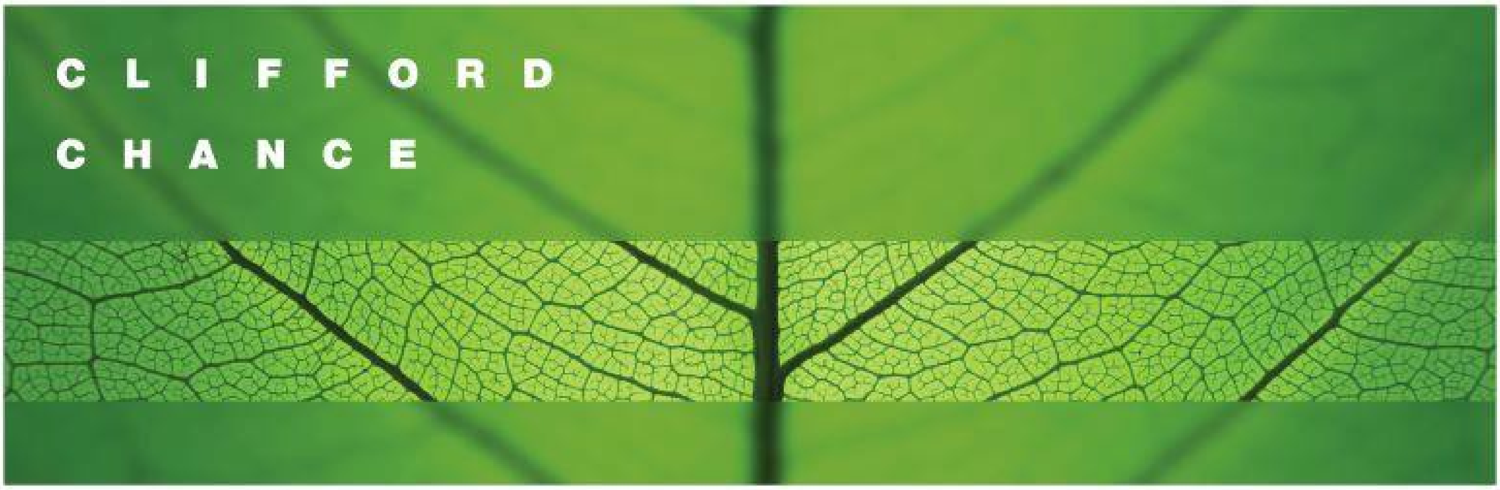

IBORS AND THE TRANSITION TO RISK FREE RATES IN THE SINGAPORE DEBT CAPITAL MARKETS

The impending end of the London Interbank Offered Rate, "LIBOR", has been a discussion point for financial markets participants ever since the Wheatley Review, and thereafter, a speech by Andrew Bailey, Chief Executive of the UK's Financial Conduct Authority (FCA) on 27 July 2017 which famously heralded its demise[1]. Market participants need to prepare for the likelihood that LIBOR will cease to exist by the end of 2021. Even if LIBOR continues to be available into 2022, the FCA may determine that it is no longer representative of its underlying market. Since 2014, the message from international regulators has been clear: with respect to the risks presented by the end of LIBOR, there needs to be a move from LIBOR to near "risk-free rates" (RFRs) which are anchored in active and liquid underlying markets.

This briefing examines the impact of the transition from LIBOR to RFRs with a specific focus on the Singapore and Singapore dollar debt capital markets, and outlines what issuers and their advisers will need to consider as we approach the deadline for the end of LIBOR.

Key issues

- Global financial markets are transitioning from LIBOR benchmarks to risk-free rates, in preparation for the discontinuation of LIBOR at the end of 2021
- As USD LIBOR is a key input for the Singapore Swap Offer Rate, Singapore has developed a Transition Roadmap for the move to risk-free rates
- Singapore issuers and debt capital markets participants will need to carefully consider how this changing environment will impact new and existing capital markets documentation, particularly in respect of capital markets instruments maturing after the 2021 deadline for LIBOR discontinuation

The Transition to Risk-Free Rates

LIBOR is a wholesale funding rate based on unsecured wholesale transactions conducted by LIBOR panel banks. However, owing to limited activity in the unsecured wholesale market, it became increasingly clear that the submissions made by the panel banks were based on "expert judgment" rather than empirical data from active underlying wholesale markets. The impetus for a transition away from this expert-based determination of a

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

reference rate to a more robust RFR has been considered by international regulators well before Andrew Bailey's speech in July 2017[2].

As a result, regulators – particularly those in the principal financial centres of the main LIBOR currencies – have been actively working to develop and recommend alternative RFRs based on more robust computational methodology to replace LIBOR. In a recent publication, the International Capital Markets Association (ICMA) has summarised a number of such RFRs, as follows[3]:

- *Secured Overnight Funding Rate (SOFR)* – for USD LIBOR, SOFR, which is a broad measure of the cost of borrowing cash overnight collateralised by U.S. Treasury securities, has been recommended by the Alternative Reference Rates Committee (ARRC) of the Federal Reserve Bank of New York;
- *Sterling Overnight Index Average ("SONIA")* – for GBP LIBOR, SONIA has been recommended by the Working Group on Sterling Risk-Free Reference Rates of the Bank of England (BoE); it is based on actual transactions and reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions; and
- *Euro Short Term Rate (€STR)* – for EUR LIBOR, €STR has been recommended by the Working Group on Euro Risk-Free Reference Rates of the European Central Bank, reflecting the wholesale euro unsecured overnight borrowing costs of banks located in the euro area[4].

However, for international bond markets, it is not simply a case of choosing the appropriate alternative RFR to replace the relevant LIBOR benchmark. By its nature, LIBOR is a forward-looking term rate quoted in seven different tenors and which is known at the start of a given interest period, whereas the alternative RFRs are overnight rates which are only published the following day. LIBOR also embeds an element of credit risk in its overall figure, which overnight rates do not. While overnight alternative RFRs may therefore be suitable for certain financial products (such as derivatives), a forward-looking rate remains desirable for products in the debt capital markets, such as floating rate notes (FRNs) which, mechanically, need to be determined for a successive interest rate period, and as a commercial matter, are important for issuers to be able to determine their cost of funding in advance. As ICMA has pointed out, "this means that determination of a three-month or six-month rate based on the alternative RFRs requires significantly different mechanics to those used for determination of a three-month or six-month rate based on LIBOR."

The various recommended alternative RFRs do not, therefore, represent a seamless replacement for LIBOR, and there remain strong calls from market

2 See the Financial Stability Board Official Sector Steering Group Report, "Reforming Major Interest Rate Benchmarks", 22 July 2014: http://www.fsb.org/wp-content/uploads/r_140722.pdf

3 ICMA, "A quick guide to the transition to risk-free rates in the international bond market", 27 February 2020.

4 EUR LIBOR should be distinguished from the Euro Interbank Offered Rate or "EURIBOR", which is a daily rate published by the European Money Markets Institute and is the rate at which wholesale funds in euro could be obtained by credit institutions in the EU and EFTA countries in the unsecured money market. While EURIBOR is not scheduled to be discontinued, ICMA has pointed out that regulators have recommended to market participants using EURIBOR that they should be prepared for the possible discontinuation of EURIBOR, and to consider appropriate fallbacks.

participants for a term rate in order to smooth the transition from LIBOR to alternative RFRs[5].

The demand for a term rate to replace IBORs has led to the market (specifically in the U.S. dollar and Sterling FRN and securitisation markets) adopting different calculation conventions to arrive at an average figure for a daily in-arrears RFR, with consensus moving towards daily compounding of that rate[6]. These conventions include "lookbacks", "observation period shifts", "lockouts" and "payment delays", designed to provide users with a clear methodology in arriving at an average approach, and thereby addressing the issues that arise with replacing a term rate (LIBOR) with an overnight rate (the alternative RFRs).

In a speech given on 26 February 2020, Andrew Hauser, Executive Director, Markets at the BoE, in response to market feedback on the need for a term-based RFR to replace LIBOR, announced an initiative by the BoE to publish a compounded SONIA index from July 2020. This index is intended to complement the overnight SONIA rate, and in so doing, "provide a flexible tool to help market participants construct compounded SONIA rates in an easy and consistent way, supporting achievement of their 2020 Q3 target for new issuance[7]."

SGD Interest Rate Benchmarks

Turning to the position in Singapore, there are two key interest rate benchmarks used for financial products in Singapore, summarised as follows:

- *Singapore Interbank Offered Rate (SIBOR)* – the rate at which panel banks can borrow Singapore dollars in the unsecured interbank market, calculated by Thomson Reuters in four tenors (1-month, 3-months, 6-months and 12-months), based on a trimmed average of input from a poll of 20 "panel banks". In the capital markets context, SIBOR is most frequently used in the money markets (for certificates of deposit and commercial paper); and
- *SGD Swap Offer Rate (SOR)* – the effective rate of synthetic Singapore dollar borrowings, through borrowing U.S. dollars and swapping into Singapore dollars. SOR is derived from the volume-weighted average rate of USDSGD FX swap transactions, with USD LIBOR as a key input, and is published by the Association of Banks in Singapore (ABS) as an overnight rate, and in 1-month, 3-month and 6-month tenors.

In addition, the Singapore Overnight Right Average (SORA), is the average rate of unsecured overnight interbank Singapore dollar transactions brokered in Singapore, published daily by the Monetary Authority of Singapore as an overnight rate.

SOR, in particular, is frequently used as a reference rate for interest or distribution rate adjustments on perpetual and bank capital securities. While the Singapore and Singapore dollar markets do not directly use LIBOR as a reference rate, USD LIBOR is a component in the computation of SOR. As a consequence, the discontinuation will have a direct bearing on its use as a reference rate in the Singapore derivative and cash markets.

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5 The Clifford Chance briefing, "Transitioning from LIBORs and IBORs – An International Overview" (December 2018) sets out the replacement RFRs for which a term rate is planned.

6 See the Financial Stability Board's "Overnight Risk-Free Rates: a User's Guide": https://www.fsb.org/wp-content/uploads/P040619-1.pdf

7 https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/turbo-charging-sterling-libor-transition-why-2020-is-the-year-for-action-speech-by-andrew-hauser.pdf?la=en&hash=5C23D82C1F3FC5FE04C0E2E77C2A8B832AFFA92F

As a result of the discontinuation of LIBOR, the ABS and Singapore Foreign Exchange Market Committee (SFEMC) published the "Roadmap for Transition of Interest Rate Benchmarks: From SGD Swap Offer Rate (SOR) to Singapore Overnight Rate Average[8]" (the Transition Roadmap) in August 2019, which included certain preliminary recommendations for the Singapore dollar debt markets, including that SORA could be an appropriate replacement for SOR in a variety of cash market products (including floating rate notes/bonds, loans, mortgages and other instruments)[9]. The ABS and SFEMC noted that SORA-based cash products would benefit from "being perfectly hedged using SORA-based derivatives", but "acknowledges that many cash market participants are currently more operationally familiar with a forward-looking term interest rate and recognises that SIBOR would continue to be a relevant reference rate in the near and medium term." In addition, the Transition Roadmap also acknowledges that a forward-looking interest rate benchmark based on SORA-referenced derivatives, "term-SORA", could be developed in future once activity in that market picks up, with term-SORA potentially being used as an alternative reference rate for cash market users, and potentially in the same manner that the BoE is aiming to published a compounded SONIA index.

The Roadmap concludes, in relation to cash market products, that "a key aspect of the work during the first half of the 2020 calendar year would involve understanding the types of cash market products that can directly reference SORA, and those that would require term-SORA or credit-sensitive benchmarks such as SIBOR". For the first half of 2021, and assuming that liquidity in the derivatives market can support the development of term-SORA benchmarks, a wider variety of cash products could reference term -SORA.

In summary, the Singapore position is similar to that facing other financial centres in transitioning from IBORs to RFRs, with the regulatory imperative of developing a robust alternative benchmark based on empirical market data being fully aligned with other major financial markets.

Implications for the Singapore Debt Capital Markets

In light of these developments, Singapore issuers and market participants will need to carefully consider how this changing environment will impact their capital markets documentation, particularly as the tenors of newly issued instruments are likely to pass through the 2021 deadline. In particular, while the overall policy direction remains the same as other financial centres, the unique use of SOR in the Singapore dollar market gives rise to particular issues that will not otherwise confront G3 currency markets, as will be discussed below.

Floating Rate Notes

It is likely that U.S. dollar, euro, Pound Sterling, yen or Swiss franc securities issued by Singapore issuers (and that require a benchmark reference rate as part of the computation of the return to investors) will likely rely on developments in those currency markets, such as the compounding conventions discussed above. However, Singapore dollar-denominated cash market transactions that traditionally reference SOR will need to develop their own methodologies, at least until such time as a term-SORA is accepted as a seamless replacement for SOR.

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8 https://abs.org.sg/docs/library/consultation-report-on-roadmap-for-transition-of-interest-rate-benchmarks-from-sor-to-sora.pdf

9 See Section 3.1.2, Transition Roadmap.

FRNs are not issued in the Singapore dollar debt capital markets with the same frequency as in the U.S. dollar or euro markets, where the transition to RFRs has given rise to the compounding computation methodologies described above. However, to the extent this changes, it is likely that the same "lookback" and "observation period shift" techniques could be applied in arriving at SOR, which – similar to SOFR, SONIA and €STR - is published as an overnight rate.

For FRNs already in issue, whether in the G3 currency markets or Singapore dollar market, and which have a maturity date following the 2021 deadline, consideration should be given to the need for a consent solicitation in order to replace the existing LIBOR or SOR reference rate with such a compounding computation. Typically, these securities will include some form of fallback which will default the interest rate to the last prevailing rate prior to the disappearance of the underlying benchmark, meaning that a floating rate security will 'convert' into an essentially fixed rate security, which is in neither the issuer's nor the noteholders' interest. Based on the European experience, it may therefore be feasible for issuers to consider consent solicitation without the need to offer consent fees as an incentive for amendments to the rate of interest, as noteholders may already be sufficiently incentivised to support any resolution which will ensure that their investment remains linked to an underlying rate, particularly in a low-interest rate environment.

Benchmark Discontinuation Fallback Provisions

Traditionally, English and Singapore law debt capital markets documentation (both for standalone floating rate securities and medium term note (MTN) programmes) have included provisions which provide for a fallback mechanism in the event of a relevant reference rate not being available to an issuer or its calculation agent at the relevant time. In summary, these provisions set out a process whereby, in such event, the calculation would request quotes from a predetermined number of reference banks in the relevant principal financial centre of that currency, and then use those to form the basis of a rate calculation. If, for any reason, such quotes could not be obtained, the rate of interest would default to the rate in effect in the immediately preceding interest rate period, leading to an effective transformation of the security into a fixed rate security.

These provisions do not, however, contemplate a scenario where the benchmark would cease to be available or disappear altogether. Since it became apparent that LIBOR would discontinue at the end of 2021, market participants and their advisers have begun developing more detailed fallback provisions for inclusion in floating rate and programme terms and conditions which provide for a fallback in the event of a permanent cessation of a benchmark. In summary, these new fallback terms provide for the appointment of an independent adviser (usually appointed by the issuer, and acting in good faith) to determine an alternative or successor rate, together with an adjustment spread, on the occurrence of certain "benchmark events". These events include the cessation of the publication of the relevant rate and it being unlawful for the issuer or any of its agents to calculate payments using that rate. The benchmark events also include certain pre-cessation triggers which aim to anticipate the benchmark discontinuation, including public statements by the administrators of the relevant reference rate that the rate will cease to be published, will be permanently or indefinitely discontinued or otherwise be prohibited from use, usually within a six month time-frame following such public statement.

There is no prescribed form for these provisions, although market practice does appear to be coalescing around the principles underlying the wider form of fallback provisions described above. In the United States, however, the ARRC has published recommendations for fallbacks for new issuances of LIBOR FRNs[10].

As the new benchmark fallback provisions contemplate the discontinuation of any benchmark that is relied upon in the calculation of a rate of interest (and are not specific or limited to LIBOR), they are suitable for use in a wide variety of debt securities issuance programmes (such as MTN programmes), with Singapore issuers increasingly including them in their documentation.

While including these fallback provisions is advisable, market participants should remain mindful that they should be treated only – and literally - as a fallback, and not as a substitute for an alternative RFR upon issuance of securities referencing a benchmark. There remains uncertainty as to how these would operate in practice and what the outcome of the selection and application of such an alternative or successor rate would be, a point which issuers would also be well-advised to ensure is disclosed in the risks relating to the securities.

SOR Make-Whole Call Options

In U.S. dollar high yield transactions, it is common for issuer call options to include "make-whole" provisions that are designed to compensate noteholders for the loss of future earnings from interest payments resulting from an issuer's right to "call" the notes earlier than anticipated. These make-whole provisions are typically based on a discount rate that is based on the yield on a series of U.S. Treasury securities that have a maturity corresponding as closely as possible to the first call date on the notes (plus a fixed margin).

In the Singapore dollar market, though rare, and absent a U.S. Treasury reference point, such make-whole provisions typically utilise the SOR corresponding to the duration of the period remaining to the maturity date for purposes of the discount rate.

Accordingly, while the IBOR transition will have no impact on U.S. Treasury-based make-whole provisions for U.S. dollar-denominated debt securities, consideration will need to be given to SOR-based make-whole calls, and what an appropriate discount rate would be. In a scenario where notes are already in issue, and with first call dates falling after the 2021 deadline, issuers may also consider whether a consent solicitation process is economically feasible, if they wish to preserve the flexibility to exercise the call option in future.

The Money Markets: Certificates of Deposit and Commercial Paper

It is apparent that the most frequent use of SOR and SIBOR in the Singapore dollar cash markets is in the short-term money markets for certificates of deposit (CDs) and commercial paper (CPs), typically issued as a form of short-term funding primarily by banks and other financial institutions.

The transition to RFRs is likely to pose less practical concerns for issuers of floating rate CDs and CPs, as given their short-term duration and smaller issuance sizes, issuers are likely to be able to redeem and repay any such floating rate instruments well in advance of the 2021 deadline. Further, we understand that SIBOR, and not SOR, is the more frequently used rate, which

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10 https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/FRN_Fallback_Language.pdf

does not present the immediate difficulties associated with the USD LIBOR component of SOR.

Nevertheless, given that CD and CP programmes are, by their nature, "evergreen" and, unlike MTN programmes, are rarely updated, it is advisable for issuers to ensure that the same form of fallback provisions are included in the terms and conditions of these programmes, in addition to considering the removal of references to SOR-linked CDs or CPs being issued under the programme after the 2021 deadline.

Perpetual Securities and Regulatory Capital

Of more pressing relevance to the Singapore dollar market is the manner in which the transition to alternative RFRs will impact Singapore dollar-denominated perpetual capital securities[11] and regulatory capital instruments such as Basel III additional tier 1 capital securities, each of which utilise SOR as the reference rate for calculating distribution resets at future dates.

Until recently, the view in the Singapore market was that IBOR transition would not have a direct impact given it is unlikely that SOR will cease to be published (even with USD LIBOR as a key input, as discussed above), or that more typical screen replacement page fallback provisions would be sufficient.

However, careful consideration should be given to the fact that one of the key inputs in SOR, USD LIBOR, will be discontinued, and that the ABS-SFEMC, in its Transition Roadmap, has made clear that there is a consensus "to avoid continued reliance on a US interest benchmark in the computation of a key SGD interest rate benchmark, and to explore the adoption of a SGD benchmark which would be more reflective of domestic funding conditions[12]."

Although the best outcome will be for SORA (with a form of term-SORA) to be adopted as the Singapore dollar RFR for its cash markets well in advance of the 2021 deadline, to the extent that issuers of perpetual securities need to continue to reference SOR in their perpetual securities, particular care should be exercise in ensuring that the terms of the securities include fallback provisions which specifically reference not just the "reference rate" for the calculation of the distribution on the securities, but also any component thereof, in order to allow those provisions to operate not only in the worst-case scenario of a complete discontinuation of SOR, but where USD LIBOR (as a component of SOR) is no longer included in the calculation. Issuers of such securities would also be well advised to ensure that their offering disclosure in the primary market clearly sets out the impending unpredictability of what the reset rate, and therefore investors' return, may prove to be in the event of SORA becoming the successor rate.

For perpetual securities already in the market with distribution rate resets referencing SOR, and which do not have the benefit of the fallback provisions, issuers will need to choose between redeeming or buying back such securities prior to the 2021 deadline (or the reset date immediately following it), or whether a consent solicitation to amend the terms of the securities to provide for an alternative rate in advance of the rest date is economically the more feasible approach.

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11 Perpetual capital securities are particularly popular instruments for Singapore real estate investment trusts, given that – if properly accounted for as equity – they are a useful tool for raising capital without contributing to overall leverage limits that they are otherwise subject to.

12 Paragraph 2.1.1

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