Hogan Lovells

FCA announces discontinuation of LIBOR

October 10, 2017

As you may know by now, on July 27, 2017 Andrew Bailey, chief executive of the UK's Financial Conduct Authority (FCA), announced in a speech that market participants should not rely on LIBOR (the London Interbank Offered Rate) being available after 2021.This was referred to at the recent Loan Market Association Conference in London as being "the death knell for LIBOR." LIBOR is a global benchmark that is used across product classes and its long term sustainability is thus a topic under consideration in the U.S. and elsewhere around the world. This article briefly summarizes key questions around this topic.

The FCA is concerned that "it is not only potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them" and is keen that work now begins in earnest on planning for a smooth transition away from LIBOR to alternative reference rates that are firmly rooted in data obtained from transactions.

Of course, the reform of interest rate benchmarks has been on the global agenda for the last few years in the wake of the benchmark manipulation scandals. In particular, in 2014 the Financial Stability Board (FSB) laid out a reform agenda and alongside the reform of existing benchmarks, including LIBOR, the FSB recommended the development and adoption of alternative near risk-free benchmarks. The risk-free rate of return is the theoretical rate of return an investor would expect from an absolutely risk-free investment over a specified period of time (it is often based on the yield on high-quality government bonds). So the FCA speech should be considered in this context and, rather than kick-starting work on a LIBOR replacement, it can be seen as now providing a firm timeframe.

LIBOR's administrator, ICE Benchmark Administration Ltd., has said that it intends to continue to produce LIBOR after 2021 because it believes that in accordance with the Wheatley reforms it has modified the index into a sustainable, modern part of the financial system. LIBOR's survival, however, cannot be guaranteed as the FCA has said that it will not compel or persuade LIBOR panel banks to continue to submit quotes after 2021 and so in practice they may be unlikely to do so.

Likely impact on new transactions

The FCA acknowledges that the transition to a new rate will take time.

Until there are robust alternatives in place, market participants need to consider on a case by case basis what action to take in relation to current transactions - there is not yet a consistent market-wide approach. The interests of lenders in the loans market, investors in the debt capital markets and of market participants in derivatives, including interest rate swaps, differ. For instance, regulated banks fund themselves differently to non-bank lenders meaning that even within the loans market different types of lenders may have different views on what a suitable replacement rate should be.

In the absence of any guidance, it is likely that transactions will continue to be based on LIBOR as documents can be adapted only when market thinking on replacement rate(s) is more developed (and this may vary from jurisdiction to jurisdiction).

If LIBOR is replaced with a risk-free rate, which is fundamentally different in nature to LIBOR, it will be important to ensure that the fallback provisions in finance documents will work for that transaction including in respect of any underlying instruments. For instance, many leveraged loans and project/infrastructure finance loans are hedged by interest rate swaps, which certainly in the project finance arena will be of a long duration.

Fallback provisions

Loans: Loan documents based on the current Loan Market Association (LMA) forms and many U.S. forms will have one or more fallback positions to cover the situation in which LIBOR is unavailable. At the time of writing, the LMA has said that it is too early to make any changes to the LIBOR wording in their standard forms so new transactions will continue to be based on the existing wording, including the fallback provisions. Provisions to address these issues are beginning to appear on a deal-by-deal basis attempting to expand the fallback provisions to address more than just temporary unavailability.

For instance, in the LMA's "Unavailability of Screen Rate" provision, parties can choose to have recourse to the Reference Bank Rate and/or to lender actual cost of funds, however, these provisions are not designed to replace LIBOR on a long term basis and are not designed for where LIBOR has been replaced by a totally different rate with a different methodology for calculation. It is also likely that Reference Banks would simply not provide quotes after LIBOR ceased to exist and the documentation would usually not compel them to do so.

The optional "Replacement of Screen Rate" clause is also available which is designed to make it easier for the parties to amend the facilities agreement to incorporate an alternative rate in place of LIBOR. Without that provision such an amendment would require the consent of the borrower and all of the lenders which would be hard to obtain on a widely syndicated loan. The provision alters the position to enable the change to be implemented provided that the borrower obtains the consent of the Majority Lenders to do so. While this may facilitate the amendment being made, the provision may not be palatable to all lenders on certain transactions as it would mean that fundamental changes in the loan's rate of return could be forced upon any minority lender.

The Asia Pacific LMA documentation mirrors the LMA standard documentation on these issues.

Debt Capital Markets: This has obvious implications for all types of debt capital markets transactions including bonds and securitizations. Long term floating rate notes are not very common in the plain vanilla bond markets (most have between 18 months to 3 years maturity); they are more common in bank and insurance regulatory capital issuances, corporate hybrid issuances and securitization transactions.

Some issuers are providing for flexibility in bond documentation that will allow the parties to make amendments to interest rate determination provisions in the event of the discontinuation of LIBOR.

Care should be taken to ensure that any amendments are followed through so that there are no unhedged mismatches and that any amendments to the bond documentation are also made to the floating leg of any interest rate swap and any relevant asset-specific swaps will also need to be amended.

Some issuers are introducing additional risk factor language in offering documents to highlight any risks arising as a result of the demise of LIBOR or other interbank offered rates (IBORs). Any such risk factor language needs to be carefully worded and tailored to the specific circumstances of the bond terms and conditions and interest rate fallback provisions.

Derivatives: As with other debt capital market transactions, derivatives transactions are also likely to continue to refer, where relevant, to LIBOR until market thinking is more developed. The International Swaps and Derivatives Association, Inc. (ISDA) is currently developing robust fallbacks and looking at what would constitute a permanent discontinuation of LIBOR or any other IBOR and therefore trigger new fallbacks.

Impact on legacy transactions

In structured transactions where different financial products interrelate, it will be essential to ensure that changes to each part of the structure are coordinated and that any substitute rate is suitable for each element involved. In the absence of a legislative solution:

- If the terms and conditions of legacy bond transactions need to be amended, this will typically need to be done by way of a liability management exercise but this could be costly and time consuming for issuers and with the outcomes being uncertain.
- In the case of legacy loans, each credit agreement may need to be amended and the borrower will need to obtain the requisite lender consent threshold in order to make that change in accordance with the requirements of the loan documents. This will be laborious and costly. It should be noted that many legacy loans are expected to be prepaid or repaid or be amended or refinanced in advance of establishment of a new benchmark so these amendments are expected to be undertaken on a case by case basis.

Potential replacements for LIBOR

The FCA has stated that it is up to market participants to develop and implement replacement reference rates. There is no obvious go-to single replacement rate.

In the UK, in April 2017, the Bank of England Working Group on Sterling Risk-Free Reference Rates (which was set up to recommend a risk-free rate and promote its adoption as an alternative to sterling LIBOR) selected reformed SONIA as its proposed benchmark for use in sterling derivatives and relevant financial contracts, as announced by the Bank of England).

SONIA is an overnight unsecured rate produced by the Bank of England and fixed daily; unlike LIBOR it is not a forward looking rate reflecting the duration of the relevant interest period.

In the U.S., in June 2017 the Alternative Reference Rates Committee announced its choice of a broad U.S. Treasuries repo financing rate. Both this rate and SONIA are overnight rates and backward-looking as they report the rate for past transactions. The FCA notes that both of these benchmarks benefit from more active underlying markets than LIBOR and neither involves expert judgment.

In Europe, there is no preferred risk-free rate as yet but on 21 September 2017 the European Central Bank announced that it would introduce a new unsecured overnight interest rate that would serve in addition to benchmarks produced by the private sector. The high-level features of the new rate are to be communicated to market participants over the course of next year, with those participants then able to provide feedback.

At the end of 2016, the Study Group on Risk-Free Reference Rates in Japan selected TONA.

Industry actions

Swaps and Derivatives

ISDA has been looking at the development of robust fallbacks for contracts for some time as well as mechanisms that would apply in the event that there was a permanent discontinuation of LIBOR (or any other key IBOR); including amendments to the ISDA 2006 Definitions to add selected fallbacks and proposals to amend legacy contracts that continue to reference LIBOR or IBORs. ISDA is actively working on long term alternatives to the IBORs and how an overnight risk-free rate could be used as an alternative to the forward IBORs.

It is anticipated that neither the amendments to the ISDA 2006 Definitions nor the development of any potential new protocol mechanism to incorporate these changes will amend the actual rate in the particular contract (so any contract amended in this way will still be a LIBOR/IBOR contract) but instead is likely to incorporate the new fallbacks.

ISDA has stressed that it is committed to ensuring that whatever is put in place will be suitable for the entire market. It is important that the fallbacks work for end users and are consistent with the underlying instruments that end users are hedging.

Debt Capital Markets

The International Capital Markets Association (ICMA) is coordinating with ISDA in the expectation that the bond market will follow the initiatives in the derivatives market. It is also seeking to liaise closely with other trade associations to facilitate a market-wide approach for both the short and the longer term.

The Association for Financial Markets in Europe (AFME) is also engaging with policymakers on this issue.

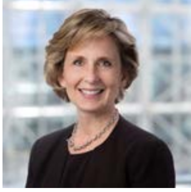
Loans market

The main bodies representing lender - the LSTA, LMA, and APLMA - are also actively considering the effect the discontinuation of the benchmark will have on existing and future transactions. The LMA has confirmed that it too is closely monitoring the situation.

The LSTA outlined the points for consideration in respect of loans and collateralized loan obligations.

We will continue to remain involved in discussions with the various organizations and keep a close eye on strategic trends throughout the market.

Contacts



Deborah K. Staudinger
Partner, New York
T +1 212 918 3326
deborah.staudinger@hoganlovells.com

Evan Koster
Partner, New York
T +1 212 918 8269
evan.koster@hoganlovells.com

Emil Arca
Partner, New York
T +1 212 918 3009
emil.arca@hoganlovells.com

Penny Angell
Partner, London
T +44 20 7296 5786
penny.angell@hoganlovells.com

James Doyle
Partner, London
T +44 20 7296 5849
james.doyle@hoganlovells.com

www.hoganlovells.com

"Hogan Lovells" or the "firm" is an international legal practice that includes Hogan Lovells International LLP, Hogan Lovells US LLP and their affiliated businesses.
The word "partner" is used to describe a partner or member of Hogan Lovells International LLP, Hogan Lovells US LLP or any of their affiliated entities or any employee or consultant with equivalent standing. Certain individuals, who are designated as partners, but who are not members of Hogan Lovells International LLP, do not hold qualifications equivalent to members.
For more information about Hogan Lovells, the partners and their qualifications, see www. hoganlovells.com.
Where case studies are included, results achieved do not guarantee similar outcomes for other clients. Attorney advertising. Images of people may feature current or former lawyers and employees at Hogan Lovells or models not connected with the firm.
© Hogan Lovells 2017. All rights reserved.