Discontinuation of LIBOR

How documentation in securitizations and other debt capital markets transactions is responding to the development

Issues

Market participants should not rely on the London Interbank Offered Rate (**LIBOR**) being available after 2021. That was the message delivered on 27 July 2017 by Andrew Bailey, chief executive of the United Kingdom Financial Conduct Authority (the **FCA**). This approach stems from the FCA's concern that it is potentially unsustainable and undesirable for market participants to rely on reference rates such as LIBOR that do not have active underlying markets to support them. Accordingly, the FCA proposes to transition to alternative reference rates that are firmly based on transactions.

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.

There are three main issues that are thrown up by the planned discontinuation of LIBOR:

– what will replace LIBOR?

– how do current transactions in the market address the fact that LIBOR could potentially be discontinued during the term of the transactions?

– how do we deal with transactions that have already been entered into with maturities that extend to beyond 2021?

This article looks at each of these issues in turn.

What will replace LIBOR?

The long term issue is obviously the development of a robust and feasible alternative to LIBOR. Although there is no official definition of "robust", the International Swaps and Derivatives Association, Inc. (**ISDA**) has stated that it is important that any rate designed to replace LIBOR is not susceptible to manipulation and is based on liquid transactions.

The FCA has said that market participants should take primary responsibility for the development and transition to alternative reference rates, although it is ready to support and coordinate efforts. There is no replacement already available.

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 near risk-free reference rate and promote its adoption as an alternative to sterling LIBOR) selected SONIA as its proposed benchmark for use in sterling derivatives and relevant financial contracts. The group published a White Paper in June 2017 on the adoption of SONIA in sterling markets and sought feedback on the appropriate scope of adoption of the risk free rate across broader financial markets beyond derivatives, such as loan or bond markets and the substitution of SONIA into legacy contracts referencing LIBOR. SONIA is an overnight unsecured rate produced by the Bank of England, backward looking and fixed daily so it will not reflect the dependence of rates on the term of a loan. On the other hand with LIBOR, a borrower knows the interest rate payable for the relevant period. The Bank of England is looking to develop SONIA for different terms – three, six and twelve months. However, no concrete steps have been taken in this regard.

In the US, in June, the Alternative Reference Rates Committee announced its choice of a broad US Treasuries repo financing rate as a replacement for USD LIBOR. It is worth noting that this rate is not yet being published.

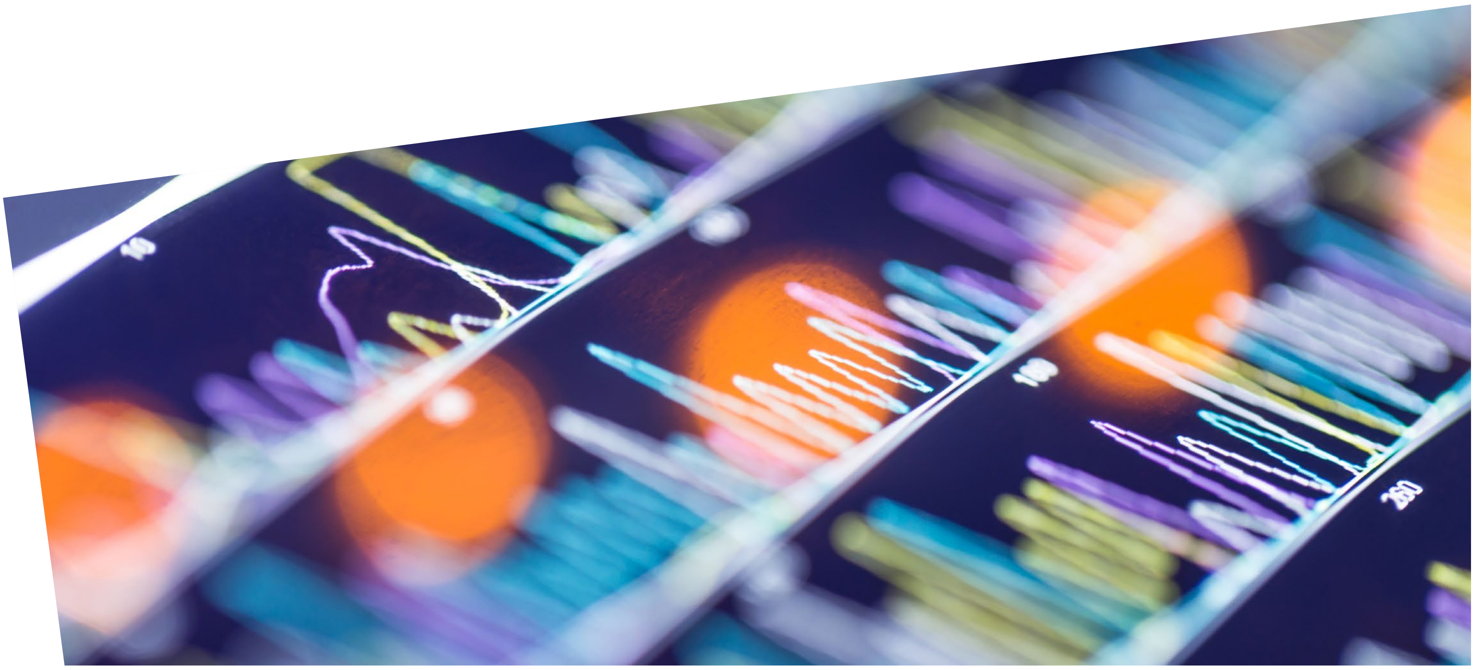
The FCA notes that both of these benchmarks benefit from more active underlying markets than LIBOR and neither involves expert judgment although they are backward looking as they report the rate for past transactions.

ISDA has also been working on long-term alternatives to LIBOR (and indeed to other benchmark rates) for some time and has set up working groups to address the following:

- suggestion of a fallback rate, or if determined necessary, fallback rates and/or other fallback mechanisms, that would apply if LIBOR (or any other applicable interbank offered rate) is permanently discontinued;
- amendments to the ISDA 2006 Definitions to add selected fallbacks that would apply upon any such permanent discontinuation;
- development of a proposed plan to amend legacy contracts referencing the applicable interbank offered rates to include the amended definitions, including potential development of a protocol mechanism to facilitate multilateral amendments.

Given the inter-connectivity of the markets and the importance of ensuring matching cashflows between bonds and swaps, the bond market and other markets will need to be guided by the derivatives market to establish benchmark rates fall backs and alternatives. It is crucial that the relevant working groups consider the financial markets as a whole and the full spectrum of products utilizing benchmark rates as a reference rate when determining the appropriateness of alternative rates.

Given that the work on replacing LIBOR with a more robust, risk free rate which is less susceptible to manipulation is still ongoing and there is little clarity of what LIBOR will be replaced with, it is difficult for market participants to pre-judge the outcome of the on-going work on the risk-free rates to produce an interim or long-term rate as any alternative to LIBOR. Flexibility and ease of amendment in deal documents will therefore be critical.



European Benchmark Regulation

Separately, the EU Benchmark Regulation (Regulation (EU) 2016/1011) (the **BMR**) applied in the European Union from 1 January 2018. The BMR aims to provide a framework for benchmarks to be produced in a transparent and reliable manner. For a more detailed discussion of the BMR, please see the next article in this Global Insights brochure entitled "EU Benchmark Regulation: Is your transaction up to the mark?".

However, of interest is the requirement under Article 28(2) of the BMR pursuant to which supervised entities (regulated firms including EU credit institutions, investment firms, insurers or reinsurers, pension funds, AIFs, UCITS, central counterparties and trade repositories) must produce and maintain "robust written plans" detailing what they would do if a benchmark materially changes or ceases to be produced, which must be made available to their competent authority upon request and included in the relevant contractual documentation. The plans should, where feasible and appropriate, nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives.

In addition, the BMR requires that, with effect from 1 January 2018, prospectuses published under the Prospectus Directive which relate to an offer of transferable securities that reference a benchmark, are required to include clear and prominent information stating whether the benchmark is provided by an administrator included in the ESMA register. Prospectuses approved prior to 1 January 2018 need to be updated by 1 January 2019. Supervised entities can continue to use "existing' benchmarks until 2020.

How do current transactions in the market address the fact that LIBOR could potentially be discontinued during the term of the transactions?

Until a robust alternative to LIBOR that works for the financial markets as a whole is put in place, parties will need to consider whether transactions with maturities beyond 2021 should include provisions addressing a potential scenario where LIBOR is discontinued on a permanent basis. Although there is currently no consistent market-wide approach, considerable efforts are being made in this regard. The interests of lenders in the loans market, investors in the debt capital markets and of market participants in derivatives (including interest rate swaps) will all need to be considered. Within specific markets, there are also divergent views on what a robust alternative to LIBOR could be – for instance in the loans market, regulated banks fund themselves differently to non-bank lenders, thereby resulting in differing cost of funds (and potentially, differing interests).

In the absence of any guidance and divergent approaches being considered to address the discontinuation of LIBOR, it is likely that transactions will continue to be based on LIBOR as documentation can be adapted only when market thinking is more developed (and this may vary from jurisdiction to jurisdiction).

In the meantime, documentation is being designed to provide flexibility to make amendments to interest rate determination provisions that may be required as a result of the discontinuation of LIBOR.

Loans

Loan documents based on the current LMA forms and many U.S. forms typically have one or more fallback positions to cover a situation in which LIBOR is unavailable. In relation to their loan documentation, the LMA has said that it is too early to make any changes to the LIBOR wording in their standard forms. Accordingly, new transactions will continue to be based on the existing wording, including the fallback provisions. These include the standard "unavailability of screen rate" provision pursuant to which parties can choose to have recourse to the Reference Bank Rate and/or to lender actual cost of funds. One of the main issues with the fallback provisions under the LMA form loan documentation is that they have been developed primarily to address temporary unavailability of LIBOR. They are not designed for where LIBOR has been replaced by a totally different rate with a different methodology for calculation. Using the fallbacks as a long-term solution may be difficult and more costly to administer in the long term. 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. Mechanisms such as fallbacks to the last available LIBOR might result in a floating loans note being effectively converted into fixed rate loans, which is unlikely to be acceptable to lenders.

The LMA form loan documentation also includes an optional "Replacement of Screen Rate" clause, which is designed to make it easier for the parties to amend the facilities agreement to incorporate an alternative rate in place of LIBOR. The provision enables the loan documentation to be amended to incorporate an alternative rate provided that the borrower obtains the consent of the Majority Lenders to do so (as opposed to a more typical amendment clause which would require the consent of all lenders). The issue with this approach is that while it may facilitate the amendment being made, the provision may not be acceptable 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.

One potential fallback that has been subject of extensive discussions is the introduction of a provision that, if LIBOR is unavailable, the reference rate will be the rate as determined by the lenders/agent. The concern that has been raised with this fallback is that it places too much discretion in the hands of the entity tasked with determining the alternative reference rate.

More recently, the LMA have announced that, with effect from 22 December 2017, they have updated their secondary trading documents, being their standard terms and conditions, the user's guide and the trade confirmations for bank debt, claims and risk participation to address the discontinuance of LIBOR. The definition of "Relevant Benchmark Rate" (used for the purposes of calculating the Relevant Rate in respect of the cost of carry element of Delayed Settlement Compensation and the sell-out element of the buy-in/sell-out provisions) has been amended to include, where the specified screen rate is not available and where it is not possible to calculate the interpolated rate, any rate specified by the Seller, acting reasonably.

It remains to be seen how the difference in approach between the loan documentation and the secondary trading documentation will be dealt with.

Debt Capital Markets

The discontinuation of LIBOR could potentially have implications for all types of debt capital markets transactions including bonds and securitizations. While 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.

Bonds

Though, unlike ISDA or LMA documentation, there is no "master" or "standard" form for terms and conditions of notes in the bond market, the terms and conditions of most bond documentation typically contain limited fallback options if LIBOR is unavailable. These are (i) screen rate determination (if the relevant screen rate comprising LIBOR is not available, the provisions provide for a successor or replacement screen, an alternative fallback to rates to be determined by a number of reference banks who lend in the relevant interbank market and an eventual fallback to rates determined at the discretion of a given party (typically the cash manager or the calculation agent)) and (ii) ISDA determination (which typically refers to calculation on the same basis as the floating rate leg for an interest rate swap for the relevant designated maturity determined by the calculation agent on the basis of ISDA definitions).

While prospectuses and offering documents in plain vanilla bond transactions have begun to include a risk factor relating to the discontinuation of LIBOR, in the absence of any certainty as to when LIBOR will be discontinued and what rate will replace it, the approach is very much to "wait and watch" until further clarity is achieved in this regard and no provisions are being included in the bond documentation itself to address the likelihood or LIBOR being discontinued.

Securitizations

In relation to securitization transactions, it is becoming increasingly common for bond documentation to include provisions that will allow the parties to make amendments to the interest rate determination provisions if LIBOR is discontinued. Recognising that amendments to bond documentation could be time consuming and expensive (due to the nature of the consents provisions typically included in securitization transactions), provisions are now being included in documentation to "simplify" the consent process in circumstances where the issuer proposes to amend the reference rate. The simpler process requires the note trustee to agree to amendments to the reference rate (and other amendments which are necessary or advisable to facilitate such change) without the consent of noteholders or other secured creditors if the note trustee is provided with a certificate by or on behalf of the relevant issuer that the amendment is being made solely for the purposes of enabling the issuer to amend the reference rate. In order to provide maximum flexibility and permit issuers to carry out the amendments in good time before any discontinuation kicks in, the trigger for the issuers to request that the note trustee consent to amendments to the reference rate is not the discontinuation *per se* of LIBOR but any steps that would indicate that LIBOR is likely to be discontinued. These include:

- a material disruption to LIBOR, a change in the methodology of calculating LIBOR which is adverse to the issuer or any noteholders or LIBOR ceasing to exist or be published
- the insolvency or cessation of business of the LIBOR administrator (in circumstances where no successor LIBOR administrator has been appointed)
- a public statement by the LIBOR administrator that it will cease publishing LIBOR permanently or indefinitely (in circumstances where no successor LIBOR administrator has been appointed that will continue publication of LIBOR)
- a public statement by the supervisor of the LIBOR administrator that LIBOR has been or will be permanently or indefinitely discontinued or will be changed in a manner which is adverse to the issuer or any noteholders
- a public statement by the supervisor of the LIBOR administrator that means LIBOR may no longer be used or that its use is subject to restrictions or adverse consequences
- the reasonable expectation of the issuer (or an entity such as the servicer or the cash manager on its behalf) that any of the events specified above will occur or exist within a specified time frame (typically six months) of the proposed effective date of such modification.

Given the considerable uncertainty around the nature of the reference rate that would replace LIBOR, the consent provisions also include parameters for determining a new reference rate. In recent transactions, the following have been included as potential alternative reference rates:

- any reference rate published, endorsed, approved or recognized by the Federal Reserve, the Bank of England, any regulator in the United States, the United Kingdom or the European Union or any stock exchange on which the Notes are listed or any relevant committee or other body established, sponsored or approved by any of the foregoing
- the SONIA or Broad Treasuries Repo Financing Rate (or any rate which is derived from, based upon or otherwise similar to either of the foregoing)
- a reference rate utilized in a material number of publicly listed new issues of asset backed floating rate notes denominated in the same currency
- a reference rate utilized in a publicly listed new issue of asset backed floating rate notes denominated in the same currency by the same originator or by another originator in the same group
- auch other reference rate as reasonably determined by the issuer (or an entity such as the servicer or the cash manager on its behalf).

The parties that will ultimately be affected if LIBOR or any other reference rate is unavailable would be the noteholders. In order to protect their rights, the noteholders have, in recent transactions, been given the right to veto any amendment relating to LIBOR by way of a "negative consent" provision. Under this provision, in order to veto the proposed amendment, noteholders representing at least a specified percentage (in most recent cases, this has been set at 10%) of the principal amount outstanding of the notes should have notified the relevant issuer that they do not consent to the proposed amendments. Approaches as to which class(es) of noteholders have the negative consent right vary from transaction to transaction. In certain transactions, the negative consent right has been given to the most senior class then outstanding and in other transactions (where the floating rate notes are not the most senior class) to either the class(es) of floating rate notes or class(es) of notes that rank senior to such affected class).

Any modification to the reference rate will also need to satisfy other conditions including consent of all parties to the transaction documents that are proposed to be amended and a confirmation from the rating agencies rating the notes that such amendments would not cause a downgrade of the rated notes, although rating agencies are often sensitive to such provisions.

Whilst the above provisions have been included in some recent securitization transactions, there is no consistent approach in new transactions and decisions to include the fallback language referred to above are being made on a case-by-case basis. The Association for Financial Markets in Europe (**AFME**) is in the process of producing model wording to address the modification of the reference rate on the lines of the clauses described above. The model wording is in draft form and remains to be agreed. It is clear that any model wording would need detailed consideration by various market participants and would need to address various issues including the following (some of which have been identified by AFME):

- in transactions that involve interest rate hedging relating to a floating rate, care should be taken to ensure that any amendments are followed through in the swap documentation so that there are no unhedged mismatches;

- any relevant asset-specific swaps will also need to be amended;
- where the transaction documentation involves definitions such as “basic terms modifications”, “reserved matters” or similar formulations, the definitions of such terms should be expressed to exclude modifications to the reference rate made in accordance with the terms above;
- would it be sensible to introduce a put option for noteholders/call option for the issuer in case the reference rate modification cannot be agreed?
- if so, what should be the exact circumstances in which any such options can be used (e.g. only if there is no LIBOR screen rate and fallbacks have been followed to apply a fixed rate)?
- should there be a time limit for use of any such option after those circumstances exist?

In addition to the flexible amendment language described above, prospectuses and offering documents in relation to securitization transactions have also begun to include additional risk factor language in offering documents to highlight any risks arising as a result of the discontinuation of LIBOR.

Derivatives

As with debt capital market transactions, derivatives transactions are also likely to continue to refer, where relevant, to LIBOR until other options are more developed. ISDA has set up working groups to develop fallback provisions and consider what would constitute a permanent discontinuation of LIBOR or any other reference rates. ISDA is also looking to develop a protocol to provide for amendments to existing contracts for those that elect to adhere to the amendments. During the time that the fallbacks and the protocol are being developed, no language is currently being used in documentation to address the potential of LIBOR being discontinued.

A principal risk in relying on the short term solutions described above is that the entire market does not move to new fallbacks, resulting in different issuers/transactions/markets amending reference rate provisions at times or only some contracts move to new fallbacks. Therefore, it is essential that a “permanent discontinuance” is clearly defined. The various bodies working on fallback provisions will have to ensure that fallbacks put in place will be suitable for the entire market.

What about existing transactions?

In terms of legacy transactions that continue to reference LIBOR, market participants would need to evaluate the fallback provisions in agreements that refer to LIBOR and consider how to amend those agreements to specify a replacement reference rate when necessary.

As mentioned above, ISDA is looking to develop a protocol to provide for amendments to existing contracts for those that elect to adhere to the amendments.

Unlike in the derivatives market, changes to pre-existing bond terms and conditions and loan agreements cannot be made via a protocol mechanism. Amendments to legacy bond terms and conditions would typically require a liability management exercise such as a consent solicitation. In the case of loan agreements, each loan agreement may need to be amended and the borrower will need to meet the requisite lender consent threshold in order to make that change in accordance with the requirements of the loan documents.

Both the process relating to amendments of bond documents and loan agreements would be time consuming and expensive. The issuer/borrower will also run the risk of the requisite conditions for the amendments not being met. This may result in many legacy loans or bonds being prepaid or

refinanced in advance of the establishment of a new benchmark (which might also prove to be costly and time consuming) or these instruments reverting to a fixed rate equivalent to the last available LIBOR rate. An alternative mechanism could be some form of coordinated statutory measure in the main jurisdictions. It is difficult to assess, at this stage, what form the statutory measures (if any) can be put in place.

Next steps

Whilst it is clear that various industry bodies and market participants are being proactive in taking steps to address the discontinuation of LIBOR (and other benchmark rates), the processes have raised more questions than answers at this stage. Whilst any development of market standard approach to address the discontinuation will take some time, it is important that these issues are addressed in a manner that works for market participants across the various markets and recognizes the inter-connectivity between these markets.

Contacts

Julian Craughan
Partner, London
T +44 20 7296 5814
julian.craughan@hoganlovells.com

Aarti Rao
Senior Associate, London
T +44 20 7296 2274
aarti.rao@hoganlovells.com