A post LIBOR world: impact and analysis

This is the first of a series of articles in connection with the proposed phasing out of the LIBOR benchmark. This article provides some initial thoughts on how existing transactions will manage the potential transition to a new benchmark.

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In a recent speech, Andrew Bailey, Chief Executive of the Financial Conduct Authority (FCA), announced the planned phasing out of LIBOR (the London Interbank Offered Rate) as the primary benchmark in financial transactions by the end of 2021. Whilst announcing the phasing out of LIBOR, Andrew Bailey made clear that the FCA will not mandate the end of LIBOR and will, instead, be looking at market participants to take primary responsibility for the development of, and the transition to, a new benchmark.

Andrew Bailey's speech follows on from the recommendations of the Financial Stability Board (FSB) recommendation that the existing global interbank benchmarks are replaced with so called risk-free rates (RFRs). RFRs are seen by the FSB as being significantly more robust that the current global interbank rates and as being less susceptible to manipulation by the market. Japan and the United States of America have already started the process of identifying and integrating RFRs to replace their existing interbank benchmarks.

The proposed phasing out of LIBOR has highlighted questions which had already been raised in the financial markets as to how and when replacement benchmarks would be adopted and the impact that the phasing out of LIBOR (in this instance) will have on existing transactions.

The EU Benchmark Regulation (due into force on 01 January 2018) (BMR) will also have an impact on existing interbank benchmarks. The requirements and impact of the BMR is however beyond the scope of this article however, please see our Benchmarks Regulations microsite for further information on the BMR.

In this article we consider the potential impact of phasing out LIBOR and provide some initial thoughts on how existing transactions, across three sectors of the financial markets, will manage the transition to a new benchmark.

Background

From the late 1960s, LIBOR became the benchmark used for pricing floating rate loans and subsequently it became the basis of interest rate derivative transactions. The uses of LIBOR have continued develop and it is now the benchmark to which the global financial markets default. This remains the case despite the negative attention that LIBOR attracted from the courts and the regulators following the global financial crisis. Wider press coverage suggests that currently there are $350 trillion of transactions using LIBOR as its benchmark.

When considering the viability of LIBOR to continue as the predominant benchmark in the financial markets, it is necessary to consider one of the key changes since the global financial crisis: transaction volumes across the entire financial markets have decreased significantly meaning that there is appreciably less volume in the unsecured wholesale interbank market - the market to which LIBOR is the benchmark. This was a key point for Andrew Bailey in his speech. He cited that LIBOR is sustained currently by the use of judgements of those at the LIBOR panel banks rather than being a fact/transaction based benchmark, with the contention that if submissions for LIBOR are not coming from an active market how can the benchmark of that market be a sustainable benchmark for the wider financial markets?

Moreover, Andrew Bailey noted that LIBOR panel banks are becoming increasingly uncomfortable providing LIBOR rate submissions (despite the FCA currently actively encouraging the panel banks to make LIBOR submissions) based on judgements which is necessary, given the limited market activity the LIBOR panel banks can use to validate their judgements in certain LIBOR currencies and tenors.

In light of how pervasive LIBOR currently is in the global financial markets, any move away from LIBOR will take years to achieve. Further, it is not yet clear how complicated it will be to transition existing transactions to a new (and as yet, unidentified) benchmark. What is clear is that there will be greater complications where existing documentation does not contemplate an alternative benchmark as this may lead to circumstances where the parties cannot agree on the replacement benchmark and/or the payments which are due as a consequence of the discontinuance of LIBOR.

Potential impact

Whilst it is not possible to be definitive at this early stage as to where things will end, the phasing out of LIBOR will undoubtedly have a significant impact across the financial markets. Below we consider its impact on existing loans, capital markets transactions and derivatives in greater detail. This is by no means an exhaustive list of the facets of the global financial markets which will be impacted by the phasing out of LIBOR, these examples serve merely to demonstrate some of the issues which we are expecting to arise.

Existing loan transactions and their documentation

Floating rate lending transactions which have been documented using one of the Loan Market Association (LMA) standard form facility agreements will almost certainly benefit from one of the interest rate fall back options which have been included in the LMA standard form facility agreements for a number of years now. The LMA standard form documents provide alternatives for when LIBOR is not available and, depending on the drafting option chosen, these can include the concept of receiving benchmark rates from designated reference banks or each individual lender's (self-certified) cost of funding for the relevant transaction. Experience has however shown that whilst these fall back options work, they work only for a short period of time and therefore they may not be suitable for sustained periods of time. Recent iterations of the LMA standard form facility agreements have sought to assist with this potential issue by including a drafting option to replace an unavailable benchmark which requires the consent of the obligor group and the majority lenders (when this would otherwise typically be an all lender decision).

To the extent that a floating rate lending transaction is not documented using LMA standard form facility agreements and/or the alternative methods of benchmark calculation referred to above have been removed from the transaction documents, this will give rise to greater complications. Where the parties agree to amend the documentation to reflect the revised benchmark, this could occur in one of three ways:

- the parties may agree amongst themselves that an alternative benchmark (which is not the LIBOR replacement benchmark) will be used
- the parties may agree that the documentation will be updated to reflect the then current market standard documentation (which will include details of the replacement benchmark), or
- legislation may be passed which confirms that from a set date, reference to LIBOR will be interpreted to be a reference to the LIBOR replacement (although query the efficacy of this option given the truly global nature of the transactions which have LIBOR as the benchmark).

In the event that the parties are unable to agree on the amendments to the transaction documents to reflect the amendments to the benchmark:

- if LIBOR continues to be published (as is currently being suggested by InterContinental Exchange, the entity currently responsible for the administration of LIBOR), those transactions can continue "as is", or
- in the case where LIBOR is no longer published, the parties may ultimately end up in court. One or other of the parties may be arguing that alternative benchmarks or methods of calculating interest should be used. Depending on how the claims are framed, the court may be invited to apply principles of contractual construction to determine what the parties intended by the words actually used in their contract.

Alternatively, the court might be asked to imply a term into the contract to give it business efficacy or perhaps even to rectify it on the basis that it contained a mistake. Much will depend on the wording actually used in the contract and the context in which it appears as well as the commercial context. The outcome of such claims can be notoriously difficult to predict as the rules relating to them are complex and allow a judge considerable leeway.

Existing capital market transactions and their documentation

There is no standard benchmark provision in capital markets transactions, which will vary from product type to product type and even from transaction to transaction. However, where relevant securities are issued that reference LIBOR, typically the relevant LIBOR provisions will refer to the relevant screen rate and revert to various fall back options in the event the screen rate is unavailable. The fall back options will typically involve reverting to interpolations of the two most closely available rates, and/or obtaining reference rates from a number of reference banks, decreasing in number if there is no availability. If the minimum number of reference rates are not available, bond terms and conditions will typically revert to the rate used for the last interest period where it could be calculated, or will defer to the judgment of one of the agents (for example the calculation agent).

Changing the applicable benchmark where there is no proviso for it in the terms and conditions of the bonds will require an amendment to be made to the underlying documentation. An amendment of this type is likely to be something that requires the approval of the relevant majority of noteholders, unless it can be argued it is of a formal, minor or technical nature, depending on the exact modification provisions in the bond documents. These vary from transaction to transaction and would need to be reviewed in each case.

Risk factors have already started to appear in bond prospectuses related to uncertainty and changes around the calculation, or even availability, of benchmarks. It is likely that these will need to be amended to explicitly deal with the phasing out of LIBOR. Market consensus over how to approach the issue in transactions going forward is likely to be reached relatively quickly but existing transactions will need to be reviewed on an individual basis to ascertain what, if any, amendments are required, and how those amendments will need to be implemented.

Existing derivative transactions and their documentation

Over the Counter (OTC) derivative transactions will almost certainly have been documented using the 2006 International Swaps and Derivatives Association (ISDA) Definitions, which contains the market standard provisions for interest rate products. As with the LMA standard form facility agreements and typical capital markets provisions discussed above, those ISDA Definitions already contain fall back options for when LIBOR is not available - namely the determination of the interest rate by reference to rates quoted by four major banks in the London interbank market. As already discussed above, such fall back options give rise to issues relating to its use in practice. However, they also give rise to a policy concern that they essentially undermine the work to replace LIBOR with an alternative benchmark, as it means that the relevant transactions would still be subject to an interest rate determined in the interbank market.

ISDA is currently working on producing provisions to replace the existing fall back options. These are likely to take the form of standard contractual provisions that could be used to replace the existing fall back provisions with new fall back options to the risk-free rates (being SONIA in the case of LIBOR for ISDA based transactions). These provisions could then be used to amend existing documentation, as well as be used for new transactions. As is now common-practice for such industry-wide amendments, the implementation of such contractual amendments is likely to be facilitated by the use of an ISDA Protocol, which will ease the administrative burden of having to amend many thousands of derivatives contracts on a bilateral basis. However, as adherence to ISDA Protocols is voluntary, it remains to be seen whether there will need to be any regulatory action in order to encourage market participants to adhere to such ISDA Protocol, such as a regulatory requirement on dealers to upgrade existing fall back provisions in all its OTC derivatives transactions.

What lies ahead?

The real impact of the phasing out of LIBOR will only become apparent when it becomes clear whether or not LIBOR will continue to be published after the end of 2021. If LIBOR is still published, then existing transactions can continue by reference to LIBOR without needing amendment, whilst new transactions can be written by reference to the replacement benchmark. If, as many market observers suggest, LIBOR does not continue to be published beyond the end of 2021 (not least because the FCA will, as it currently stands, stop encouraging the LIBOR banks to provide reference rates at this time) then the impact of the phasing out of LIBOR will be significant and, in certain segments of the market, be costly given the amendments which will be required to the underlying documentation.

Although the identification of a market wide replacement for LIBOR remains uncertain at this stage, the replacement benchmark will be a RFR - a rate which is a transaction-based measure and therefore divorced from any determination by reference to an interbank market. In light of past allegations of manipulation, we anticipate that the replacement benchmark will be overseen by the regulators. Some commentators are suggesting that in the wider financial market the replacement (sterling) benchmark will be SONIA - a sterling overnight rate - as it is the most comprehensive sterling alternative benchmark currently. This was one of a number of examples which Andrew Bailey cited in his speech as having a variety of key features (for example, being anchored in significantly more active markets than those which currently provide LIBOR) which make SONIA a more viable long term option. Indeed, as noted above, in the sterling derivatives segment of the market, SONIA has already been chosen as the replacement benchmark following the consultation and analysis which was undertaken by a sub-committee of the Bank of England: the Working Group on Sterling Risk-Fee Reference Rates.

The FCA has expressed a desire for market participants to take responsibility for the development and transition to a new benchmark. This raises the question of who, or which, organisation will take the lead in this process and in which forum the market participants will be able to express their opinions on the replacement benchmark. This will undoubtedly be a challenging and time consuming process not least due to the number of market participants involved and the varying regulatory regimes which impact the (key) participants.

It will also be necessary for the financial market to consider and obtain the opinions of the corporate entities who use the financial markets and its products. The potential move away from LIBOR may result in increased costs for these corporates if the replacement of LIBOR is considered to be more expensive than it would be if they were able to retain LIBOR. The short-term, practical implication of this may be that where their consent is required, it will be difficult to get corporate entities to agree to amendments to documentation where it is perceived that the cost to them will be higher a result of this amendment.

With respect to existing transactions and documentation, the FCA have acknowledged the potential difficulties in phasing out LIBOR. Indeed, they have suggested at this stage that many of the complexities that will arise when the process of transition begins have not yet been properly considered. Importantly, the FCA have made clear that they will not force the phasing out of LIBOR if a satisfactory replacement cannot be found as the uncertainty and disruption to the financial markets which this would cause would not be an acceptable outcome. To assist with this process, the FCA has reached agreement with LIBOR panel banks that they will continue to provide reference rates until the end of 2021.

The position on the documentary changes will likely remain uncertain in the short term. This uncertainty will, in due course, turn to a question of how and what, if any, amendments will be needed to the existing financial documentation. This will, however, only happen when the market and its participants provide clarity on what the replacement benchmark (assuming that there eventually will be one!) will be.

Ultimately, more information on the transition away from LIBOR is required and Simmons & Simmons will continue to monitor any developments to ensure that we will be in a position to assist clients with managing and navigating risks which arise from the adoption of and the transition to the new benchmark.

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