SLAUGHTER AND MAY

LIBOR: Goodbye to all that

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Since the LIBOR-rigging scandal came to light almost a decade ago, several institutions have withdrawn from LIBOR contributor panels and, according to the Financial Conduct Authority (FCA), it seems that some or all of those who continue to contribute, are doing so largely at the regulator's behest. The announcement by Andrew Bailey, chief executive of the Prudential Regulation Authority, in July that the FCA will no longer facilitate the production of LIBOR has therefore been widely interpreted as raising serious questions about the sustainability of the benchmark after the end of 2021, the FCA's chosen cut-off date.

The first question this brings up revolves around the alternatives to LIBOR currently being proposed and some of the challenges that those alternatives would need to overcome in order to be usable across the full range of products that reference LIBOR. Treasurers will also need to consider the practical steps they might take now to ease any transition to an alternative rate should that become necessary or desirable.

Why is LIBOR currently so reliant on FCA support?

Significant efforts have been made in recent years to transition LIBOR to a predominantly transaction-based rate, as recommended by the Financial Stability Board (FSB), which at the request of the G20 is driving the process of reforming major benchmarks. LIBOR submissions are now formulated using a 'waterfall' approach, to ensure submissions are corroborated by transaction data as far as possible. This essentially involves contributors looking first to transaction data in preparing their submissions. Expert judgement comes into play only if insufficient data is available.

It has not been possible, however, to eliminate expert judgement from the LIBOR process altogether, which appears to be the crux of the current problems in sustaining appropriate levels of rate submissions.

The implications behind Bailey's speech in July are that the sustainability of LIBOR comes down to the reluctance of banks to offer their expertise. Bailey cited an FCA survey, not yet entirely complete, which appears to confirm there to be insufficient liquidity in the interbank and other relevant markets to support the transition of LIBOR to a fully transaction-based rate. That being the case, contributors must exercise some level of judgement according to the current methodology. Judgements involve risk, in particular where there are very low levels of relevant borrowing activity. The prospect of incurring financial and (as a result of reforms to the regulatory regime) criminal sanctions and reputational damage in relation to benchmark submissions is a risk that many banks are unwilling to take.

What are the alternatives?

The process of identifying alternatives to LIBOR has been ongoing for a while. The FSB, as already noted, recommended in 2014 a number of measures to strengthen major benchmarks. At the

same time, it recommended that stakeholders should seek to identify ‘nearly risk-free’ rates that might be used as alternatives. Working groups were set up around the world to that end, to look at potential alternatives for each major currency.

In the UK, the Working Group on Sterling Risk-Free Reference Rates (the Sterling Working Group) was tasked with identifying a preferred risk-free rate for the sterling markets. Having debated various options, the working group announced the Sterling Overnight Index Average (SONIA) as its recommended rate for the derivatives market in April. Similar exercises are under way for other currencies. In the US, the Alternative Reference Rates Committee announced a treasuries repo financing rate as an alternative to LIBOR for certain US dollar derivatives and other financial contracts. In Switzerland, secured benchmark rate Swiss Average Rate Overnight (SARON) is proposed, while for Japanese yen, the uncollateralised overnight call rate, the Tokyo Overnight Average Rate (TONAR) has been suggested.

The question that immediately arises is what the cost and practical implications might be for treasury operations of different rates for different currencies. Moving from a single unsecured rate with a consistent methodology to a series of different rates originating from different administrators – some collateralised and some uncollateralised – might seem like a backwards step. However, while the Holy Grail – a rate that could seamlessly replace LIBOR across the myriad products and contracts in which it is currently referenced – remains beyond reach, a coordinated initiative to find appropriate rates across each relevant currency may be the only viable way forward.

The process is also in its initial stages. The endorsement of risk-free rates by each of the working groups is a significant step, but their work has so far focused primarily on the derivatives market. The next challenge, to which attention has only recently turned, and which is potentially of more interest to corporate treasurers, is to determine the appropriate scope of adoption of these risk-free rates (if any) as alternatives to LIBOR beyond the derivatives market.

Solutions are unlikely to be straightforward. For example, difficulties are immediately apparent if it is proposed that SONIA, or a rate referencing SONIA, should be applied to a corporate-facing sterling-denominated syndicated loan:

- First, SONIA is an overnight and backwards-looking rate, published at 9am on the day after the date to which it relates. Most corporate loans are currently priced based on LIBOR as quoted at the beginning of each interest period. The application of a backwards-looking rate, or a rate derived from a backwards-looking rate, would mean that the borrower’s cost of funds would only be apparent at the end of an interest period, which would affect treasurers’ ability to manage cash flows and facility usage.

- Second, SONIA, as a risk-free rate, does not take into account bank funding costs and thus does not plug smoothly into the ‘cost plus’ model on which the loan market operates. LIBOR does not cover lenders’ funding costs accurately due to the variety of ways in which banks fund themselves and the fact that many lenders are not banks. However, it does provide lenders with some protection against fluctuations in funding costs. If the removal of bank risk from reference

rates led to a more conservative attitude to margins, this would be of concern to treasurers. Treasurers will be aware that factors other than funding costs have a significant influence on loan pricing, especially at the relationship-led end of the market, but the implications of a move away from a bank credit risk-based measure might become a more pressing consideration in market conditions where liquidity is less abundant than it has been in recent years.

- Third, there is the question of hedging. Cost-effective hedging must be available for any alternative rate. As different risk-free rates with varying characteristics are adopted for each LIBOR currency, this potentially adds a further layer of complication to cross-currency hedging arrangements.

It may only be possible to start assessing the practical impact of a move from LIBOR to a basket of rates for different currencies and, potentially, different products, when the full range of proposals is available.

LIBOR revisited?

Whether revisiting LIBOR turns out to be the only practical option for some products remains to be seen. If that were the case, given banks' unwillingness to contribute voluntarily and the absence of regulatory support, it seems fairly certain that LIBOR+ (as the reformed rate has been termed) would need to evolve further.

One option that is apparently being explored is the possibility of transferring the exercise of expert judgement from submitters to a computer system. In 2016, ICE Benchmark Administration stated in its Roadmap for LIBOR study that it had embarked on a feasibility study on the design and implementation of an algorithm that would calculate LIBOR from banks' transactional data. The outcome of this study is not known. It would be interesting to understand whether this is still ongoing or considered a realistic possibility.

Action points for treasurers

As further proposals emerge with regard to alternative rates, feedback from the broadest possible range of rate users will be crucial. If not done already, treasury departments are urged to conduct an audit of LIBOR exposures, to ensure that they are in a position to evaluate the implications of any alternative rates across the full range of products, for example, loans, bonds, intragroup transactions, hedging products and potentially more.

Treasurers should also remind themselves of the implications under the terms of their current LIBOR-based products of LIBOR ceasing to be available. Do fallback rates apply? How robust are they? For example, lending documentation from the Loan Market Association (LMA) contains an extensive fallback-rate regime, which operates if LIBOR is unavailable.

A LIBOR AUDIT: QUESTIONS TO CONSIDER NOW

- How is the business exposed to LIBOR?
- Does the maturity of any relevant products or contracts extend beyond 2021?
- Do existing contractual terms provide for what happens if LIBOR is unavailable?
- Could those fallback options be improved?
- What is the process for amending the terms of any relevant documentation to a) improve fallback options, and/or b) accommodate any replacement rate?

There are multiple options, but most agreements cater first for the use of a reference bank rate, or if that is not available, for lenders to receive their self-certified cost of funds. Floating rate notes might also typically provide for the use of a reference bank rate (obliging the agent to obtain quotations from reference banks for rates for loans to other leading banks for the relevant interest period in the principal financial centre of the relevant currency).

If a reference bank rate is not available, the ultimate fallback is for the rate of interest at the last preceding interest-determination date to continue to be used. Relevant terms of intragroup loans and other LIBOR-based floating-rate products, as well as the operation of default interest clauses that reference LIBOR, are likely to vary and will need to be carefully assessed. Most fallback options currently available, however, are unlikely to be workable on anything other than a short-term basis.

Contractual provisions that anticipate and effect a transition to a new rate can probably only be developed once the shape of the new rate is known. However, treasurers can prepare themselves by thinking about the process under current terms for agreeing any amendments necessary to accommodate a new rate and whether there is anything that can be done to make that process easier.

To take loans as an example here, the LMA templates (see *The Treasurer*, May 2017, page 34) provide a framework for agreeing a replacement rate that attempts to make the process as smooth as possible. If interest is being paid on a cost-of-funds basis, either the agent or the borrower may instigate a 30-day negotiation period with a view to agreeing a substitute basis. The LMA forms also provide, optionally, for any amendments to the agreement required to implement a substitute rate to be made with consent of the borrower and the majority lenders, a provision that may prove particularly useful in facilities involving larger syndicates.

Whether or not Bailey's speech signals the end of LIBOR, treasurers will need to monitor the market's next steps both in relation to LIBOR and other IBORS to which their business is exposed. The ACT plans to continue to engage with treasurers, trade associations and regulators on this important topic as it evolves.

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Kathrine Meloni
T +44 (0)20 7090 3491
E kathrine.meloni@slaughterandmay.com

Stephen Powell
T +44 (0)20 7090 3131
E stephen.powell@slaughterandmay.com

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