SLAUGHTER AND MAY

Hong Kong Briefing: Transforming Interest Rate Benchmarks

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Are you ready for risk-free rates?

Improvements to the robustness and transparency of interbank offered rates (IBORs) have been gathering momentum around the world since the LIBOR manipulation scandal came to light in 2012. In line with the recommendations of the Financial Stability Board (FSB), this has involved reviewing calculation methodologies and the development of near risk-free rates (RFRs) as alternatives to the relevant IBOR.

Following comprehensive reforms to LIBOR, the UK's Financial Conduct Authority (FCA) concluded in 2017 that it is not sustainable. The FCA announced that it will not support the production of LIBOR beyond the end of 2021 and made clear that market participants should assume that LIBOR will not be usable after that date. Products referencing USD, GBP, CHF, EUR or JPY LIBOR must be transitioned to the relevant RFRs. Conventions for using RFRs in place of LIBOR must be developed for new business.

Working groups around the world are looking into replacement RFRs and conventions for each currency across the main products that currently use LIBOR. There is a daunting (and mounting) pile of guidance notes, consultations and documentation provisions on this topic. In some sectors LIBOR is starting to disappear. In others, solutions for referencing RFRs are still being developed, meaning that for the time being, LIBOR continues to be used.

This briefing outlines the progress towards transition from LIBOR and the methods currently being used and discussed for referencing RFRs in place of LIBOR. It focusses primarily on the USD market, where (alongside sterling) thinking is perhaps most advanced, and as such, likely to influence the approach taken in relation to other currencies.

This briefing also considers the implications for HIBOR of the transition from LIBOR to RFRs. The Hong Kong Monetary Authority (HKMA) has indicated it does not intend to discontinue HIBOR, but as RFRs become the predominant benchmarks globally, repercussions for the usage of domestic IBORs such as HIBOR should be anticipated.

Background – why the change?

LIBOR has been comprehensively reformed and there is no suggestion that it is currently being manipulated. The FCA's decision to cease to compel banks to contribute to it is the result of changes in banks' funding models. LIBOR was designed to reflect average rates for inter-bank lending. Transactions in the relevant inter-bank market are not executed in sufficient volumes to produce an average, meaning that a certain amount of judgment must be applied by contributors. Contributor banks are required to make significant investments in their controls around submissions and submitting a rate increases risk profile for little benefit. The FCA therefore currently persuades panel banks to contribute. This arrangement is not viewed by the FCA as sustainable given LIBOR is not representative of an underlying market.

What are RFRs and how do they differ from LIBOR?

RFRs are rates on near risk-free investments. They are overnight rates, mostly based on the previous day's transactions within a defined pool. The calculation methodology and the transactions on which each RFR is based varies by currency.

RFRs are therefore very different to LIBOR. LIBOR is calculated consistently across all currencies. The measure of bank credit risk inherent in LIBOR (as an inter-bank lending rate) is absent from a RFR, meaning that the transition from one to the other must accommodate an economic discrepancy. LIBOR is a forward-looking term rate that purports to represent the average cost of inter-bank lending in the relevant currency over a range of maturities. The replacement of a forward-looking term rate with a backward looking overnight rate presents one of the most significant operational challenges of the move to RFRs.

RFRs have been identified for all five LIBOR currencies. Four of the five RFRs are in the market and capable of use. The exception is €STR, the RFR for euro which is due to be published from 2 October 2019. SOFR is the recommended RFR for USD LIBOR, the most widely used benchmark in the global market. SOFR is based on overnight transactions in the USD Treasury repo market and was published for the first time by the Federal Reserve Bank of New York on 3 April 2018.

Are the identified RFRs being used in place of LIBOR?

The RFRs that are already in the market are being used, but not on a widespread basis or across the full product spectrum. Broadly speaking, RFRs are replacing LIBOR in transactions involving market participants who are more familiar with overnight rates and have systems in place that enable their use. This, broadly speaking, means the wholesale markets and the financial sector.

The derivatives market, for example, is adapting to RFRs – and it is important that it does so. Firstly, LIBOR-linked derivatives form the bulk (in volume terms) of legacy LIBOR exposures, making it important to reduce the inventory that ultimately needs to be amended as soon as possible. In addition, liquidity in RFR-linked overnight interest swap (OIS) trades and/or futures is crucial to the production and viability of any forward-looking term rate that might be derived from the RFR for the relevant currency in the future (discussed further below).

Less progress has been made in the cash markets.

The financial institution (FI) and public sector issuer portion of the USD floating rate note (FRN) market has adapted to SOFR for a large number of issuances. In the sterling market, SONIA is now the norm in place of LIBOR for FRNs from FI and public sector issuers. While the initial challenges of adapting internal systems to use RFRs even for the financial sector should not be underestimated, the resources available as well as the size and diverse funding base for the sector have meant that once the market convention was established, the switch could occur rapidly.

However, RFRs are a novel concept for most non-financial corporates, in particular for cash products such as loans and bonds and it is this portion of the market that has been slowest to adapt. We are not aware that any corporate has yet issued a new RFR-linked FRN in USD or indeed, any other currency (although Associated British Ports recently became the first issuer to convert a legacy sterling LIBOR FRN to a rate based on SONIA). Similarly, we are not aware of any syndicated loans using RFRs in place of LIBOR, although bilaterals referencing RFRs are starting to emerge (such as a recent bilateral sterling loan referencing SONIA between NatWest and National Express).

What will speed up the transition of cash products to RFRs?

In practice, the loan and bond markets need to coalesce around a single methodology (or a small number of variants) for using RFRs in cash products to stimulate the broad adoption of RFRs.

As discussed further below, the issue at the top of the current agenda for those involved in LIBOR transition is whether the conventions for referencing SOFR (or other RFRs) used in products that have started to transition, are workable more broadly – or whether for the broader cash markets, it is necessary to adapt them and/or focus on alternative types of rate.

Once the conventions for using RFRs have been determined, the other key building blocks required to support the RFRs should fall into place:

- pricing adjustments can be determined (to address the economic differences between LIBOR and the RFRs);
- systems providers can be comprehensively briefed as to the features and requirements of the new rates;

- regulators can engage decisively with rate vendors to assess how the rates should be made available to the market (e.g. screen rates, rate calculator tools, indices); and
- documentation can be finalised.

What about forward-looking term rates derived from RFRs?

As noted by the FSB in its **July 2018** paper, “in principle, forward-looking term rates could be based on overnight RFR-referencing derivatives such as futures or overnight index swaps in which a fixed rate payment is exchanged (swapped) for the floating RFR, because these provide information on market expectations of the RFR over a forward-looking period.”

For users of cash products such as loans, a transition from LIBOR to a forward-looking term rate based on a RFR, is less of a shift in terms of operations and cash management practices than referencing RFRs directly. Accordingly, the development of forward-looking term rates is the preferred option of many loan market participants. The UK Association of Corporate Treasurers and the Loan Market Association are among those that have argued strongly for the development of forward-looking term rates for syndicated lending.

Whether forward-looking term versions of the RFRs will be made available, and if so, when, remains in question. It is clear that RFR-derived term rates will not be available for all ex-LIBOR currencies, largely because to produce such a rate, there needs to be a liquid and appropriately sized derivatives market in the underlying RFR.

The US authorities are working towards the publication of a forward-looking term SOFR rate in 2021. However, there are no guarantees that the 2021 deadline will be met; while the trading volume of SOFR-linked derivatives is increasing, levels remain far below those referencing USD LIBOR. The Swiss Franc working group, in contrast, has already confirmed that there are no plans to produce a Swiss Franc RFR (known as SARON)-derived term rate. The viability of RFR-derived term rates in relation to other currencies remains under consideration.

Against that backdrop, the message from the official sector is that market participants must not expect forward-looking term rates to be available when LIBOR is discontinued at the end of 2021. In the regulators’ view (certainly in the US and the UK), the focus of LIBOR users should be on determining how to reference RFRs directly in cash products rather than waiting for forward-looking term rates.

What are the options for referencing RFRs directly in cash products?

The RFRs are overnight rates. The cash markets require the RFRs to be available over a period (e.g. 1 month, 3 months, etc.). In the absence of a term rate, this means that RFRs must be compounded or averaged over the required period.

If a daily RFR is compounded or averaged over a period, the precise amount of interest due on the interest payment date will not be known until the last day of the period. Some have suggested this may not be a material concern in practice, to the extent the RFRs are relatively stable over a period compared to LIBOR. However, the lack of certainty has prompted concerns that the use of compounded or averaged RFRs could lead to interest settlement times being delayed beyond current norms. To address this, a mechanism for calculating the amount of interest due sufficiently in advance of the end of the interest period is required for the loan and bond markets, to enable payments to be mobilised and any tax due to be calculated in good time.

The main possibilities under discussion are:

- Observing the RFR over a period that begins and ends on a date that falls a certain number of Business Days (e.g. 5) earlier than the start and end of the interest period.

  This "lag" mechanism has been used in the SONIA-referencing FRNs issued so far. It is also, reportedly, the mechanism used in the first publicly announced SONIA-referencing bilateral loan, entered into recently by NatWest and National Express.

- Observing the RFR over the interest period, but "stopping the clock" a few days (e.g. 4 days) prior to the end of the interest period, and using the RFR on the lock date as the interest rate for each of the last few days of the period.

  This "lock" mechanism has been used in a number of SOFR-referencing FRNs.

There are pros and cons of each approach – and potentially differing views on the required length of any "lag" or "lock", which market participants are likely to be keen to minimise.

In an attempt to socialise the main techniques that the cash markets might adopt for referencing RFRs directly, the FSB published a paper for the global audience: "**Overnight risk-free rates: a user's guide**". The paper was in part based on the US-based Alternative Reference Rates Committee (ARRC)'s "**User's Guide to referencing SOFR**", which is intended to explain how market participants can use SOFR in cash products. The RFR Working Group in the UK have taken similar steps in the form of a "**Discussion Paper for Referencing SONIA in new contracts**".

These papers intend to prompt debate and feedback, with a view to determining whether the market is likely to settle on a single option for referencing RFRs, and if so, which. They are recommended reading for users of IBOR-linked loans and bonds, both to illustrate the direction of travel and the implications and potential challenges of referencing RFRs directly in cash products. Users are strongly encouraged to give feedback and comment on the options put forward to advisers, trade associations and regulators.

What is happening in the interim?

Pending consensus on conventions for referencing RFRs across the full product spectrum, products including loans, FRNs and certain securitisations (and related derivatives) are still using LIBOR. To the extent current transactions extend beyond 2021, attempts are being made to anticipate the eventual transition to RFRs.

In the syndicated loan market, for example, the focus is on adjusting amendment and waiver clauses to ensure that at the point the loan transitions from LIBOR to a RFR, any relevant amendments can be made via a streamlined amendment process. What that process involves varies, but the intention is generally to avoid the need for unanimous lender consent. The APLMA has produced some drafting that permits relevant adjustments to be made with Majority Lender consent (following the approach of the LMA).

The ARRC has produced some sample drafting for USD syndicated loans in two alternatives. The first caters for a streamlined process for the parties to agree a replacement benchmark in the future, similar in intent to the APLMA/LMA approach. The second purports to sidestep an amendment process by providing a waterfall of fallback rates, based on the thought that when LIBOR is discontinued, there will be either an “official” recommended rate/approach or market consensus on the replacement. It is not yet clear which of the ARRC’s two proposals is gaining most traction in the New York law market.

The nature of the contractual provisions being adopted varies by product and by currency/governing law. Even then, for similar transactions the actual contractual provisions used may well be different. This is a topic that requires advice on the most practical solution in the circumstances.

What’s next for fallbacks?

The approach to anticipating the demise of LIBOR will evolve as the market determines the most appropriate fallbacks for particular products. These are thought likely to fall into place as ISDA reaches firm conclusions on fallbacks for derivatives.

The development of fallbacks for derivatives referencing LIBOR and certain other IBORs, including HIBOR, continues to advance. ISDA's proposal (which remains subject to consultation) is that swaps referencing the IBORs will fall back to the relevant RFR compounded in arrear, plus a credit spread adjustment. The credit spread adjustment reflects the fact that LIBOR caters for bank credit risk, which is absent in RFR-based pricing. RFRs, being near risk-free are hence generally lower than LIBOR.

ISDA is currently working on finalising the parameters of the credit spread adjustment for an initial set of currencies and is also engaging with rate vendors to determine how these rates will be made available to the market and by whom.

Once the fallback rates are finalised, ISDA will issue fallback drafting for transactions referencing the relevant IBORs in the form of updated definitions that can be adopted on a case by case basis. A protocol will also be made available which, if adhered to by both parties to the relevant transaction, will automatically incorporate the new fallbacks into existing transactions. ISDA's most recent timeline indicates that it hopes to make the new definitions available for the IBORs on which it has so far consulted towards the end of 2019 and open the related protocol for adherence in 2020.

The question then for the cash markets is whether to follow ISDA's approach to fallbacks, or whether it is or may be necessary to do something different (e.g. fallback to forward-looking term rates (if available)).

What does this mean for HIBOR deals?

Not all IBORs suffer from the same deficiencies as LIBOR, and not all will be discontinued. The HKMA has taken steps to develop and improve HONIA (the Hong Kong dollar Overnight Index Average), the RFR for Hong Kong Dollars, but has also said that HIBOR will continue. Similar conclusions are being reached in relation to other IBORs, for example, EURIBOR. The upshot is that for floating rate transactions in those currencies, market participants will have a choice going forward of continuing to use the relevant IBOR, or moving to a rate based on the RFR.

We would expect that conventions in the floating rate Hong Kong dollar markets will be strongly influenced by the change in interest rate conventions in transactions in the ex-LIBOR currencies. Our best guess is that after the end of 2021, Hong Kong market practice will be to follow an interest rate based on HONIA and using conventions similar to SOFR (or SONIA, the sterling RFR).

In the context of derivatives, ISDA, as mentioned above, is producing fallback drafting for HIBOR transactions. We expect this to be adopted by the majority of ISDA market participants, which we believe will have an impact on the approach taken to HIBOR-priced loans and bonds.

What do I need to do now?

It is time to get ready for RFRs. The key action points for IBOR users are to determine the extent of their IBOR exposures – by currency and by product – and ensure they are up to speed with the options for replacing the relevant IBOR in relation to that product.

This should include a review of contractual terms to determine the process for amendment and any existing fallback rate regime that might apply were amendments to cater for a new benchmark rate not adopted. ISDA is developing a protocol for derivatives that if adhered to by both parties, will implement relevant amendments in legacy transactions automatically. For other products, for example loans, the amendment process will need to follow the approach specified on a case by case basis.

Slaughter and May is monitoring closely developments in relation to transition from LIBOR, EURIBOR, HIBOR and other interest rate benchmarks across all of the major financial products. For further information, please contact any of the lawyers listed below or your usual adviser at Slaughter and May.

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