Capital Markets Client Alert

Akin Gump
STRAUSS HAUER & FELD LLP

Phasing Out of LIBOR – Current Status and Developments in Fallback Language in the Debt Capital Markets

August 20, 2019

Contact Information

If you have any questions concerning this alert, please contact:

Rizwan Kanji
Partner
rkanji@akingump.com
Dubai
+971 4.317.3010

Hamed Afzal
Counsel
hafzal@akingump.com
Dubai
+971 4.317.3036

Introduction

In July 2017, Andrew Bailey, Chief Executive of the U.K.'s Financial Conduct Authority (**FCA**), announced that the market should transition away from LIBOR by the end of 2021 (**LIBOR Policy Speech**). As we approach the 2021 end date, we will briefly touch upon the current status of LIBOR transition and also take a look at the most recent trends in the fallback language which is being used in the context of debt capital market products.

Current Status of Transition

For each of the five LIBOR currencies—pound sterling, U.S. dollars, Japanese yen, Swiss franc and Euro—national working groups have been established which have each selected an overnight risk-free reference rate (**RFR**) as their preferred LIBOR replacement rate as follows:

- Pound sterling – Reformed SONIA (Sterling Overnight Index Average), administered by the Bank of England.
- U.S. dollars – SOFR (Secured Overnight Financing Rate), administered by the Federal Reserve Bank of New York.
- Japanese yen – TONAR (Tokyo Overnight Average Rate), administered by the Bank of Japan.
- Swiss franc – SARON (Sales Average Rate Overnight).
- Euro – €STR (European Short-Term Euro Rate) (alternative rate to EONIA (Euro Overnight Index Average)), to be administered by the European Central Bank.

There are a number of key differences between RFRs and reference rates such as LIBOR, principally that RFRs are overnight interest rates which are based on liquid and active underlying markets, whereas LIBOR, which was originally developed for the interbank lending market, now relates to a relatively inactive market, given that banks have largely turned to alternative sources of funding (one of the key sources of criticism for the continued use of LIBOR as a benchmark rate).

There are a number of other economic and administrative differences between LIBOR and RFRs, meaning that any transition from LIBOR to RFRs will require further thought, and will not be a simple administrative change in the benchmark rate. For example, LIBOR is a forward-looking term rate, which means that the rate of interest is fixed and publicly available at the beginning of each interest period, and is quoted for a range of different maturities (which allows issuers/borrowers future visibility as to their costs of funding). In contrast, RFRs are backward-looking overnight rates, which means that interest must be calculated daily on the basis of the relevant overnight rate and, therefore, the parties cannot calculate the amount due in advance. This lack of visibility is potentially problematic given that issuers/borrowers may need to hold additional cash balances to cover any interest rate movements during an interest period, which would impact their cash management processes. The working groups discussed above are currently considering these differences and how to address them in practice to progress the transition towards RFRs.

Fallback Language for Debt Capital Markets Products

Legacy Floating Rate Notes/Sukuk

Floating rate notes or Sukuk (**FRNs**) issued prior to the LIBOR Policy Speech typically include default/traditional fallback language which, in summary, provide that if LIBOR is not available at the relevant rate fixing time, then the party responsible for determining the rate (typically a calculation agent appointed on behalf of the issuer) must request quotes from a certain number of leading "reference" banks in the interbank market, and use the quotes provided to determine a rate. If the calculation agent cannot obtain a certain number (or any) quotes from "reference" banks, then the rate will be the rate in effect for the last preceding interest period.

In the event that there is a permanent cessation of LIBOR, the relevant "reference" banks are unlikely to be in a position to provide such quotes. As a result, the majority of legacy FRNs that reference LIBOR and contain traditional fallback language akin to the foregoing will become fixed rate instruments if LIBOR ceases to be available, given that the rate in effect for the last preceding interest period will be applied to every interest period for the remaining life of the instrument. This is an unintended consequence of most historic forms of fallback language—which were only ever expected to operate on a temporary basis—and is clearly unlikely to reflect the commercial terms that parties thought they were entering into.

Amending legacy FRNs to replace the above traditional fallback language with fallback provisions which are more appropriate in the long term can be challenging (given the approval thresholds and procedural requirements of engaging with public bondholders). In addition, the costs of launching such an amendment process (typically by way of a consent solicitation) can be significant (particularly if consent fees are offered to investors to encourage them to vote for the relevant amendments).

Issuances of FRNs post the LIBOR Policy Speech

Expanded/alternative Fallback Provisions

Following the LIBOR Policy Speech, issuers of FRNs began to include expanded fallback provisions to supplement the "traditional" fallback provisions described above. Such alternative or expanded fallback provisions do not refer to specific RFRs, but instead contemplate the issuer appointing an independent adviser upon the

© 2019 Akin Gump Strauss Hauer & Feld LLP

occurrence of one or more trigger events (i.e., the announcement of an actual or upcoming cessation of the benchmark rate) to select (or to advise the issuer in the selection of) an alternative rate and adjustment spread to be applied to such rate on the basis of (a) any recommendations made by relevant official bodies (such as the relevant central bank or supervisory authority) or (b) if no such recommendations have been made, customary market practice.

Whilst these provisions have their limitations (e.g., the ability to find an appropriate expert to make the required judgements), they have been viewed as a practical interim solution pending further progression of the LIBOR transition.

Latest Developments

Most recently, off the back of numerous statements and publications during the course of 2018 and 2019, including (most recently) a publication by the Alternative Reference Rate Committee (the working group tasked by the U.S. Federal Reserve with finding a replacement for USD LIBOR) (**ARRC**) of its "Guiding Principles for Fallback Contract Language" in July 2018, its consultation and "Recommended Fallback Language for Floating Rate Notes" published on April 25, 2019 (**ARRC Recommendations**), several recent FRNs (issued mainly by supranational and financial institution issuers) have adopted further, more varied fallback language.

In relation to new U.S. dollar-denominated FRNs, the drafting set out in the ARRC Recommendations contemplates the hardwiring of different forms of SOFR as the replacement rate to USD LIBOR, as well as including some optionality for users. These are of course recommendations only, and ARRC acknowledges that variations will be appropriate on a case by case basis.

Conclusion

As the end of 2021 approaches, there are a number of steps that issuers/borrowers can start to take to prepare for the transition away from LIBOR:

- Keep abreast of the latest developments as the pace of activity is likely to increase across the various national working groups tasked with managing the transition for the various LIBOR currencies.
- Review new and existing contracts that reference LIBOR to ascertain and understand the fallbacks that would apply on a cessation of LIBOR.
- In relation to legacy instruments issued before the LIBOR Policy Speech, ascertain what level of instrument holder consent would be required to amend the relevant contracts in the event of a LIBOR cessation (where existing LIBOR fallback language is considered inappropriate).
- Consider nominating an individual with responsibility for LIBOR transition within the organization.

akingump.com

© 2019 Akin Gump Strauss Hauer & Feld LLP