



# ICLG

## The International Comparative Legal Guide to: **Lending & Secured Finance 2018**

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A practical cross-border insight into lending and secured finance

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EDITORIAL

Welcome to the sixth edition of *The International Comparative Legal Guide to: Lending & Secured Finance*.

This guide provides corporate counsel and international practitioners with a comprehensive worldwide legal analysis of the laws and regulations of lending and secured finance.

It is divided into three main sections:

Three editorial chapters. These are overview chapters and have been contributed by the LSTA, the LMA and the APLMA.

Twenty one general chapters. These chapters are designed to provide readers with an overview of key issues affecting lending and secured finance, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in lending and secured finance laws and regulations in 54 jurisdictions.

All chapters are written by leading lending and secured finance lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor Thomas Mellor of Morgan, Lewis & Bockius LLP for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at [www.iclg.com](http://www.iclg.com).

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# Replacing LIBOR: the Countdown to 2022

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Four years from now, the scandal-plagued London interbank offered rate, or LIBOR, may no longer exist. With the July 2017 announcement of the U.K. Financial Conduct Authority (FCA) that panel banks will not be compelled to submit LIBOR rate information after 2021 because there are insufficient actual transactions to support submissions, it is likely that LIBOR will be phased out due to the absence of FCA backing. Although publication of LIBOR may not completely end in 2021, global financial markets need to be prepared for a transition from LIBOR to limit disruption if LIBOR ceases to be an accepted reference rate for financial contracts.

First published in 1986 by the British Bankers Association (BBA), an unregulated British banking lobby group, LIBOR began as a standardised benchmark to assist banks with setting interest rates on corporate loans. LIBOR refers to the London-based unsecured wholesale market rate for deposits between major banks denominated in certain currencies. These deposits can be available either on an overnight basis or for varying durations, such as one, two, three, six or 12 months. Traditionally, this market has been a source of liquidity for banks and the rates paid for these deposits have served as the basis for LIBOR interest rates.

What began as an interest rate used in syndicated loans became ubiquitous in the financial markets when institutions began using it in the 1990s to set the floating leg in derivatives contracts and the Chicago Mercantile Exchange adopted LIBOR to calculate the value of its Eurodollar futures contract in 1997.<sup>1</sup> Today, LIBOR serves as the reference rate for an estimated \$350 trillion of financial contracts, including commercial and retail loans, floating rate notes, derivatives, mortgages and securitised loans. The notional value of all outstanding financial products referencing USD LIBOR is estimated to be approximately \$200 trillion.<sup>2</sup>

## How LIBOR Works

Historically, LIBOR for a particular interest period was determined by averaging quotes of several reference banks as of approximately 11:00 a.m. London time. Today, LIBOR is determined by reference to a screen quote from a customary market quotation service, such as Reuters or Bloomberg, with reference bank quotes used only as a fallback if the screen quote is unavailable.

The LIBOR quotation service uses rates compiled and published by ICE Benchmark Administration Limited (IBA), a U.K. subsidiary of global exchange operator Intercontinental Exchange (ICE). As IBA explains on its website,<sup>3</sup> IBA provides an indication of the average rate at which a panel bank can obtain unsecured funding in the London interbank market for a designated period in certain specified currencies. Producing a total of 35 rates on each business

day, IBA determines LIBOR for five currencies (U.S. Dollars, Euros, Japanese Yen, Pound Sterling and Swiss Francs) with seven maturities, ranging from overnight to 12 months. IBA obtains quotes from a reference panel currently numbering between 11 and 16 banks for each currency for which LIBOR rates are determined. After discarding the top and bottom quartiles, IBA averages the remaining quotes to determine the rate, now known as ICE LIBOR.

## The LIBOR Scandal

Beginning in 2012, an international investigation into LIBOR revealed a widespread plot among multiple large banks to manipulate LIBOR rates for profit starting as far back as 2003. During the global economic upswing of 2005 to 2007, Barclays and other banks reportedly manipulated LIBOR so that their traders would make profits on swaps. According to *The New York Times*, “swaps traders often asked the Barclays employees who submitted the rates to provide figures that would benefit the traders, instead of submitting the rates the bank would actually pay to borrow money”.<sup>4</sup>

Following the onset of the financial crisis in 2008, LIBOR came under scrutiny with claims that banks were underreporting rates to avoid perceptions that they were being charged higher rates due to their weakened financial condition. The market for interbank lending had dried up, and, with no regulatory supervision, bankers were essentially making up numbers. Although the BBA denied it, government investigations soon showed not only that rate manipulation was pervasive, but also that government officials and central bankers had known about LIBOR’s deficiencies for years but had failed to act.<sup>5</sup> In 2012, regulators discovered extensive manipulation of LIBOR by banks to benefit themselves and their traders’ positions. Allegations of LIBOR manipulation led to lawsuits, criminal prosecutions and billions of dollars in fines and settlements paid by some of the world’s largest banks. By the end of 2016, a dozen banks had paid regulators about \$10 billion in penalties.

As a result of the LIBOR investigations, the U.K. government began considering reforms to LIBOR, and in 2012 the U.K. Parliament passed legislation to strengthen financial regulation and reform the LIBOR system.<sup>6</sup> That legislation created the FCA as a new government agency with expanded powers to investigate and regulate financial markets, including LIBOR.

In September 2012, a report on LIBOR was published based on an independent review led by U.K. financier Martin Wheatley, who became the first head of the FCA.<sup>7</sup> *The Wheatley Review* caused several reforms to be implemented in 2013 and the replacement of the BBA with IBA as the LIBOR administrator in 2014. As

administrator, IBA has formalised the submissions process and made significant improvements to LIBOR. Still, trust in the integrity of LIBOR continued to erode due to concerns about manipulation and a decrease in the level of interbank borrowing activity serving as the basis for actual LIBOR quotes.

### The FCA Announcement

On July 27, 2017, Andrew Bailey, the FCA's Chief Executive, announced that, after 2021, the FCA would no longer exercise its authority to compel panel banks to submit quotes used to determine LIBOR. In his speech, Mr. Bailey emphasised that there are insufficient underlying interbank transactions to continue to rely on LIBOR as a benchmark, noting that it is unsustainable "for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them".<sup>8</sup> Because there currently is a very low volume of transactions on which banks can base their LIBOR submissions, banks rely on their "expert judgment" to form many of their submissions, and even those submissions that are transaction-based may be based on few actual trades. A key concern is the element of subjective judgment inherent in the LIBOR rate, which, in the FCA's view, leads to a "greater vulnerability to manipulation". Although the use of expert judgment allows daily publication of LIBOR, many banks understandably are uncomfortable with providing judgment on transactions with such a minimal level of activity.

Mr. Bailey noted that while LIBOR could remain viable past 2021, market participants cannot safely assume that it will and central bankers and regulators need to develop a robust alternative set of rates before then to protect against financial market disruption if LIBOR is no longer published. The FCA has obtained agreements with panel banks to continue submitting rates until the end of 2021, at which time a new benchmark is expected to replace LIBOR. Emphasising that the transition from LIBOR should be "planned and orderly rather than unexpected and rushed" in order to mitigate risks, Mr. Bailey stated that a transition period will enable the markets utilising LIBOR to develop and implement alternative rates in a coordinated manner that avoids major disruption.

While the public's understanding of the risk of LIBOR's unreliability increased significantly with the FCA announcement, the official sector has been concerned about it for years. In 2013 and 2014, both the LIBOR manipulation scandal and regulators' concerns as to the reliability and robustness of bank submissions prompted the undertaking by regulators of reviews of major financial benchmarks.

In the U.K., in June 2013 the FSB established an Official Sector Steering Group (OSSG) of central banks and regulators that it tasked with coordinating reviews of LIBOR and other interbank offered rates (IBORs),<sup>9</sup> and guiding the work of a Market Participants Group, which in turn was asked to examine the viability of adopting additional reference rates.<sup>10</sup> Drawing upon reviews of benchmark administrators by the International Organization of Securities Commissions (IOSCO)<sup>11</sup> and the work of the Market Participants Group, in 2014 the FSB published a report that prioritised as key objectives the transition to rates that are anchored in actual transactions and the development of alternative nearly risk-free reference rates (RFRs).<sup>12</sup> In the U.S., the Financial Stability Oversight Council (FSOC) in its 2014 annual report also reported concerns over the integrity of LIBOR and recommended that U.S. regulators identify alternative interest rate benchmarks based on observable transactions and develop an adoption plan for a transition to new benchmarks.<sup>13</sup>

Since these reports were issued, regulators have done substantial work on reforming global benchmarks in accordance with principles developed by IOSCO as set forth in its 2013 *Principles for Financial Benchmarks* report.<sup>14</sup> In the European Union, the EU Benchmarks

Regulation, a regulation entered into force in June 2016 that became fully effective on January 1, 2018, introduces a regulatory framework for benchmarks across the EU and establishes, among other things, a requirement for the authorisation of administrators of financial benchmarks used in the EU.<sup>15</sup>

In the U.S., in November 2014, the Federal Reserve, in cooperation with the Treasury Department and the Commodity Futures Trading Commission (CFTC), convened the Alternative Reference Rates Committee (ARRC) to identify a robust reference rate to replace USD LIBOR.<sup>16</sup> The ARRC is a public-private sector initiative comprised of major banks, which are also interest rate derivatives dealers, and regulators, including the CFTC, the Federal Reserve Bank of New York (FRBNY), and the Treasury Department. The ARRC was tasked with identifying a set of alternative reference interest rates that are more firmly based on transactions from a robust underlying market and that comply with emerging standards such as the IOSCO *Principles for Financial Benchmarks*. Although the ARRC considers LIBOR an unreliable benchmark for all financial contracts, the ARRC so far has focused primarily on identifying a replacement rate for USD LIBOR for interest rate derivatives, where the exposure to LIBOR vastly exceeds other sectors.

Similar initiatives to identify and transition to alternative RFRs are progressing in the U.K. by the Working Group on Sterling Risk Free Reference Rates under the guidance of the Bank of England (BoE),<sup>17</sup> in Japan by the Study Group on Risk-Free Rates under the guidance of the Bank of Japan,<sup>18</sup> and in Switzerland by the National Working Group on CHF Reference Rates under the guidance of the Swiss National Bank.<sup>19</sup>

### The Development of Risk-Free Reference Rates

In June 2017, the ARRC announced its selection of a Broad Treasury Financing Rate (BTFR), based on secured transactions in the overnight U.S. treasury repo market, as its proposed replacement for USD LIBOR.<sup>20</sup> In July 2017, the CME Group announced that it will develop futures and options contracts based on BTFR.<sup>21</sup> In August 2017, the Federal Reserve requested public comment on this proposed repo rate (among other rates), which it referred to as the "Secured Overnight Financing Rate" (SOFR).<sup>22</sup> SOFR will be based on about \$660 billion in actual daily repurchase transactions between banks, hedge funds, money market funds and others, and does not require expert judgment.

On November 2, 2017, the ARRC hosted a roundtable at the FRBNY to present the ARRC's work, including its recommendation of SOFR as an alternative rate and details of its paced transition plan. The FRBNY, in coordination with the Treasury Department's Office of Financial Research, expects to begin publishing SOFR daily in mid-2018.<sup>23</sup> To commence the transition, ARRC members are expected to put into place the infrastructure for futures and/or Overnight Index Swap (OIS) trading in SOFR by the second half of 2018. The ARRC projects trading in futures and/or a bilateral OIS referencing SOFR to begin by the end of 2018. A term reference rate will be created once sufficient liquidity in the SOFR derivatives markets has developed to produce a robust rate, expected by the end of 2021.<sup>24</sup>

Representatives of both ARRC and non-ARRC member firms discussed how the risks surrounding LIBOR may impact not only the interest rate derivatives market, but also a wide range of other financial products and markets. Federal Reserve Governor (now Chair) Jerome Powell stated (in introductory remarks) that the ARRC so far had focused its work on derivative products because that is where the largest exposures to LIBOR are, but noted "...[n]ow, however, market participants have realized that they may

need to more seriously consider transitioning other products away from LIBOR<sup>25</sup>. Corporate loans are one of the cash products that will be considered by the ARRC going forward, along with floating rate notes, mortgages, securitisations, CLOs and consumer loans.

Chairman Powell's statement reflects concerns expressed by market participants that fundamental differences between SOFR and LIBOR require consideration by the ARRC in order to avoid the potential for disruption of a number of cash product markets. Whereas LIBOR is a forward-looking unsecured term rate that takes into account rate differences resulting from the credit risk of interbank lending and changes in pricing of that credit risk over time (term risk), SOFR is a backward-looking RFR representing the cost of overnight funding through a repurchase transaction secured by government debt.<sup>26</sup> As a secured overnight rate that reflects neither credit nor term risk, SOFR is much lower than LIBOR and there is a substantial concern that a value transfer would occur for existing transactions upon switching from LIBOR to SOFR. To address these significant distinctions between the two benchmarks, the Loan Syndications and Trading Association (LSTA), which has taken a leading role in channelling concerns of the \$4.3 trillion U.S. syndicated loan market, requested in its comment letter to the Federal Reserve that term fixings for SOFR and a bank credit risk spread be published.<sup>27</sup> To further a transition to SOFR for cash products, the ARRC's membership recently was reconstituted to include buy-side end users of cash products.<sup>28</sup>

Despite the push by policymakers for a transition from LIBOR to an alternative rate, many U.S. investors would like to see LIBOR remain available. Nearly 80% of respondents to a Bank of America Merrill Lynch survey believe that LIBOR should continue to be quoted with a "more robust methodology".<sup>29</sup> In his speech, Mr. Bailey left open the possibility that LIBOR may continue to be quoted after 2021. In fact, IBA has announced plans to continue publishing LIBOR after 2021, which would require panel banks being willing to continue making submissions without FCA compulsion.<sup>30</sup> However, the FRBNY seems to favour pressuring market participants into SOFR in order to prevent creation of a bifurcated market.

In the U.K., the Working Group on Sterling Risk Free Reference Rates has proposed the Sterling Overnight Index Average (SONIA) as a near risk-free alternative to GBP LIBOR for use in sterling derivatives and other relevant financial contracts. Currently in the process of reforming the benchmark, the BoE expects SONIA to serve as the new benchmark rate commencing in April 2018.<sup>31</sup> In November 2017, the BoE announced that a key near-term priority will be for the working group to make recommendations on the development of term SONIA rates.<sup>32</sup>

The European Central Bank reportedly plans to publish a new overnight rate for interbank unsecured lending among euro-area banks and has called on market participants to provide comments on the high-level features of a new unsecured overnight interest rate.<sup>33</sup> In Japan, an RFR based on actual transactions in the overnight unsecured market has been developed for Yen (the Tokyo Overnight Average Rate, or TONAR). The National Working Group on CHF Reference Rates has recommended the Swiss Average Rate Overnight, or SARON, an overnight secured rate administered by the Swiss National Bank, as the alternative RFR for Swiss Franc LIBOR.<sup>34</sup>

### What Happens Next?

While substantial progress has been made on identifying RFRs for derivatives, work on alternative reference rates for loans and other debt contracts is just beginning. The ARRC proposes the eventual creation of term reference rates intended to approximate LIBOR for different tenors based on derivatives contracts referencing SOFR after those products achieve liquidity. But uncertainty exists as to

what extent overnight rates can be used to create forward-looking term reference rates, who will calculate and publish those rates, and whether those rates will be commercially satisfactory to LIBOR users under debt agreements. The development of term reference rates is projected to take several years, and the lack of clarity surrounding the process presents a challenge to parties drafting debt agreements during the transition period.

If new rates are not adopted consistently across various types of financial instruments, one of the many issues of concern is a potential economic mismatch between benchmarks used in loans and floating rate notes and those referenced in interest rate derivatives intended to hedge that exposure. Another issue is that LIBOR is published for five currencies and, absent global coordination on a replacement benchmark, the determination of reference rates for these currencies may use disparate approaches, resulting in different pricing for different currencies under multicurrency facilities utilised by corporate borrowers.<sup>35</sup>

What happens during the transition to loan agreements and debt securities referencing LIBOR? Assuming LIBOR's demise, conversion of debt agreements that reference LIBOR with maturities beyond 2021 to an alternative reference rate will be critical for market stability. As discussions on a replacement rate for these contracts are just starting, current transactions likely will continue referencing LIBOR until an alternative rate has gained debt market acceptance. In the U.S., debt market participants have been evaluating customary LIBOR fallback provisions in agreements and focusing on whether greater flexibility can be built in to select a replacement rate for LIBOR with a limited consent process. While many LIBOR-tied debt instruments provide mechanisms to determine a fallback rate if LIBOR is not available, these mechanisms generally are not sufficiently robust or intended to be utilised in the long term. With no alternative rate yet accepted in the debt markets, including workable procedures for selecting a successor rate upon LIBOR discontinuance is the most prudent course of action that parties can take during the transition period.

### Syndicated Loans

Legacy credit agreements in the U.S. syndicated loan market typically have fallback mechanisms in the event that LIBOR is temporarily unavailable. Although variations exist, the LIBOR definition may provide that if the screen rate is unavailable, the rate is determined by interpolating between LIBOR rates of other specified durations, or by the rate offered to the agent bank by major banks for U.S. dollar deposits in the London interbank market for delivery on the first day of the interest period in the approximate amount of the loans. But these fallbacks are inadequate if LIBOR no longer exists. Similarly, market disruption clauses addressing a temporary unavailability of LIBOR or other trigger event by establishing fallback pricing at an alternative base rate are not a solution because borrowers would be dissatisfied with more expensive base rate pricing on a permanent basis if LIBOR disappears.

In anticipation of the LIBOR sunset, parties to new U.S. syndicated loan agreements with maturities extending past 2021 have begun including mechanisms for selection of a successor interest rate without requiring the consent of all affected lenders (which typically is required for any interest rate reduction), with triggers such as agent determination that LIBOR unavailability is unlikely to be temporary, regulatory announcement that LIBOR will no longer be published, or LIBOR still being reported but no longer being the prevalent rate in the leveraged loan market. No market consensus on these provisions has yet developed and a variety of approaches have appeared in documentation.

At one end of the range, some provisions allow the agent alone to select a comparable or successor rate and apply it in a manner consistent with market practice. Others allow the agent and the borrower to choose a successor rate, with many (but not all) of these provisions giving the majority lenders consent rights, either by affirmative consent or negative consent (usually a five-business day period to object), to the successor rate amendment. Many of these mechanisms require the successor rate to be selected in a manner giving due consideration to the then prevailing market convention for determining an alternative interest rate for U.S. dollar denominated syndicated loans at the time. Although many of these replacement rate provisions expressly override the syndicated loan market convention that changes to interest rate provisions require the consent of the majority lenders and any interest rate reduction require the consent of all affected lenders, other provisions don't expressly override these voting requirements, resulting in ambiguity.

Some replacement rate provisions are drafted narrowly to refer to a successor reference rate or index rate, suggesting that only a new benchmark can be selected without making other changes. But replacing LIBOR with SOFR would require a spread adjustment to preserve pricing. Toward that end, some broader provisions expressly permit a successor rate amendment to make appropriate adjustments to the loan agreement to preserve pricing. It is expected that these alternative rate provisions will evolve over time when there is further clarity on an alternative rate that is accepted in the U.S. loan market. For legacy loans, modifying the fallback provisions to implement greater flexibility to amend probably will be undertaken on a case-by-case basis because many legacy loans will be amended or refinanced before the end of 2021.

In Europe, since 2014 the Loan Market Association (LMA) template loan documentation has included an optional "Replacement of Screen Rate" clause that permits replacement of a benchmark rate that becomes unavailable with the consent of the borrower group and the majority lenders. Absent inclusion of the LMA optional provision in the loan agreement, an amendment to replace the benchmark likely would require the consent of all lenders.

### Collateralised Loan Obligations

Many indentures in the U.S. \$470 billion CLO market contain a fallback provision if the LIBOR screen rate is unavailable on the interest determination date. In that case, the calculation agent would request quotes from reference banks in the London interbank market and determine the rate based on the mean of the quotes provided. If an insufficient number of quotes are obtained, LIBOR for the subject interest period will be LIBOR as calculated on the prior interest determination date. Since reference banks no longer will be providing quotes if LIBOR becomes permanently unavailable, this mechanism effectively would turn floating rate obligations into those of a fixed rate instrument, which is not what investors bargained for. Also, this fallback mechanism risks creating a mismatch between the interest rates on the CLO securities and on the CLO's underlying loans if those loans reference a successor benchmark.

Amending fallback provisions in legacy CLO indentures typically requires the consent of 100% of the noteholders of each class and a portion of the equity so it may not be feasible. Given this high consent threshold, most CLOs likely will address the discontinuance of LIBOR by winding down the CLO and redeeming the notes after the no-call period.

It is anticipated that when the loan market accepts an alternative benchmark, CLO market acceptance quickly will follow. Until that occurs, the CLO market is focused on achieving a consensus on robust and consistent fallback methodologies for LIBOR

replacement. Some new CLO indentures permit an amendment to provide an alternative rate with majority consent from the controlling class of noteholders and ratings confirmation. Possible alternative rates appearing in some recent CLO indentures include (i) the quarterly pay reference rate acknowledged as being the industry standard for leveraged loans by the ARRC or the LSTA, or (ii) the quarterly pay reference rate used in calculating the interest rate of at least 50% in principal amount of either (x) the CLO's underlying loans, or (y) floating rate securities issued in the new issue CLO market since a specified recent date bearing interest based on an alternative benchmark. If the requisite consents to amend are not obtained, a fallback mechanism may either require or permit the collateral manager, in its commercially reasonable discretion, to select an alternative reference rate that may be one of the above replacement rates. The ultimate fallback remains the same as that in existing CLOs: if no amendment has been adopted and the collateral manager has not selected a new rate, LIBOR will be the rate determined on the prior interest determination date.

### Floating Rate Notes

Typically, indentures in the U.S. market for floating rate debt securities tied to LIBOR provide for the calculation agent to determine a fallback rate if no LIBOR screen rate is available on an interest determination date. In such event, the calculation agent would source rate quotes from reference banks in the London interbank market that such banks would offer to prime banks for U.S. dollar deposits for a designated amount for the relevant interest period and, if at least two quotes are obtained, use the arithmetic mean of such quotes. If London banks do not provide sufficient quotes, frequently the calculation agent may source quotes from major New York City banks for loans to leading European banks. When sufficient rate quotes are not obtained, the rate for the preceding interest period continues in effect. Given that reference banks are highly unlikely to voluntarily offer similar rate quotes after LIBOR's demise, this fallback methodology risks applying the rate in effect at the end of 2021 as fixed for the remainder of the term – clearly not a desirable outcome. Further, conversion to a fallback rate that could differ significantly from a new benchmark accepted in the market, such as SOFR, would risk creating inconsistencies in the debt capital markets and general dissatisfaction among noteholders.

If a fallback mechanism is not included in the indenture or form of notes, any indenture amendment that would reduce the interest rate would require the consent of all noteholders, which would be potentially costly and difficult to obtain. Alternative interpretations concerning the consent required for this type of amendment would be, when read most expansively, that no consent is required because the amendment would be effected to cure an ambiguity, omission, mistake or similar defect and the amendment does not materially adversely affect the interests of security holders. However, due to the potential economic impact on security holders, it is difficult to argue that changing the benchmark for a floating rate security is a ministerial change. Another interpretation would be that the consent of the holders of a majority in outstanding principal amount of the notes would be sufficient to effect the amendment if no interest rate reduction were to result. However, the possibility that an amendment could decrease the rate is likely to drive the parties to conclude that, pursuant to the terms of the indenture as well as Section 316(b) of the Trust Indenture Act of 1939,<sup>36</sup> a unanimous approval is required.

Given the interrelationship between LIBOR-based debt securities and the derivatives markets, it is expected that the debt capital markets will be guided by the guidelines on fallback provisions

that are being developed by working groups established by the International Swaps and Derivatives Association, Inc. (ISDA). For the time being, most LIBOR-tied debt securities issued since the FCA announcement still rely on the standard fallback mechanisms described above. However, a limited number of recent indentures authorise the calculation agent (in some cases in consultation with the issuer), if LIBOR has been permanently discontinued, to substitute the alternative reference rate selected by the central bank, reserve bank, monetary authority or similar institution (including any committee or working group thereof) in the relevant jurisdiction and to make other necessary or desirable amendments to facilitate that change, in each case consistent with market practice.

Disclosure documents for recently issued LIBOR-tied debt securities, for the most part, contain a risk factor discussion of the implications of the FCA announcement, the uncertainty surrounding the discontinuance or reform of LIBOR and a transition to alternative reference rates, and the potential adverse effect of a replacement benchmark on the level of interest payments and the value and liquidity of the securities. This discussion could be expanded, if appropriate under the circumstances, to cover the lack of robust fallback provisions in existing documentation, the potential that application of the ultimate fallback effectively could result in a fixed rate, the possible need to amend existing indentures to specify an alternative rate through a consent solicitation, and whether requisite consents could be obtained at an acceptable cost or at all.

### Interest Rate Derivatives

With the support of the FSB, in 2016 ISDA began an initiative of consultation with market participants on the implementation of alternative RFRs and the development of robust fallbacks for LIBOR and other key IBORs. The objectives of various working groups established by ISDA include:

- identification of triggers for fallback rates;
- identification of alternative RFRs designated by the applicable RFR working group or OSSG;
- development of possible methodologies for application of credit spread and term structures for fallback application (seeking to eliminate or minimise the potential for manipulation and value transfer when the fallback is applied);
- amendment of the 2006 ISDA Definitions to incorporate the fallbacks into new trades (changes would not automatically apply to legacy transactions); and
- development of a plan for amendment of legacy contracts to include the amended definitions, including a protocol to incorporate the fallbacks into legacy trades.<sup>37</sup>

Although the ISDA work is primarily relevant to interest rate derivatives, it potentially could be adopted for other financial instruments, particularly when hedged by an interest rate swap, but that would need to be addressed on a market-by-market basis.

In addition, ISDA has begun a comprehensive analysis of potential issues and solutions relating to a transition to RFRs, which will include a targeted global survey of buy- and sell-side firms to identify the means by which market participants can effectively implement benchmark transitions and highlight potential challenges.<sup>38</sup> According to ISDA, the report will explore, among other topics, potential adjustment required to transition from IBORs to RFRs for new and legacy contacts, including documentation issues, the potential for value transfer, threats to market liquidity, the requirement for term fixings and differences in credit spreads between existing and new rates. On February 1, 2018, ISDA, together with the Association of Financial Markets in Europe (AFME), International

Capital Market Association (ICMA) and the Securities Industry and Financial Markets Association (SIFMA) and its asset management group (SIFMA AMG), published a roadmap that highlights key challenges involved in transitioning financial market contracts from IBORs to RFRs.<sup>39</sup> The roadmap aggregates and summarises existing information published by regulators and the various RFR working groups in order to provide a single point of reference on the work conducted so far to select alternative RFRs and plan for transition.

### Conclusion

Substantial progress has been made by regulators and policymakers towards replacing LIBOR in 2021, with SOFR currently anticipated to be the replacement rate for most U.S. dollar-denominated instruments. Still, it is too early to form any clear views on what rate or methodology will replace LIBOR in debt agreements, and what impact the transition from LIBOR will have on the financial markets that rely on this benchmark. Although the FCA announcement contemplates a planned and orderly transition period over the next several years, uncertainty exists as to whether a longer transition period will be needed and to what extent market disruption can be minimised in connection with the transition.

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