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ICMSA Bulletin – The discontinuation of LIBOR/IBORS - implications for English-law note trustees

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In July 2017, Andrew Bailey, chief executive of the UK Financial Conduct Authority (the FCA), announced in a speech that the FCA would, from the end of 2021, no longer be persuading or compelling banks to submit quotes for LIBOR (the London Interbank Offered Rate) and that market participants should therefore not rely on LIBOR being available after 2021. The FCA is concerned that not only is it potentially unsustainable but also undesirable for market participants to rely indefinitely on reference rates such as LIBOR that do not have active underlying markets to support them. Under the EU Benchmarks Regulation (EU 596/2014), the FCA would not, in any event, be able to compel banks to submit quotes indefinitely (it only has the power to compel banks to do so for up to 24 months).

The FCA is therefore keen that market participants plan for a smooth transition away from LIBOR to alternative reference rates that are firmly rooted in data obtained from transactions. Although the market is focusing on LIBOR, because of Andrew Bailey's speech, other commonly used benchmarks that do not have active underlying markets to support them could also be discontinued and the observations in this bulletin would equally apply in relation to those benchmarks.

Other important benchmarks that are likely to be reformed or replaced include EURIBOR (the Euro Interbank Offered Rate) and EONIA (the Euro Overnight Index Average). Like LIBOR, EURIBOR and EONIA are derived from quote submissions from bank panels. The European Money Markets Institute (EMMI), which is the benchmark administrator for both EURIBOR and EONIA, has declared that unreformed EURIBOR and EONIA do not comply with the requirements of the EU Benchmarks Regulation. EMMI has stated that, among other things, the two-week, two-month and nine-month EURIBOR tenors will be discontinued from 3 December 2018.

Future transactions

Considerable market attention has focused on identifying an alternative to LIBOR for future floating-rate transactions. Working groups in the US, the UK, Switzerland and Japan have selected risk-free reference-rate alternatives to LIBOR. In the United Kingdom, the Bank of England Working Group on Sterling Risk-Free Reference Rates selected reformed Sterling Overnight Index Average (SONIA) as its proposed benchmark for use in sterling derivatives and relevant financial contracts. SONIA is an overnight unsecured rate produced by the Bank of England and fixed daily. SONIA is published daily for the previous day in contrast to LIBOR which is a forward-looking rate that reflects the duration of the relevant interest period and an element of credit/market risk. There have already been some bond programmes that have been supplemented to provide for floating rate notes based on SONIA.

In the US, the Alternative Reference Rates Committee announced in June 2017 its choice of the Secured Overnight Funding Rate (SOFR), a broad U.S. Treasuries repo financing rate, as the alternative to USD LIBOR. SOFR is an historic overnight, secured rate. For Swiss Francs, SARON has been selected, with TONAR the preferred risk free rate for Japanese Yen.

EMMI is currently working to reform EURIBOR using a "hybrid" methodology which gives primacy to transaction-based data. On 13 September 2018, the Working Group on Euro Risk-Free Rates recommended the Euro Short-Term Rate (ESTER), a risk-free rate developed by the ECB as the alternative rate to EONIA. The ECB is targeting October 2019 as the deadline for its daily publication.

In the interim, within the securitisation market, the Association for Financial Markets in Europe (AFME) has worked with issuers, underwriters, investors, trustees and other service providers to develop a modification mechanism to facilitate transition to a new reference rate, once a benchmark is endorsed or recognised by the Bank of England or FCA or otherwise used in a material number of publicly-listed issuances, such that it can be considered the market's adopted LIBOR replacement. The AFME wording provides a framework for future amendment to the reference rate (once the dust has settled on a recognised alternative) and, over the last 6 months, iterations of this wording have been adopted into new securitisations and introduced as a forward-looking amendment within programme updates, in anticipation of the need to move away from LIBOR. Importantly, this mechanism does not require any discretionary input from the note trustee, instead being implemented by way of a negative consent process. This wording (which is available on AFME's website) makes clear, however, that its use is limited to the securitisation market and, for the reasons identified below, could only be added to future transactions, unless investor consent is obtained.

Beyond securitisations, market participants have also developed benchmark replacement wording or alternative fall-back language which enables an issuer to replace LIBOR (or any other relevant benchmark) following the occurrence of a "Benchmark Event" – broadly, a situation where a benchmark rate is not available or ceases to exist, or a public announcement is made with respect to the proposed discontinuation of such benchmark rate. The wording typically provides for a mechanism whereby an issuer, in consultation with an independent adviser, is able to replace the affected benchmark rate with an alternative or successor benchmark rate subject to certain prescribed conditions, but notably, without the consent of noteholders. The wording is becoming common in EMTN and covered bond programmes which have been updated during the course of 2018. The note trustee's consent is required to make such amendments through signing the amending transaction documentation. However, the note trustee would not be exercising discretion as it would be obliged to execute the documents and such consent is typically subject to satisfaction of certain conditions including certification of compliance with the set procedure and the amending documentation not affecting the note trustee's liability position. Other fall-back formulations that the market may adopt may also involve the appointment by the issuer of a financial adviser to determine the appropriate successor rate and any further adjustment calculation with no requirement for the note trustee to exercise discretion.

Existing transactions

In a speech on 12 July 2018, Andrew Bailey said that firms should treat the discontinuation of LIBOR as something that will happen and an event for which firms must be prepared and that those that do have practicable ways of converting their contracts from LIBOR to other reference rates, or at least adding fall-backs into those contracts, should be able to identify a transition path – even if it is one with organisational, operational and other challenges. Market participants will therefore now need to consider the approach to take for existing transactions referencing LIBOR which (unless redeemed early) are due to mature after 2021. The product types that will be most affected include asset-backed notes, regulatory capital securities issued by financial institutions, where floating-rate and fixed rate reset interest is common and senior floating rate debt securities, including issuances under EMTN programmes.

Issuers and securities holders will need to examine the existing contractual fall-back language in those securities to see if, and how, those provisions will apply. There is no uniform market-wide fall-back language but, in a large number of existing deals, a set of contingencies is built into the floating-rate-calculation provisions that follow a familiar pattern. However, these fall-back provisions were drafted in contemplation of a potential temporary non-availability of the relevant screen rate rather than a permanent discontinuation of the applicable benchmark. For instance, floating-rate notes typically provide that, if the relevant screen rate is not available on a particular determination date, the interest rate shall be determined by reference to quotations for the benchmark given by a certain number of reference banks. The difficulty for market participants is that most reference banks have said that they will not be willing to provide quotations once LIBOR is discontinued, and so this fall-back may fail. Absent quotations from reference banks, the fall-back is often to the rate which applied at the last determination date. The effect of this would be to convert floating-rate securities into fixed-rate ones (as observed in a July 2018 paper by the Working Group on Sterling Risk-Free Reference Rates) and this is likely to prejudice either investors or issuers depending on whether interest rates generally are rising or falling.

In order to avoid the disruptive consequences of floating-rate securities becoming fixed-rate overnight or becoming incapable of calculation (and the disputes that might follow therefrom), issuers and investors are likely to want a suitable long-term alternative reference rate to be incorporated into their securities so that it can be applied once LIBOR is discontinued.

Note trustees will no doubt be supportive of efforts by issuers and noteholders to achieve this outcome on transactions. However, except in very rare cases (where transaction documents and terms and conditions explicitly allow), it will not be within the note trustee's power to exercise its discretion to amend the transactions documents to include the requisite language, meaning that noteholders' consent will be required.

> A note trustee typically has discretion to agree with the issuer to make any modification of the note conditions that is, in its opinion, (i) of a formal, minor or technical nature, (ii) made to correct a manifest error or (iii) not materially prejudicial to the interests of the noteholders. However, this discretion is commonly restricted such that modifications to make certain fundamental or commercial changes ("basic terms modifications" or "BTMs") are expressly outside the scope of the note trustee's discretionary powers. Modifying the method of calculating the interest payable on debt securities, will almost invariably constitute a BTM, where BTMs are provided for, and will therefore require noteholder consent.

Even on transactions that do not provide for BTMs (and do not otherwise prevent the note trustee exercising discretion to amend interest-rate provisions) note trustees are highly unlikely to exercise discretion to include new interest rate fall-back provisions. The only limb of the note trustee's typical discretion powers that could plausibly apply is the no-material-prejudice limb. However, the method of determining the interest rate payable on the securities impacts directly and fundamentally on the economic rights of the holders. The issues surrounding what makes a suitable fall-back to LIBOR are highly complex and bespoke to each deal, and different market participants will have different views. The decision ought to be more properly categorised as a commercial one to be determined between the issuer and noteholders and not one that it is likely to be appropriate for a note trustee to make.

Next steps

It is to be hoped that a prevailing consensus on a suitable long-term alternative to LIBOR will emerge and become the accepted norm for future transactions. In the interim, issuers of new floating rate instruments should look to include appropriate language in their documents (such as that proposed by AFME in the case of securitisation transactions or the benchmark replacement wording or amended fall-back language as described above) to facilitate transition to an alternative rate as and when this becomes clear.

For existing/legacy deals, issuers of floating rate transactions with tenors extending beyond the discontinuation of LIBOR will need to review their transaction documents to assess the fall-back provisions and determine whether an amendment should be proposed. Given the number of transactions that may fall into this bracket and therefore the potential for market disruption, where amendment of the rate is considered necessary, issuers should consider appropriate steps to manage risks related to the cessation of a benchmark.