International Capital Market Services Association

BULLETIN – 190118/45

ICMSA Bulletin – The discontinuation of LIBOR/IBORS - implications for English-law agency roles

Issued by the International Capital Market Services Association www.icmsa.org

As reported in ICSMA Bulletin 181018/44, ICMSA Bulletin – *The discontinuation of LIBOR/IBORS - implications for English-law note trustees* (the October Bulletin) (available here 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. Further background information is set out in the October Bulletin.

Future transactions

Working groups in the US, the UK, the Euro area, Switzerland and Japan have selected risk-free reference-rate (RFR) alternatives to relevant LIBOR rates. In the United Kingdom, for example, the Bank of England Working Group on Sterling Risk-Free Reference Rates selected the reformed Sterling Overnight Index Average (SONIA) as its proposed benchmark for use in sterling derivatives and relevant financial contracts. In the US, the Alternative Reference Rates Committee has selected the Secured Overnight Funding Rate (SOFR), a broad U.S. Treasuries repo financing rate, as the alternative to USD LIBOR. In Europe, the European Central Bank is developing a euro short-term rate (ESTER) based on data already available to the Eurosystem as a replacement benchmark for EONIA and to create an alternative benchmark to EURIBOR. ESTER has been recommended by the Euro area working group on risk-free rates as the new euro risk-free rate and will reflect the wholesale euro unsecured overnight borrowing costs of euro area banks and serve as a backstop reference rate; it is expected to be published in October 2019. Both SONIA and SOFR have already been adopted in recent note issues and programmes with wording developed from the applicable ISDA supplements published in the first half of 2018. However, the market is far from settled as to what the best replacement for LIBOR is and, in particular, how the forward-looking and term attributes of LIBOR can be replicated. For example, the Financial Stability Board has declared that RFR-derived term rates cannot match the robustness of the overnight RFRs.

In the interim, the Association for Financial Markets in Europe (AFME) has developed language for the securitisation market which provides a modification mechanism that can be included in new transactions to facilitate transition to a new reference rate, once a replacement benchmark for LIBOR is endorsed by the market or regulators. The AFME wording is available on AFME's website. Beyond securitisations, market participants have also developed benchmark replacement wording or alternative fall-back language for the EMTN and covered bond markets. Both forms of language enable an issuer to replace LIBOR (or any other relevant benchmark) following the occurrence of specified events signalling the discontinuance of the existing benchmark rate in the notes and provide for transition to the replacement rate, without noteholder consent, provided, in the case of the AFME provision, a specified percentage of noteholders have not objected within a specified period following notice. Key elements of this wording are increasingly being adopted in respect of a wide range of debt products, encompassing both fiscal agency structures and trustee structures. An important aspect of the formulation for the EMTN/covered bond markets is that an independent adviser is appointed by, and at the cost of, the issuer and takes responsibility for selecting a benchmark rate which has been formally adopted by the relevant central bank, or that it considers reflects what has become customary market usage in the international debt capital markets for notes of the same currency and term and for providing a margin adjustment spread or methodology for calculating that spread. If either no independent adviser can be appointed or the adviser fails to make the determinations it is required to make, it falls to the issuer to make the determinations.

Importantly, none of the main alternative fall-back formulations that are currently being proposed and/or adopted impose any new obligations on those agency parties that are most likely to be affected by any change to interest payment provisions, such as the Fiscal Agent/Paying Agent/Agent Bank and the Calculation Agent. Under each of these main fall-back formulations, agents will continue to owe their duties to the issuer and will only be expected to perform their payment and calculation services acting on direction from their principals and in accordance with clear mechanical processes set out in the transaction documents. The responsibility for selecting a suitable alternative or successor rate and any adjustment margin will fall on the issuer or, depending on the new fall-back formulation chosen for the particular transaction, an independent financial adviser appointed by it. Consequently, it would seem that the liability position of agents on these transactions is likely to remain unchanged by the inclusion of the currently typical fall-back formulations.

It is important that issuers and arrangers avoid more bespoke fall-back formulations that impose on or afford agents any discretion in relation to the selection of replacement rates or in the determination of discontinuation events/triggers or otherwise compel them to make independent determinations, such as on the margin adjustment spread necessary to achieve economic equivalence for market participants. Such discretion is inappropriate for a calculation agent (as opposed to a financial adviser) and may otherwise create liability exposure for agents that is not commensurate with their commercial position on the transaction. Moreover, agents, unlike trustees, are not fiduciaries and so should not be expected to exercise any discretionary powers to make decisions on behalf of the issuer or noteholders. Where the agents are part of the same group as the issuer, which is not uncommon with financial institution issuers, any expansion of the role of the agent in relation to determination of reference rates or margins could result in actual or perceived conflicts of interest and thus may be detrimental to the perceived integrity of the transaction.

In some existing formulations of the EMTN/covered bond language, the issuer is required to consult with the Paying Agent in relation to some of the determinations that issuer is empowered to make in relation to the adoption of a replacement benchmark rate. Issuers and agents will want to consider carefully whether such consultation is appropriate, at least to the extent that the consultation might potentially go (or be regarded as going) beyond the merely mechanical aspects of payment procedures.

There is also a danger that bespoke fall-back formulations may trip certain service providers into regulated roles. The corollary of this would be to impose on these service providers onerous obligations that they may be unwilling or unable to perform. A notable example of this would be if new fall-back provisions gave the calculation agent discretionary powers to select an alternative rate in the event of benchmark cessation. With these discretionary powers, a calculation agent would likely be considered a benchmark "user" under article 3(1)(7) of the EU Benchmarks Regulation (EU 596/2014) (the BMR) and therefore be obliged to produce and maintain "robust written plans" that set out the actions that it would take if the benchmark it is using materially changes or ceases to be provided. The European Securities and Markets Authority (ESMA) BMR Q&As, published on 17 July 2018, provide useful insight into the circumstances in which calculation agents are likely to be considered benchmark "users". In a helpful clarification, ESMA stated that if the issuer of securities has set the terms of the financial instrument that references the benchmark, the calculation agent would not be considered a benchmark "user". Therefore it is important to ensure that any new fall-back provisions provide that the role of the calculation agent should simply be to calculate, on behalf of the issuer, the payment due on the securities on the basis of pre-determined terms, which they have no power to amend. In a similar vein, it is important to ensure that the calculation agent does not have any discretion in relation to determining whether a discontinuation event has occurred. As agent of the issuer, the calculation agent will be reliant on the issuer determining the point at which a fall-back rate applies (unless such event is specifically triggered by an irrefutable pronouncement by a recognised market authority such as a determination by ISDA).

Existing transactions

Market participants also need to consider the approach to take for existing transactions that reference 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. Recent estimates in the financial press have put the value of bonds that will need to switch to an alternative reference rate as being in excess of $512 billion, although with the very significant level of unlisted private placements emanating from so called "Jumbo" Programmes, this estimate may be conservative.

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. However, in a large number of existing deals, a set of contingencies is built into the floating-rate-calculation provisions that follow a familiar pattern whereby 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. Since most reference banks have said that they will not be willing to provide quotations once LIBOR is discontinued, this fall-back is likely to fail. The ultimate fall-back is then typically to the rate which applied at the last determination date. It seems that 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).

If deals are not amended to provide for new contractual fall-back mechanisms that allow for a transition to an appropriate alternative or successor rate, there is likely to be widespread market disruption as the economic profile of bond debt is decisively reconfigured. On the occurrence of the discontinuation of the relevant benchmark, the first "fixed" interest payment, which will reflect the screen rate as at the last determination date, will continue to flow through the Paying Agent or Fiscal Agent. However, in terms of their existing roles, neither the Paying Agent nor the Fiscal Agent will be under any obligation to determine the application of the "fixed" interest payment, which will be the responsibility of the Issuer after consultation with the Calculation Agent. For example, generally the Paying Agent will not be under any obligation to provide confirmation to any party that the fixed rate is the correct amount of interest owed under the securities on the relevant payment date. In addition, the interest rate payable on the securities will continue to be calculated by the Calculation Agent in accordance with the pre-determined terms set out in the conditions of the securities. 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.

Any modification to the method of calculating interest payable on the securities constitutes a fundamental economic and commercial change to the securities. 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. In the October Bulletin, we stated that the decision as to what should replace LIBOR is a commercial one to be determined between the issuer and noteholders and not one that it is likely to be appropriate for a trustee to be involved in. Indeed, in the vast majority of transactions, amendments to the transaction documents to reflect the replacement of the discontinued benchmark with an alternative rate will be considered a "Reserved Matter" or a "Basic Terms Modification", meaning that noteholders' consent will be required. Moreover, none of the standard agency roles provides any relevant discretion in this area and it is for issuers and their noteholders to agree any amendments to cater for LIBOR discontinuance using the formal consent process prescribed in the notes. Agents will continue to perform their contractual obligations under the transaction documents in exactly the same way and their roles on the transaction will be unaffected, both operationally and legally.

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 2021 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. In any event, under existing contractual fall-back language as well as under the majority of the new fall-back formulations being adopted by market participants, the roles and obligations of agents should remain unchanged. However, issuers and agents should remain alert to any drafting being proposed in fall-back provisions that unintentionally trips agents into regulated and potentially risky roles that such agents are not licenced or otherwise able to perform.