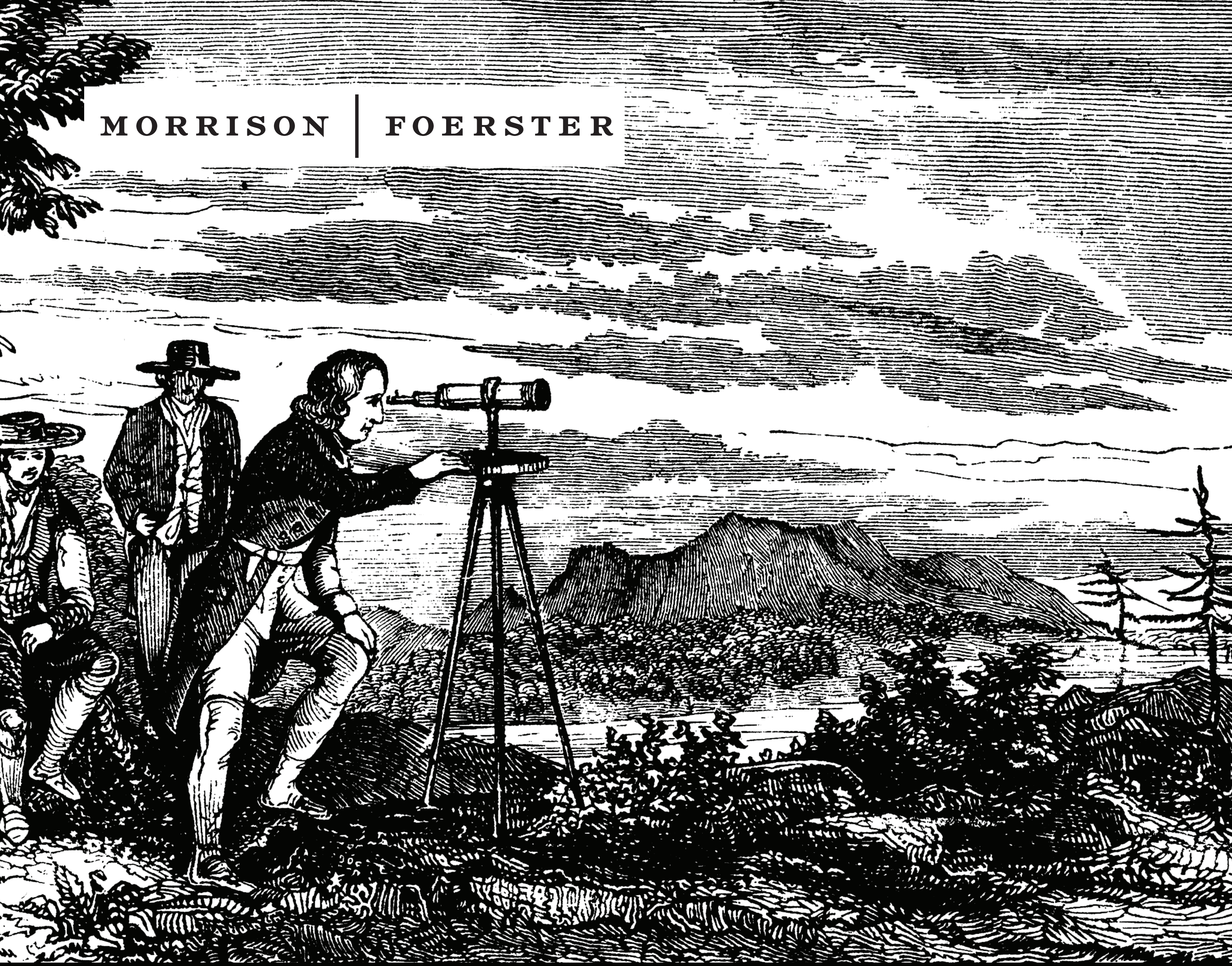

MORRISON | FOERSTER

REPLACING FAMILIAR BENCHMARKS: PREPARATIONS TO PHASE OUT THE IBORs

August 2017

Long a mainstay of the financial world, the floating "IBOR" rates, based on the rates of actual or purported interbank offered loans, are now being swept slowly into the dustbin of history. The quantity, in both number and size, of existing financial products based on these floating rates is enormous, with the outstanding principal amount of such transactions globally estimated to be in the hundreds of trillions of dollars. IBORs are used extensively in numerous currencies as bases for floating rates in a wide range of transactions including derivatives, structured products, mortgages, floating rate securities and other consumer and commercial loans. A phase-out of the use of familiar benchmarks will therefore be a massive undertaking that will take many years to accomplish. In this article we review, primarily in relation to derivatives, the state of play regarding the IBORs, their possible replacements, prospects for a transition to new floating rates and some of the issues that parties to existing and new IBOR-based transactions should consider.

TABLE OF CONTENTS

WHAT ARE THE IBORs?

The IBORs are floating rates based on the actual or purported interbank offered rates for short-term loans. For derivatives and other products denominated in United States dollars, a typical "IBOR" rate has long been "USD-LIBOR-BBA," for British pounds sterling, "GBP-LIBOR-BBA" for the Euro, "EUR-EURIBOR-Reuters" and for Japanese Yen, "JPY-TIBOR-ZTIBOR." These rates, among many other interbank offered rates, are defined in definitions published by the International Swaps and Derivatives Association, Inc. ("ISDA"). Parties to a transaction may specify such rates in a variety of different tenors, e.g., one, three, six or twelve months.

Variants of ISDA's definitions of such rates are often incorporated into structured notes, other floating rate securities, loans, mortgages and other financial products. However, the landscape has changed quickly enough that the names of the floating rates themselves contain historical artefacts: the "L" before "IBOR" in certain floating rates refers to London, the market based on which many interbank offered rates were traditionally determined, and the "BBA" portion of these rates refers to the British Bankers Association ("BBA"), which formerly administered the rates.

The IBORs are determined based on daily surveys of major banks for short term loan rates in various currencies and maturities. As a result of alleged manipulation of LIBOR and other financial benchmarks, particularly in the aftermath of the financial crisis, the UK Government established an independent review on a number of aspects of LIBOR in June 2012 headed by the then-CEO designate of the Financial Conduct Authority ("FCA") Martin Wheatley. The final Report of the Wheatley Review was published in September 2012[1] and made a number of recommendations in relation to the setting and usage of LIBOR, the vast majority of which were subsequently implemented by the UK Government. Recommendations included that the setting of and administration of LIBOR as well as the making of submissions in respect of LIBOR should become regulated activities in the UK under the supervision of the FCA.

The Wheatley Review also recommended the replacement of the BBA as administrator of LIBOR. Consequently, in early 2014, a group associated with Intercontinental Exchange, ICE Benchmark Association ("IBA"), replaced the BBA as the administrator of the primary LIBORs. As administrator, IBA has significantly formalised the LIBOR submission process, introducing, among other things, a code of conduct and a conflicts of interest policy, as well as a reduced submissions policy that covers situations in which ICE receives fewer than the expected number of rate submissions from participant banks. In addition, IBA is in the process of implementing a "waterfall" for submission that is intended to ensure that panel banks, in determining their submission, prioritise actual funding transactions. While prioritising data obtained from actual transactions, however, the IBA waterfall is also intended to permit a rate to be published in all circumstances, regardless of the state of the relevant market, based on transaction-derived data and banks' internal procedures.

[1] The Wheatley Review of LIBOR, Final Report, available here.

REFORMING THE IBORS AND DEVELOPMENT OF RFRS

As a result of concerns arising from the alleged manipulation of IBORs, concerns of regulators that the rates that banks report need not be based on actual transactions, and issues raised by a wide range of stakeholders regarding the reliability and robustness of the IBOR benchmarks, the Financial Stability Board ("FSB") undertook a review of major interest rate benchmarks. For the purpose of that review it established an Official Sector Steering Group ("OSSG") of regulators and central banks, which drew upon reviews of benchmark administrators by the International Organization of Securities Commissions ("IOSCO")[2] and the work of a Market Participants Group, comprised of a wide range of commercial banks, investment banks, fund managers, corporates and other finance professionals.[3] In July 2014, the FSB published a paper developed from the work of the OSSG. This report identified as the "overarching objective" the "transition to rates which are anchored in transactions." It also recommended the strengthening of existing IBORs by underpinning them to the greatest extent possible with real transaction data (such strengthened rates being referred to as "IBOR+s") as well as developing alternative nearly risk-free reference rates ("RFRs").[4]

Similarly, a report of the Financial Stability Oversight Council ("FSOC") in 2014 identified reliance on reference rates such as LIBOR as a potential threat. The FSOC report noted that "a reference rate that is not anchored in observable transactions or that relies overly on transactions in a relatively low-volume market increases the incentives and potential for manipulative activity," and that "the current and prospective levels of activity in unsecured interbank markets raise the risk that continued production of LIBOR might not be sustainable."[5]

Subsequent to these reports, regulatory agencies have done considerable work to reform international benchmarks in accordance with principles developed by IOSCO and set out in its Final Report in July 2013.[6] In the European Union, a new Regulation on indices used as benchmarks in financial instruments and financial contracts has been adopted and will become effective from 1 January 2018 (the "EU Benchmark Regulation").[7] The EU Benchmark Regulation establishes, among other things, a requirement for the authorisation of administrators of financial benchmarks used in the EU and imposes various obligations upon such administrators.

In the United States, regulators and others have undertaken work to develop RFRs in accordance with the FSB recommendations. A group convened by the Federal Reserve,

---

[2] Review of the Implementation of IOSCO's Principles for Financial Benchmarks by Administrators of Euribor, Libor and Tibor – July 2014, available here; *see also* Second Review of the Implementation of IOSCO's Principles for Financial Benchmarks by Administrators of Euribor, Libor and Tibor – February 2016, available here.
[3] Market Participants Group on Reforming Interest Rate Benchmark: Final Report, March 2014, available here.
[4] Financial Stability Board, Reforming Major Interest Rate Benchmarks, July 22, 2014 at 12, 14, available here.
[5] Financial Stability Oversight Council, 2014 Annual Report, at 117-18, available here.
[6] IOSCO Principles for Financial Benchmarks, Final Report, available here.
[7] EU Regulation 2016/1011, available here.

known as the Alternative Reference Rates Committee ("ARRC"), which includes representatives of many major financial institutions, is working to identify alternative, transaction-based reference interest rates that comply with emerging international standards for such rates. As a potential alternative to USD LIBOR the ARRC identified in June 2017 a "broad Treasuries repo financing rate," an overnight rate based on transaction-level data from a certain tri-party repo clearing platform, activity occurring within DTCC's General Collateral Financing Service, and certain cleared bilateral Treasury repo transactions cleared by the Fixed Income Clearing Corporation.[8] The ARRC stated that it chose such rate based on market depth, usefulness to market participants, and whether the rate would comply with the IOSCO Principles for Financial Benchmarks. The new rate is expected to be published starting in the first half of 2018. In August 2017 the Federal Reserve Board requested public comment on the new rate, as well as two other new reference rates.[9]

In the UK, in July 2015 the Bank of England ("BoE") announced its plans to reform the Sterling Overnight Index Average ("SONIA") benchmark by April 2018.[10] These reforms are intended to result in the BoE being the administrator of SONIA, which should be based primarily on transaction data. In April 2017, the BoE's Working Group on Sterling Risk-Free Reference Rates (a group of major dealers active in sterling interest rate swap markets) announced the reformed SONIA as its preferred RFR for use in sterling derivatives and relevant financial contracts.[11] In Japan, a study group overseen by the Bank of Japan has recommended the use of the uncollateralised overnight call rate for yen ("TONA") as its preferred RFR for relevant transactions.[12] In relation to Euro transactions, there is still no specified replacement for EURIBOR, although the euro overnight index average ("EONIA") is likely to be a strong candidate.

In its July 2016 progress report on "Reforming Major Interest Rate Benchmarks,"[13] the FSB recognised the work done by global regulators in reforming administration of key benchmarks, including the IBORs. It advocated that administrators should continue to focus on how to anchor rates in real transactions and objective market data as far as possible. It also recognised the work done by regulators in identifying RFRs and advocated a transition where appropriate to the adoption of RFRs, although it noted that further work was needed in this regard.

---

[8] *See* The ARRC Selects a Broad Repo Rate as its Preferred Alternative Reference Rate, June 22, 2017, available here; *see also* Federal Reserve Bank of New York, Statement Regarding the Publication of Overnight Treasury Repo Rates, May 24, 2017, available here.
[9] *See* Federal Reserve Board, Federal Reserve Board requests public comment on proposal to produce three new reference rates based on overnight repurchase agreement (repo) transactions secured by Treasuries, August 24, 2017, available here.
[10] A new sterling money market data collection and the reform of Sonia, available here.
[11] SONIA recommended as the sterling near risk-free interest rate benchmark, available here.
[12] Feedback Statement on the Public Consultation of a Japanese Yen Risk-Free Rate, available here.
[13] Reforming Major Interest Rate Benchmarks, Progress report on implementation of July 2014 FSB recommendations, available here.

CURRENT CHALLENGES AND EXPECTED TRANSITION AWAY FROM THE IBORS

In July 2017 the current CEO of the FCA, Andrew Bailey, delivered a speech[14] at Bloomberg in London where he announced that, despite improvements in the setting of LIBOR following the implementation of recommendations in the Wheatley Report, it has proven very difficult to ensure that LIBOR submissions and rates are linked, as far as possible, to actual transactions. He stated that in the FCA's view it is unsustainable and undesirable for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them.

In his speech, Mr Bailey noted that the principal challenge in continuing with the IBOR benchmarks is that the underlying market which the various benchmarks seek to measure (being the market for unsecured wholesale lending between banks) is no longer sufficiently active to provide meaningful transaction data and much of the data is provided through the use of "expert judgment." He gave one extreme (and unspecified) example of a rate produced every business day on the basis of submissions from about 12 banks that between them executed just 15 qualifying transactions during the whole of 2016.[15] Although many of the banks submitting LIBOR data are uncomfortable with this position, they have to date been persuaded by the FCA, as the regulator of LIBOR, to continue to provide submissions to avoid the market disruption likely to result if LIBOR were suddenly withdrawn without proper planning. The FCA can, under its regulatory powers, compel banks to continue to provide submissions for LIBOR although it has, so far, been able to persuade banks to continue to provide submissions without the need for compulsion.

The FCA does not, however, believe that the current position is sustainable indefinitely (and, in any event, its power will be limited after the EU Benchmark Regulation comes into force). Demonstrating its concern in this area, in June 2017, the FCA published a Consultation Paper[16] which considered the ways in which it may require banks to make LIBOR submissions under its existing statutory powers and, in the future, under the Benchmark Regulation (once LIBOR is designated as a critical benchmark thereunder).

The FCA is therefore proposing a transition away from LIBOR by the end of 2021. The 2021 target date is based on the FCA's conclusion, after consultation with market participants, that it would be likely to give rise to considerable uncertainty and disruption, particularly in relation to legacy transactions, if LIBOR were withdrawn in a period of less than four or five years. At the same time, Mr Bailey indicated his view that work on a transition is only likely to start in earnest if market participants understand that there is a firm timeframe for the withdrawal of LIBOR.

The FCA notes that, during the transition period, it will be necessary for alternative benchmarks to be established, and it points out that there is little logic in continuing to use LIBOR for many of the transaction types it currently benchmarks.

---

[14] The Future of LIBOR, available here.

[15] The current low or even negative interest rates of certain central banks are believed to have decreased the number of actual transactions eligible to be reported as part of banks' LIBOR submissions.

[16] Powers in relation to LIBOR contributions, available here.

However, the FCA is not currently advocating that there should be a "ban" on LIBOR being administered in the future and it has acknowledged that IBA (or its successor) could continue to administer LIBOR beyond the end of 2021 if it is able to obtain submissions upon which it is able to do so.

The EU Benchmark Regulation adds a further interesting dynamic to the future of LIBOR and other IBORs. Although now in force, most of the provisions of the Benchmark Regulation do not become effective until 1 January 2018. However, some provisions, including rules relating to "critical benchmarks," are already effective. The EU Commission must maintain a list of "critical benchmarks" determined by reference to specific criteria. So far, EURIBOR is the only benchmark to be so designated,[17] although LIBOR is also expected to be so designated shortly. Various additional rules apply to critical benchmarks under the Benchmark Regulation. This includes specific rules regarding the withdrawal of a critical benchmark. An administrator of a critical benchmark is subject to specific rules if it intends to cease providing such benchmark including having to prepare an assessment of how the relevant benchmark is to be transitioned or ceased. The relevant competent authority may require the administrator to continue to provide the benchmark until it is transitioned to a new administrator. However, under such powers, the relevant authority cannot impose such requirement for more than 24 months.

The impact of the Benchmark Regulation on the UK is somewhat complicated by Brexit, which is expected to be completed ahead of the FCA's timeframe for LIBOR withdrawal. However, in view of LIBOR's widespread use across the EU, the reality is that LIBOR will very likely continue to be a critical benchmark under the Benchmark Regulation following Brexit. It is therefore likely that, in relation to LIBOR, the rules regarding critical benchmarks will apply even if the UK has ceased to be a member of the EU.

PLANNING FOR THE TRANSITION

Many of the transactions and securities that reference one of the IBORs are hedged by other transactions referencing the same IBOR. The widespread use of the IBORs, and the interconnectedness of the transactions referencing those rates, have led many regulatory agencies and supervisors to accept that the withdrawal or discontinuance of the IBORs, without giving the market sufficient time to plan and put alternative arrangements in place, could give rise to a substantial market disruption and could potentially even have catastrophic consequences.

Financial market participants have started to engage with the question of how a potential transition to a new benchmark floating rate might work and to which transactions a new rate should apply. The recent FCA announcement in relation to LIBOR has given more impetus to that work.

One key issue is the extent to which the new rates might be required to apply to existing legacy transactions. As substantial market disruptions could occur if a new rate were made to apply to existing legacy transactions, it currently seems unlikely that regulators

[17] Commission Implementing Regulation (EU) 2016/1368, available here.

will seek to impose new rates on existing transactions. For starters, to the extent that an existing IBOR swap or other derivative were intended to hedge another transaction, the new rate would need to apply to both transactions in order for the hedge to remain effective. Further complexities would likely arise in the context of required margin for uncleared swaps, as a revised floating rate would likely cause valuation changes that would in many cases change the amount of required collateral. ISDA has stated its view that "serious consideration must be given to whether the transitions should apply to legacy trades . . . we expect the public-private sector transition plans will target new trades only."[18] That said, for long dated transactions currently referencing an IBOR that do not have a specified fallback, there would be risk of uncertainty if the relevant IBOR were discontinued without the relevant parties having agreed to amend the transaction to include an alternative rate or fallback.

With the support of the FSB, ISDA in 2016 commenced an extensive programme of engagement and consultation with market participants on the implementation of alternative risk-free rates and the development of fallbacks for key IBORs and has established a number of working groups for this purpose. In its statements to date, including by Chief Executive Scott O'Malia at a Symposium in June 2017,[19] ISDA has stated that it is critical that any alternative rate be sufficiently liquid to support its role as a key market benchmark. ISDA has also noted that, where the volume of trades referencing a benchmark is significant, the impact of basis risk is greater. Further, ISDA has underlined the need for a formal cooperation between the public and private sectors to ensure a smooth transition to new benchmarks.

In the Symposium referred to above, Mr O'Malia also highlighted that, in addition to the question of how to address legacy trades, there are other issues to be considered in transitioning to new benchmarks. He noted that most of the risk-free rates currently being advocated as alternatives are overnight rates. In contrast, the various IBORs are quoted by reference to different tenors, which are generally matched to the tenor of the interest period they are benchmarking (e.g. one, three, six or twelve months). In particular, where a risk-free rate is used as a fallback to a current transaction with a primary IBOR benchmark, there could be a significant impact on value if the fallback is triggered. There are concerns from some market participants that a risk-free rate may not be a suitable benchmark for more risky or secured lending transactions. It is therefore possible that different alternative benchmarks might be developed for these types of transactions.

In a webcast arranged for its members following the recent FCA announcement, ISDA provided an update of the work done by its working groups to date.[20] It stated that the current expectation was that the working groups would, in due course:

[18] ISDA, Benchmark Transition Plans will be Critical, June 29, 2017, available here.
[19] ISDA Symposium – Financial Benchmarks – Scott O'Malia, Chief Executive, ISDA June 15, 2017. A link to the presentation can be found here.
[20] Benchmarks – Fallbacks for LIBOR and other key IBORs – a link to the slides discussed during the webinar can be found here.

- recommend a fallback rate or rates and/or other fallback mechanisms that would apply in the event that the relevant IBOR applying to a transaction (or other relevant benchmark) were permanently discontinued;
- propose amendments to the 2006 ISDA Definitions to enable the selected fallbacks to be incorporated in future transactions (any changes incorporated into the definitions will only apply to transactions entered into from the time of such amendment and so will not be automatically incorporated into the terms of legacy transactions); and
- develop a plan to allow market participants to amend the terms of legacy contracts to include the amended definitions, which may well involve a protocol mechanism to allow parties to incorporate the amendments into multiple transactions.

There are a number of complexities and difficult issues that must be addressed in relation to the transition away from the IBORs. ISDA has made it clear that as these issues continue to be considered, its approach may change and nothing is yet set in stone. It has also said it will undertake a full consultation on its proposals before they are finalised.

One such difficult issue is formulating a definition of a "permanent discontinuance" of a benchmark. The ISDA working groups currently favour a test based on the occurrence of one of four events: (a) the insolvency of the relevant IBOR administrator without a successor administrator being appointed in a specified time frame; (b) a public statement by the relevant IBOR administrator that it will cease publishing the relevant IBOR permanently or indefinitely without a successor administrator being appointed; (c) a public statement by the supervisor for the relevant IBOR administrator that the relevant IBOR has been permanently or indefinitely discontinued or (d) a public and official statement by the supervisor to the relevant IBOR administrator that IBOR may no longer be used. This does, however, give rise to potential issues. As Andrew Bailey stated in his speech, the FCA is not proposing to prohibit the use of LIBOR but merely to cease to require banks to make submissions to the LIBOR administrator. LIBOR could thus potentially continue to be administered on the basis of far fewer banks making submissions than is currently the case. Based on the current proposed definition of "permanent discontinuance," this would not, however, be sufficient to trigger the fallback rate coming into effect. This issue will likely be subject to further scrutiny.

Another area to which the ISDA working groups have been giving significant thought is the desire to avoid a significant value transfer in respect of relevant transactions where a fallback rate comes into effect. As highlighted above, most of the proposed RFR fallbacks are overnight rates, as opposed to the LIBOR approach of having different rates for specified tenors. Further, the RFRs also do not take into account the bank credit risk that is intended to be reflected in LIBOR. ISDA has indicated that the current approach proposed by the working groups is to develop a model so that the fallback rates will, as with the IBORs, be publicly available as a screen rate and quotes and be based on tenors at 1, 3, 6 and 12 months. They currently favour basing such quotations on RFRs based on benchmark observations for term RFR swaps of the relevant tenors. To avoid the potential for manipulation, it may be that the calculations of RFRs will be based on benchmark observations for the preceding weeks before the fallback is activated. It will be necessary for an agent to be appointed to source the relevant data and make it publicly available.

ISDA has emphasised that it is still early days in the process of developing market standard fallbacks and it is likely to be some time before it is in a position to propose amendments to the ISDA definitions or to develop protocols for legacy transactions. It could thus be argued that the FCA's announcement is premature and it would be preferable if markets had started the transition to new benchmarks and fallbacks before substantive plans are made to withdraw LIBOR or any of the other IBORs. That said, the FCA appears to have taken the view that market participants are likely to take relevant action in any significant numbers only after there is a clear timeframe for discontinuance. This does, however, leave the FCA open to the risk that it might have to extend its current deadline or take additional action to incentivise market participants to transition to a new benchmark.

The ISDA work referred to above is primarily relevant to derivatives referencing an IBOR. Although it is likely that the fallback mechanism ultimately adopted by ISDA will be replicated in many other financial contracts and instruments referencing an IBOR (particularly where hedged by a derivative), this will in many cases need to be addressed on a market by market or even case by case basis. For example, for loans based on the standard form of Loan Market Association ("LMA") agreement, there is currently no specified fallback in the event of LIBOR being discontinued, and the LMA may wish to consider whether it will follow an approach similar to that adopted by ISDA. That said, the amendment of transaction terms typically requires the consent of all parties. For transferable securities, any amendment is likely to require the consent of all or a specified portion of holders, which in practice may be difficult to obtain.

CONSIDERATIONS FOR NEW TRANSACTIONS

For parties entering into new transactions that wish to reference an IBOR, it clearly makes sense to plan so far as possible for a forthcoming possible discontinuance of such rate. Where such transaction is being hedged by a derivative, it may be sensible to build in a mechanism to seek to replicate any future amendment that is made to the derivative to incorporate a new fallback rate. For other non-derivative transactions, a specific fallback would give greatest certainty, although it may be difficult for parties to determine what the new alternative benchmark should be. Issuers of securities referencing LIBOR may wish to consider the provisions for an amendment of such security's terms and conditions, and to determine whether a more flexible approach might be made to apply to the adoption of a fallback rate.

Issuers of public securities referencing LIBOR or other IBORs, particularly floating rate notes and structured notes linked to LIBOR, should also consider whether specific risk factors and other disclosures are needed in connection with these recent developments. Brokered CDs and similar products linked to LIBOR give rise to comparable issues. To date, issuers of Eurobonds have tended to make relatively general statements about the issues in relation to EURIBOR and LIBOR and the uncertainty as to whether such rates will remain available in the future. Although no market practice has yet developed since the recent FCA announcement in relation to LIBOR, we would expect a similar approach. To the extent that fallbacks are included within the terms and conditions of an issue of securities, the prospectus or equivalent disclosure document should state clearly the fallback rates and circumstances in which they will apply.

The many issuers that have already been making disclosures regarding LIBOR-related issues should consider whether further disclosure is necessary, and will need to monitor the market for additional developments that impact these disclosures. Disclosure issues include, for example, the uncertainty relating to future levels of the benchmark rate, the possibility of its discontinuance and potential replacement, and the potential impact on the payments on the instrument that would arise from discontinuance or replacement.

AUTHORS

Peter Green
London
+44 (20) 7920 4013
PGreen@mofo.com

James Schwartz
New York
(212) 336-4327
JSchwartz@mofo.com

ADDITIONAL CONTACTS

Bradley Berman
New York
(212) 336-4177
BBerman@mofo.com

Julian Hammar
Washington, D.C.
(202) 887-1679
JHammar@mofo.com

Lloyd Harmetz
New York
(212) 468-8061
LHarmetz@mofo.com

Jeremy Jennings-Mares
London
+44 (20) 7920 4072
JJenningsMares@mofo.com

Anna Pinedo
New York
(212) 468-8179
APinedo@mofo.com

Akihiro Wani
Tokyo
+81 (3) 3214 6522
AWani@mofo.com

RESOURCES

THE BD/IA REGULATOR

The BD/IA Regulator provides frequent, focused and practical summaries of developments, along with useful analysis and takeaways for broker-dealers, investment advisers and investment funds. www.bdiaregulator.com

MOFO RE ENFORCEMENT

MoFo ReEnforcement: The Enforcement Blog provides insights and timely reports on enforcement and regulatory developments affecting the financial services industry. www.moforeenforcement.com

ABOUT MORRISON & FOERSTER

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life sciences companies. We've been included on *The American Lawyer's* A-List for 13 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

MORRISON | FOERSTER

@ThinkingCapMkts

www.mofo.com