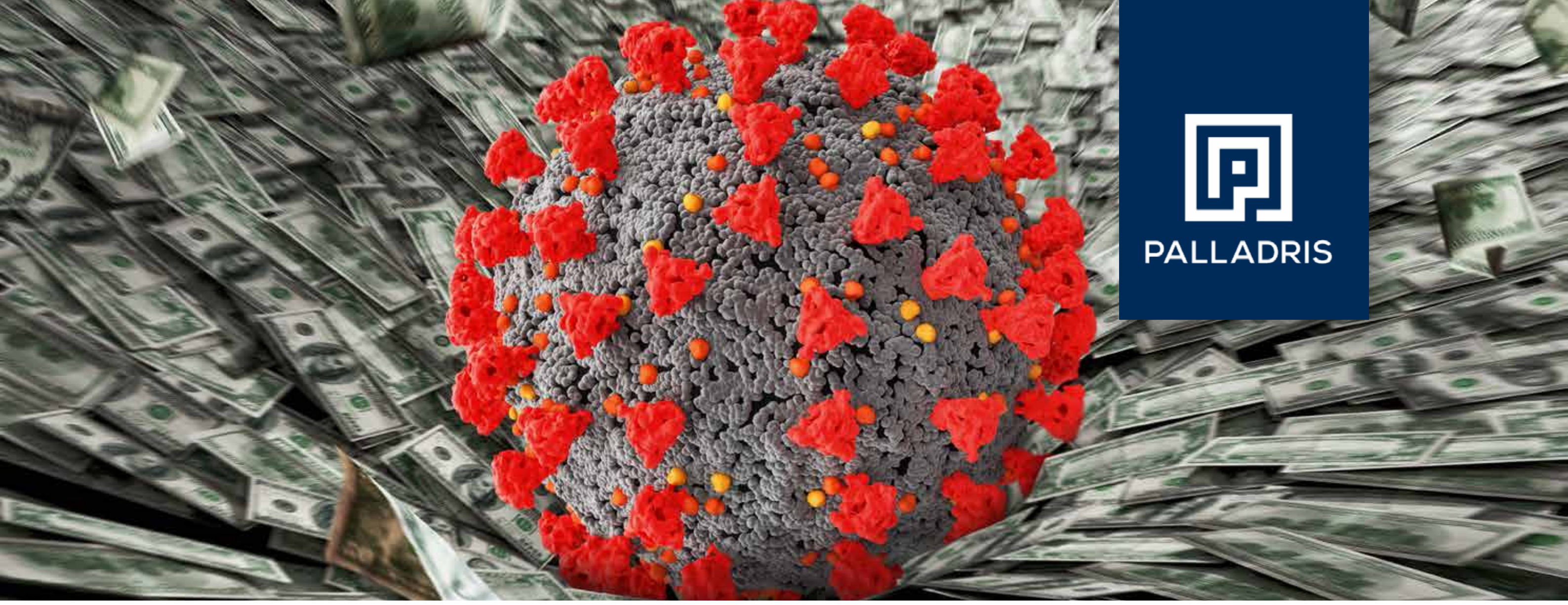


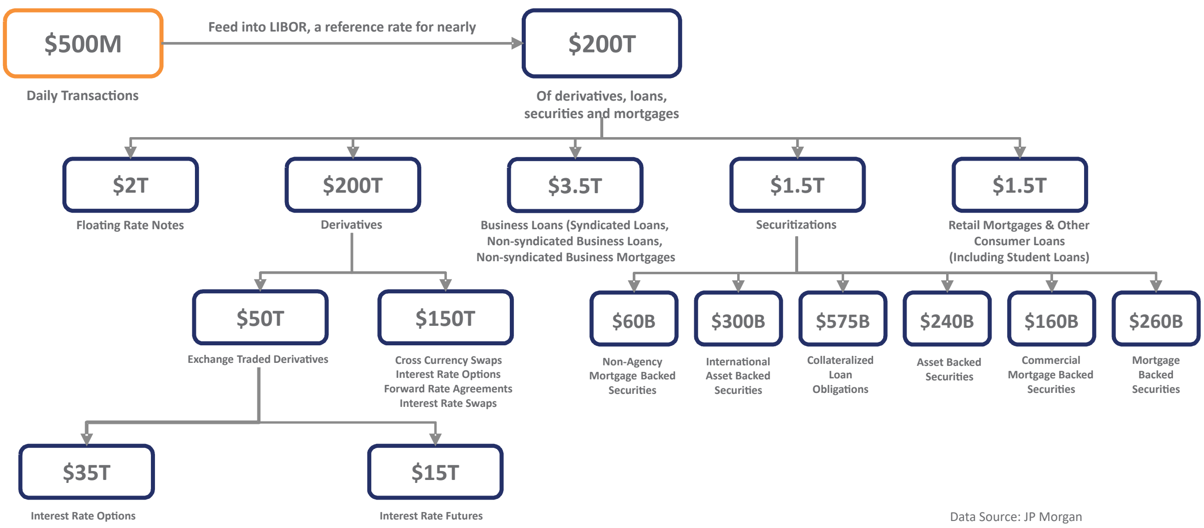
THE LIBOR DISCONTINUATION DEADLINE REMAINS DECEMBER 2021 BUT HAS COVID-19 IMPACTED YOUR FIRM'S LIBOR TRANSITION PLAN?

With the COVID-19 pandemic spreading across the globe and with restrictions imposed by governments the financial services industry has had to grapple with the impact of the consequent market disruption ensuring that it has primarily focused on business continuity in the short term and as a consequence derailing many other priorities. One area that had been in particular focus prior to the arrival of the pandemic was firms planning their LIBOR transition process. This related to how institutions that reference LIBOR as a benchmark rate, were looking to transition to alternative benchmarks by the end of next year. Unfortunately, with institutions presently having to shift their resources to maintaining business continuity and mitigating market risk, this has raised questions as to whether key LIBOR transition milestones can now be met and whether they need to be adjusted.

The London Interbank Offered Rate (LIBOR), is a series of benchmark interest rates and has been called the "world's most important number." It is a globally recognized base rate for pricing loans, debt, and derivatives.

On 27 July 2017, Andrew Bailey, Chief Executive of the UK Financial Conduct Authority, made a speech about the future of LIBOR stating that market participants should not rely on LIBOR being available after 2021. Therefore, financial institutions and market counterparts must transition to alternative rates before this date.

THE SIZE OF LIBOR



Data Source: JP Morgan

LIBOR TRANSITION TIMELINES

With financial institutions focused on business continuity, this raises the question about the feasibility of meeting the current LIBOR transition timetable. While the UK's Financial Conduct Authority (FCA) has made clear that the final transition target date of December 31, 2021 has not changed, they have been less definitive about other key milestones within the LIBOR transition process falling in 2020 and 2021.This has as a consequence raised speculation concerning extensions.

The FCA, which regulates LIBOR, has suggested that several milestones may well be pushed back they have acknowledged that there has *"been an impact on the timing of some aspects of the transition programs of many firms. Particularly in segments of the UK market that have made less progress in transition and are therefore still more reliant on LIBOR, such as the loan market, it is likely to affect some of the interim transition milestones."* [1]

However, it should be emphasised that both the FCA and the Financial Stability Board (a consortium of national and international regulators) have made clear that the final timing of the LIBOR transition has not changed. At the end of 2021, the 20 LIBOR panel banks will no longer be compelled to continue making LIBOR submissions. In the FCA's words, *"the central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet."* [2]

Given the current market uncertainty, it would be natural for some firms to therefore consider delaying their LIBOR transition plans until there is further clarity from regulators. Unfortunately, this would not be a sensible course of action since the final transition date is still in place, therefore institutions need to remain focused on their transition plans to ensure that they are ready for the discontinuation of LIBOR at the end of 2021.

> FCA and FSB has made clear that the final transition target date of December 31, 2021 has not changed.

LOAN DOCUMENTATION UPDATE

The Loan Market Association (LMA) has published for consultation its proposal for documentation on 23 September 2019 of two single currency term and revolving facilities agreements (the "Exposure Drafts") that broadly indicate how such compounded averaged in arrear "risk-free term rates" (RFR) might be calculated and used in syndicated loan facilities.

Since the LIBOR replacement will have impact on how loan agreements are drafted this publication is certainly a step forward. These Exposure drafts are a vehicle to consult the loan market on a number of issues relating to the use of such term RFRs – there being insufficient loan market practice for the LMA to produce recommended forms at this stage.

Of the two forms of Exposure Draft one has been drafted for sterling loans and the other is drafted for US dollar loans. The floating rate under both Exposure Drafts are derived from the respective RFRs that are expected to replace sterling LIBOR (SONIA – The Sterling Overnight Index Average is published by the Bank of England and represents the weighted average of unsecured overnight sterling transactions) and US dollar LIBOR (SOFR – Secured Overnight Financing Rate published by the US Federal Reserve Bank of New York calculated from overnight US Treasury REPO activity).

[1] Financial Conduct Authority, "Impact of the coronavirus on firms' LIBOR transition plans," March 25, 2020, www.fca.org.uk

[2] Financial Conduct Authority, "Impact of the coronavirus on firms' LIBOR transition plans," March 25, 2020, www.fca.org.uk

As the RFR quotations relating to an interest period are compounded and averaged in arrear, if interest is to be paid on the last day of each interest period, it is necessary to find a way to compound and average all relevant quotations before the end of each interest period. This is done using a lagging "observation period". These differences will have a substantial impact on how loan agreements are drafted and operate.

The LMA has been careful to stress that the Exposure drafts should not be treated as market standard documentation. However, while it represents a significant step towards what loan documents may look like once LIBOR has been discontinued, the Exposure drafts also highlight the significant steps still required to be made by the loan markets before the transition from LIBOR by the end of 2021.

ISDA UPDATE

On 14th May, 2020 the International Swaps and Derivatives Association, Inc. (ISDA) published a report that summarising the final responses to its consultation on the implementation of pre-cessation fallbacks for derivatives referenced to LIBOR.

The consultation, which was launched in February, asked whether the 2006 ISDA Definitions should be amended to include fallbacks that would apply to all covered derivatives referencing LIBOR following a permanent cessation of the benchmark or a 'non-representative' pre-cessation event, whichever occurs first.

The results of the consultation indicated that a significant majority of market participants supported including pre-cessation and permanent cessation fallbacks without optionality or flexibility in the amended 2006 ISDA Definitions for LIBOR and in a single protocol for including the updated definitions in legacy trades.

Following these results, ISDA expects to publish amendments to the 2006 ISDA Definitions to incorporate the fallbacks for new trades in July, 2020. A protocol will simultaneously be launched to allow market participants to incorporate the revisions into legacy trades if they choose too. Both of these measures are expected to come into effect before the end of this year.

> ISDA expects to publish in July both amendments to the 2006 ISDA Definitions to incorporate the fallbacks for new trades and Protocol to incorporate revisions to legacy trades.

SUGGESTED AREAS OF FOCUS

With the LIBOR transition final timing unchanged it is important for institutions to refocus and we have listed below a few areas that require urgent attention:

- **Identify key interim milestones.** Map expected timing of milestones, for example the release of the updated 2006 ISDA definition and ISDA protocol to facilitate the amendment of derivative contract definitions.

- **Contract remediation planning.** Preparations for contract remediation, should include due diligence namely contract analysis which will help you prepare your client outreach program. Given that contract remediation is a substantial body of work, institutions should continue to inventory legacy contracts, analyse existing terms, and develop client-outreach playbooks in advance of key contract remediation triggers, such as the forthcoming ISDA protocol.

- **Identify fallback rates.** This should be done now (if rates are available), especially for loans. Firms should consider fallback provisions that define the fallback rate upfront this is the so-called "hardwired" approach to fallbacks rather than solely requiring counterparties to

negotiate upon LIBOR cessation the alternative "amendment" approach. The amendment approach is particularly problematic for loans that default to the prime rate if a new fallback has not been selected. Given that the prime rate is substantially higher than alternative benchmarks, a delayed or failed negotiation could have significant cost implications.

- **Fallback clauses.** It is imperative that financial services firms and other market participants proactively re-negotiate LIBOR contracts to reference an alternative rate wherever possible to minimise the use of fallback clauses in case of a LIBOR discontinuation. Whilst some market participants maybe planning to rely on updated fallback clauses when LIBOR becomes unavailable. This by itself is not an answer as it may create operational risk, from needing to process new and different fallback formulae, to needing to calculate new interest payments, valuations, margin and collateral requirements for multiple contracts on a single day.

- **Re-papering.** The experience from previous larger re-papering exercises suggests that negotiations of existing transaction documentation will be challenging. Firms should develop a re-papering and negotiation strategy to define explicitly what will be required to prepare and manage the transition process end-to-end across client types to minimise conduct risk. The findings of this sample can then be used to determine the time and resources that will be required to apply the defined approach across all clients and exposures.

- **Draft client communications.** Firms should engage with clients sooner rather than later on the likely impact of recent developments on the transition timetable. Despite the fact that clients may seek definitive answers – such as whether additional interim transition milestones will be extended – communication will ensure that they are kept up to date on the next phase of the transition process.

Fallback language refers to contractual provisions that lay out the process through which a replacement rate can be identified if a benchmark is not available

Fallback language comprises three key components:

- Fallback trigger event (rate not available),
- Benchmark replacement (steps identifying replacement rate) and
- Benchmark replacement adjustment (differences between the original rate and the replacement rate)

Problems with historical fallback language

- Provisions originally drafted to provide an interim solution should a rate be temporarily unavailable, rather than contemplating permanent cessation of a benchmark.
- Language typically lack specificity in selecting a replacement rate and can therefore result in a commercially undesirable outcome.

Language can vary between different product agreements, for example derivatives and cash products.

- **Horizon scanning.** Firms should actively monitor regulatory and industry guidance. This provides valuable information as to what the regulators latest thinking is and lobby efforts by industry groups like ISDA and LMA.

CONCLUSION

Despite uncertainty surrounding the LIBOR transition timeline institutions need to prioritise preparations for the discontinuance of LIBOR by the end of 2021. Without proper preparation, firms will face a number of material risks including unanticipated operational risks, potential value transfers which can lead to huge gains or losses when fallback clauses come into force, and considerable conduct risk that could result in reputational damage, fines, and lawsuits. In addition, it is expected that LIBOR liquidity will diminish once there is no requirement for banks to participate in the LIBOR panel and at some point IOSCO will remove LIBOR as a benchmark rate.

Palladris, are happy to support clients on their LIBOR transition journey and we are ready and available to assist.

In response to the present restrictions, we are providing our services across virtual meeting platforms, utilising whiteboards, data rooms and other productivity tools.

Call us now on: +44 (0)20 3900 0366

Transitioning LIBOR with PALLADRIS

At Palladris, we have a **7 stage–process** to evaluate and create a transition plan designed for your institution.

This requires extensive stakeholder collaboration across:

- Front office/Treasury;
- Technology;
- Operations;
- Legal & compliance; and
- Credit & other risk control functions.

Our partners and associates are ex-bankers with in-depth experience across financial institutions and corporate treasury functions.

The impact of COVID-19 has constrained implementation timelines at most firms due to prioritisation of business continuity measures and there is now a real danger the deadline of Dec 2021 may not be achievable. **Call Palladris now to discuss how to get your firm back on track.**

Written by:
IFTHER ALI
Partner, Palladris
Legal, Compliance & Governance

Contact Palladris for guidance as to how to navigate the issues discussed above and ensure that your firm is able to meet the challenges raised by LIBOR.

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