CLEARY GOTTLIEB

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Benchmark Discontinuation: Staying Afloat

LIBOR and EURIBOR are likely to disappear …

— *The Horseman of the LIBOR Apocalypse.* Andrew Bailey, the head of the UK Financial Conduct Authority ("**FCA**"), announced on July 27, 2017 the effective discontinuation of LIBOR from the end of 2021, as banks will no longer be required to contribute rate quotations. The FCA's main reason is that there are insufficient underlying transactions in the markets upon which LIBOR rates are calculated, thus increasing LIBOR's vulnerability to manipulation and casting doubt on how representative LIBOR as a reference rate could be (particularly in stressed market conditions). The end-2021 deadline was set to give firms sufficient time to transition away from LIBOR.

— *Rearing its head on the Continent.* EURIBOR is not compliant with the European Benchmark Regulation, which effectively requires compliance no later than January 1, 2020 (LIBOR is already compliant). Its administrator is consulting on a new methodology based in part on transaction data and in part on bank quotations, but the new EURIBOR will not be ready until late 2019 at the earliest. Even then, it is not clear that banks will be prepared to provide the quotations on which the new EURIBOR will depend.

— *Overnight successors.* Central bank working groups have designated overnight rates – SOFR (USD), new SONIA (GBP) and ESTER (EUR) – to replace LIBOR and EURIBOR. But finance markets depend on term rates (3m, 6m), and there currently are no term rate successors or accepted adjustment factors to convert overnight rates into term rates nor to provide for the credit premium inherent in LIBOR and EURIBOR.

… and Market Participants need to be ready

— *Today, they are not ready.* The FCA announcement and a July 2018 follow-up caused many to scramble to understand the implications for existing and future contracts. But recent surveys show that most market participants are unprepared for the transition.

— *Systemic risk.* Many current contracts – trillions of dollars, pounds and euros – have no workable fallback clauses. This means parties will not be able to calculate interest payments after LIBOR and EURIBOR disappear. Major litigation could conceivably ensue. Amending contracts can be difficult and time consuming, and managing the transition may give rise to difficult tax, accounting and regulatory consequences.

— *What is to be done?* Market participants should take stock of their floating rate exposures and adopt a plan to meet the challenges of the transition. They should identify long lead-time issues – complex financing structures that might be difficult to amend, bonds with high majority requirements to change interest rates, matching of financings and hedging arrangements, accounting, tax and regulatory aspects of the transition. The FCA and UK Prudential Regulation Authority wrote to CEOs of large UK financials requesting a board-approved summary of the firms' assessment of key risks relating to LIBOR discontinuation and their plans to mitigate those risks. Others need to do the same. **A Preparation Checklist is provided on the last page of this note**.

Temporary fallbacks and contract continuity

— Well-drafted existing financial instruments referencing LIBOR would have fallback positions where LIBOR is unavailable. However, except for recent contracts that provide specifically for benchmark discontinuation, these are designed for temporary unavailability only rather than for a permanent discontinuation and may lead to severe consequences for both borrowers and investors if applied longer-term. Illustrative outcomes are shown below based on the most common form of temporary fallback wording.

— Adding New Fallbacks. The obvious solution is to amend contracts to provide workable fallbacks, but it isn't so easy. For example, bonds issued in the US and LMA-style loans have 100% consent requirements to change interest rates. Moreover, new fallback clauses only provide a process for determining successor rates, not the rates themselves, and they will only work if clear successor rates exist. Financings need to be transitioned in coordination with hedging arrangements. Amending contracts could kill regulatory grandfathering or generate significant accounting or tax gains or losses.

— Contract continuity. Where there is no workable fallback, the contract is **at risk of challenge**. The basis for challenge and potential outcome of any challenge depends on the governing law of the contract. But generally if it is impossible to change to a successor rate, or if there is a significant transfer in value, litigation could ensue.

Asset Class/Product	Existing ultimate fallback	Impact?
Loans (LMA-based)	Lenders' self-reported cost of funds	Cost of funds may vary wildly and be significantly higher. Risk of lender liability. Administrative issues for agents.
Bonds	LIBOR applicable during the last period it was available.	Effectively converts to a fixed-rate bond. Likely to cause transfer of value, changing investment fundamental. For regulated bank issuers, capital instruments referencing LIBOR may not operate as intended post-2021.
Derivatives (ISDA-based)	Reference Bank quotes.	Depends on willingness of reference banks to provide quotes. Absent quotes there is no fallback.
Securitizations and structured products	Depends on structure, different components may include combinations of the above.	Increased risk of value loss/increased costs where different fallbacks apply across the same structure.
Commercial contracts	Typically does not include any fallbacks.	Risk of dispute absent successful renegotiation.

Overnight Refuge?

— Working groups organized by central banks such as the Fed, the Bank of England and the ECB have designated recommended "nearly risk-free" rates to replace LIBOR and EURIBOR. Similar initiatives have been undertaken for other currencies. Some new rates are published already, some are not. However, **even if acceptable for use in their current guise, these alternative rates will not automatically replace LIBOR/EURIBOR in existing contracts – amendments to existing contracts would be required**.

— Each of these alternative rates is different from the main current benchmarks in two key respects:

- Term differences: Financial markets have been accustomed to the flexibility afforded by the variety of LIBOR/EURIBOR term rates (1w, 1m, 3m, 6m, 1yr). The alternative rates are available on an overnight basis only. Futures markets may develop, but their timing and depth remain to be seen. Bonds have been issued based on average values for the successor rates over interest periods, but the result is that issuers and bondholders do not know the coupon amount until the end of the period.
- Premium gap: LIBOR as a benchmark had always carried bank credit risk and term risk premia. The alternative RFRs do not and direct replacement may cause reduced returns to existing investors.

Administrator	Alternative RFR	Currently published?
Bank of England (£)	Sterling Overnight Index Average ("**SONIA**"): Based on overnight unsecured deposits.	Yes
Federal Reserve Bank of New York (US$)	Secured Overnight Financing Rate ("**SOFR**"): Based on overnight secured underlying transactions.	Yes
European Central Bank (€)	Euro Short Term Rate ("**ESTER**"): Based on unsecured overnight underlying transactions.	No, target October 2019
SIX Swiss Exchange (CHF)	Swiss Average Rate Overnight ("**SARON**"): Based on interbank overnight repurchase transactions.	Yes
Bank of Japan (Yen)	Tokyo Overnight Average Rate ("**TONA**"): Based on unsecured overnight call rate market.	Yes

Transitioning to the new world: How to Prepare

— Follow the work of various industry bodies (e.g. ISDA, LMA, ACT) that are now involved in the transition process. Consultations have been published and work is ongoing to smooth the transition. Study multilateral protocols published by organizations such as ISDA, and consider adhering to them.

— Use updated, market-standard fallback language in all new contracts. While they generally provide only a framework for a future transition, that is the best that can be done given the current state of play. At a minimum, they ensure there will be some workable mechanism to deal with the disappearance of LIBOR and EURIBOR.

— Identify exposure to benchmarks, concentrating first on the most complex and difficult financial structures. Make a concrete plan sooner rather than later that can be completed well in advance of the expected transition date. Consider contracts not only individually, but collectively to ensure coordination of the transition, particularly where exposures are linked (securitizations, hedges, etc.).

— Assess the accounting, tax and regulatory implications of any contract amendments, and develop a plan to manage any risks or uncertainties.

— **Follow the Preparation Checklist on the last page of this note.**

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BENCHMARK PERMANENT DISCONTINUATION – PREPARATION CHECKLIST

1. Organize and mobilize resources:
    - Prepare internal teams for analysis and plan implementation. ☐
    - Retain any necessary external advisors. ☐
    - Allocate responsibilities. ☐
2. On the front foot – market watch/participation:
    - Get to know variety of working groups and industry bodies and how they are treating these issues (e.g. ISDA, LMA, LSTA, ACT). ☐
    - Understand products issued in the market referencing the new rates and determine whether interest calculation methods on such products would be acceptable (in case such methodology evolves into the new market standard). ☐
    - Participate in/follow consultation processes of working groups and industry bodies. ☐
    - Consider adhering to industry protocols. ☐
3. New contracts entered into pre-transition (and which will be in effect beyond then):
    - Put in place internal policies for new contracts (fallback clauses). ☐
    - Educate deal teams on issues and new internal policies. ☐
4. Diligence existing contracts to understand existing exposure, to cover:
    - Securitizations/structured products (prioritize due to complexity and heightened mismatch risk). ☐
    - Loans (concentrating on syndicated loans, financings with complex guarantees, and tax-sensitive structures). ☐
    - Bonds (looking in particular at majority requirements for amendments). ☐
    - Derivatives (individually and together with hedged instruments). ☐
    - Commercial contracts (for example, most oil and gas joint operating agreements provide for default interest based on LIBOR). ☐
    - Intra-group loans, loans to joint ventures and any other relevant contracts. ☐
5. Risk assessment:
    - Analyze scale of aggregate exposures and conduct impact assessments. ☐
    - Identify potential mismatches within structured products (high risk). ☐
    - Identify potential mismatches between underlying cash product and hedge documentation. ☐
    - Analyze tax, accounting and regulatory issues. ☐
    - Estimate operational and cost impact of switch. ☐
6. Implementation strategy:
    - Consider timetable for amendment of contracts – especially contracts which need longer lead time between negotiation and execution (e.g. Structured products, bonds requiring 100% noteholder consent for interest amendments, large commercial contracts). ☐
    - Prepare to implement systems upgrades necessary for new rate. ☐
    - Initiate discussions with counterparties. ☐
    - Engage with regulators where applicable. ☐
7. Any other plans specific for the business. ☐

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