Changing the most important number in the world: LIBOR

Sofian Nawaiseh - Associate - Banking & Finance
s.nawaiseh@tamimi.com - Doha

Matthew Heaton - Partner, Head of Office, Head of Banking & Finance - Qatar - Banking & Finance
m.heaton@tamimi.com - Doha

Our previous article entitled ‘Interest(ing) Developments: The Replacement of LIBOR’ issued early last year discussed the challenges of the impending replacement of LIBOR (the London Inter-bank Offered Rate). LIBOR is the benchmark interest rate at which major global banks lend to each other and is used as a basis to calculate the interest rates for various financial products in many countries around the world. The article also discussed the alternative risk free rates (‘RFR’) that have been proposed to be used to replace LIBOR and the key differences between LIBOR and the RFRs. Lastly, the article addressed a number of considerations for approaching new and existing transactions and the methods for drafting or amending the legal documentation for such transactions to address the cessation of LIBOR following the set deadline of 2021.

This article provides an update on the market and regulatory aspects of the cessation of LIBOR and the transition to alternative benchmarks as well as the approach of regulators and working groups towards meeting the end of 2021 deadline for LIBOR transition.

Background

LIBOR is referred to as the most important number in the world, applicable to an aggregate of more than US$300 trillion worth of contracts that use LIBOR as the basis for calculating interest rates. The end of 2021 is the deadline for the discontinuation of the publication of LIBOR for different currencies, which will inevitably impact all participants in the loans and financial markets. As such, regulators and other key authorities and associations, such as the Loan Market Association (‘LMA’) and the International Swaps and Derivatives Association (‘ISDA’) are working closely with market participants towards achieving the smooth transition from LIBOR to RFRs.

Markets update

During 2020, a significant number of market participants both in the regional and international financial markets recognised the need to incorporate provisions in their legal documentation to address the transition from LIBOR to RFRs.

In international markets, firms started to draft syndicated and bilateral loans and financing products referencing RFRs directly. For example, in September 2020, Tesco PLC, the English giant retail company secured a GBP 2.5 billion revolving credit facility involving a syndicate of 15 lenders, including BNP Paribas acting as sole co-ordinator and NatWest acting as agent and risk-free-rate manager. The facility agreement referenced the Sterling Overnight Index Average (SONIA) and the Secured Overnight Financing Rate (SOFR) for GBP and USD respectively from day one of the facility. SONIA and SOFR are both RFRs.

Furthermore, late in 2020 the Renewables Infrastructure Group secured a revolving credit facility of an amount of GBP 500 million referencing compounded SONIA for GBP.

Regionally, the markets' awareness of the ending of LIBOR has also risen in 2020, where lenders and borrowers in the region have started approaching the transition by agreeing on mechanisms to replace LIBOR and use different benchmarks, which are typically RFRs.

From the derivatives market's perspective, counterparties are keen to incorporate the fallbacks provisions introduced by ISDA. As at 27 January 2021, more than 12,000 entities across 80 jurisdictions have adhered to the ISDA protocol, which was published on 23 October 2020 and allows firms to incorporate the fallbacks into existing derivatives contracts. This is anticipated to significantly reduce the impact of LIBOR discontinuation.

Regulatory update

Regulators and legislative authorities have also stepped up efforts to deal with the benchmarks' reform. Authorities in the United States, the European Union and the United Kingdom have initiated a number of proposed laws to tackle the cessation of LIBOR.

US: The Alternative Reference Rates Committee ('ARRC') that is convened by the Federal Reserve Board and the Federal Reserve Bank of New York to help ensure a successful transition from USD LIBOR has proposed a legislative solution to minimise the uncertainty and adverse economic impact associated with the LIBOR transition. ARRC has advised that legislative action in New York is urgently needed to establish a clear path that would reduce the consequences and mitigate the associated risks of the cessation of LIBOR. The proposed legislation is aimed to resolve these issues, especially in legal contracts and agreements that lack any provisions that deal with the end of LIBOR. ARRC's proposal aims to deal with the benchmark reform through a legislative instrument, rather than having all counterparties individually agree to amend their existing contracts or to draft supplements to deal with the discontinuation of LIBOR.

It is proposed that the statute would: (1) prohibit a party from refusing to perform its contractual obligations or declaring a breach of contract as a result of the discontinuance of LIBOR or the use of the statute's recommended benchmark replacement; (2) definitively establish that the recommended benchmark replacement is a commercially reasonable substitute for and a commercially substantial equivalent to LIBOR; and (3) provide a safe harbor from litigation for the use of the recommended benchmark replacement.

Europe: On 24 July 2020 the European Commission stated that the LIBOR reform has become a realistic prospect, and proposed to amend the European Union rules on financial benchmarks, with the aim to ensure that the phase-out of a widely used benchmark does not cause disruptions to the economy or the financial stability in the European Union. On 30 November 2020, the European Union Commission had also stated that an agreement was reached by the European Parliament and the European Council on such proposed amendments. The agreed amendments to the benchmark regulations empower the European Union Commission to designate a replacement benchmark that covers all references to a widely used reference rate that is phased out, such as LIBOR. The agreed amendments will apply immediately after publication in the Official Journal of the European Union.

UK: In the UK, the Parliament has issued a statement on the proposed amendment in regulations to address the cessation of LIBOR. It stated that the UK will amend the existing regulatory framework for benchmarks and, in particular, the Benchmarks Regulations 2016/1011 as amended as well as enhance the powers granted to the Financial Conduct Authority (the UK Regulator) to ensure its sufficiency to manage the transition from LIBOR. Such amendments are intended to take place in the forthcoming Financial Services Bill.

MENA: On the regional scale, although local and international banks in the MENA region have started to spread the awareness of the transition to its customers, the regulators, and especially central banks, have yet to issue any definitive measures or recommendations that provide clarity on the impact of the LIBOR transition on the local markets. RFRs can be construed to constitute compounded interest which is not definitively permitted in the Gulf region due to Sharia considerations. To date, central banks in the GCC have not issued any binding directions or proposed measures on the replacement of LIBOR, and as such, one cannot anticipate the regulators' view on the use of the alternative RFRs. That said, we are aware that certain regulators have started canvassing banks on views on LIBOR replacement.

As a general movement, the Arab Monetary Fund ('AMF'), which is a regional working sub-organisation of the Arab League consisting of the 22 Arab countries, has published on 10 September 2020 general guidelines and principles addressed to all Arab member states on the replacement of LIBOR (and other Inter-Bank Offered Rates 'IBORs') as a benchmark for interest rates. These principles were introduced by the AMF in an attempt to provide a framework to approach this matter and to ultimately enhance the financial stability in the region.

The guidelines of the AMF included 21 principles, from which we set out a brief about the important principles in the table below. Note that the guidelines and principles introduced by the AMF are for guidance purposes and do not have any binding effect on regulators or other market participants in the region.

No.	Parties concerned	Principle
1, 2, 3	Central banks	Forming an interim provisional committee of the central banks to draw up a transition plan from LIBOR and other IBORs. The members of such committee are preferred to be from departments concerned with financial stability, banking supervision, foreign investments, open market operations, risk management, financial consumer protection, information technology, finance and legal. The committee shall study the following aspects: 1. the extent of exposure of the central banks and the financial sector to the benchmark reference rate LIBOR and IBORs; 2. developing a plan for a gradual cessation of LIBOR and IBORs; 3. issuing guidance to the financial sector on the cessation of LIBOR and IBORS; and 4. the potential transitional risks that may arise from the cessation of LIBOR and other IBORs.
4	Central banks	Promoting consultation and dialogue with commercial banks associations, in order to find a suitable alternative to IBORs.
5, 6	Central banks	Amend, where applicable, relevant instructions that provide for the use of IBORs and provide an alternative benchmark. If such amendments are inapplicable, provide new methodologies for calculating IBORs and for such methodologies to be audited by the Central Banks.
8	General	Instructions for financial consumer protection shall be reviewed, and to identify the appropriate legal solutions for bank clients having existing credit contracts tied to benchmark interest rates linked to LIBOR or IBORs.
9	Commercial banks	Commercial banks shall develop a strategy or plan approved by the bank's board of directors to the cessation of LIBOR and IBORs, provided that periodic reports are submitted to the board of directors by the bank's executive management on the plan's progress.
10	Commercial banks	Promote awareness of banks on the amendment of information technology systems related to variable interest rates to be aligned with any new instructions or guidelines issued by the Central Bank in this regard.
13	Commercial banks	Commercial banks shall submit periodic reports on their transition plans from LIBOR and IBORS to the Central Bank in accordance with the bank's directives.

18	Central banks	A suitable mechanism shall be set to obtain accurate data on financial sector exposure to LIBOR and IBORS (including contracts extending beyond 2021). Coordination with other local and foreign regulatory authorities shall also be enhanced.
19	General	Co-ordination and cooperation between the Central Banks, the Ministry of Finance, the Ministry of Economy and Planning, along with other relevant authorities is significant to determine the magnitude of the government's exposure to LIBOR (such as: international institutions loans, bond issues in local and foreign currency, Sukuk, investments, financial derivatives … etc.)

Conclusion

The importance of the replacement of LIBOR has now focused the attention of regulators, legislative authorities, organisations, global associations, banks, companies and individuals.

Changing the most important number in the world is definitely not a straightforward mission. Some are calling for an extension of the end of 2021 deadline claiming that COVID-19 has negatively impacted the market's transition from LIBOR. Such a delay seems unlikely, as it is now up to the market participants to use the remaining period to ensure that replacement of LIBOR occurs as smoothly as possible.

Al Tamimi and Company regularly issues updates on the latest regulatory and market developments to ensure that our clients are well aware and prepared for this transition and its impact on their businesses.

For further information, please contact Matthew Heaton (m.heaton@tamimi.com).