HUNTON& WILLIAMS

Client Alert

August 2017

The End of LIBOR

Last week, it was reported that the UK Financial Conduct Authority will discontinue LIBOR, the London interbank offered rate, at the end of 2021. LIBOR is an interest rate index used in calculating floating or adjustable rates on trillions of dollars in loans, bonds, derivatives and other financial contracts. Clients have begun to ask what happens under derivatives transaction documents when LIBOR is discontinued. This alert addresses some of their questions, many of which focus on fallback rates for existing transactions and successor rates for new transactions.

Previous LIBOR Discontinuation Events

Although LIBOR currently is calculated for US dollars, LIBOR previously was discontinued for currencies other than US dollars, including Canadian dollars, and those discontinuations may offer a useful analogy in determining what will happen when LIBOR is discontinued for US dollars at the end of 2021. ISDA, a derivatives trade association more formally known as the International Swaps and Derivatives Association, Inc., issued non-binding guidance on this in March 2013. According to ISDA, if parties to a transaction governed by ISDA documents wish to alter the fallback rates already provided in those documents or the ISDA definitions incorporated therein, the consensus of its members participating in a related working group was that the non-exhaustive options below are possible approaches for dealing with existing transactions that reference LIBOR rates for discontinued currencies. We note that these options also are possible approaches if those fallback rates are not available.

- Agree to use a substitute rate in lieu of the discontinued rate
- Terminate the affected transactions

Fallback Rates under Existing Contracts

US dollar LIBOR transactions governed by ISDA documents and the ISDA definitions incorporated therein generally provide for a fallback rate to be used if the related LIBOR rate is discontinued or otherwise is unavailable. The fallback rate for many US dollar LIBOR rates used in existing ISDA documents is a rate known as “USD-LIBOR-Reference Banks,” according to current ISDA definitions. This rate is determined by the calculation agent for a transaction and generally is based on rates at which US dollar deposits are offered by four major banks to prime banks in the London interbank market for the relevant interest period and in an amount that is representative for a single transaction in the relevant market at the relevant time. If at least two such quotations are provided, the arithmetic mean is used. If fewer than two such quotations are provided, the rate generally is determined to be the arithmetic mean of the rates quoted by major banks in New York City for loans in US dollars to leading European banks for the relevant interest period and in a representative amount.

Some of the concerns with respect to this fallback rate (and fallback rates, in general) are:

- It may not be consistent with other related transaction documents, such as promissory notes, loan agreements, bond indentures and/or trust agreements.

- It also may not be available upon discontinuation of the related LIBOR rate, which would result in an inability to determine any rate for the relevant transaction.
- Even if it is available, it may not be a comparable substitute for the discontinued LIBOR rate because of the related discontinuation, or the parties simply may not like it.

If the fallback rate is not available or if the parties wish to alter it because it is not consistent with other related transactions documents, it is not a comparable substitute for the discontinued LIBOR rate or they otherwise do not like the rates determined from use of the fallback rate, the only options the parties to an existing transaction may have are to amend their ISDA documents so as to agree on a substitute rate or to terminate the related transaction.

Successor Sources

Fallback rates should be distinguished from the successor sources for the LIBOR rates provided in ISDA documents and the ISDA definitions incorporated therein. A fallback rate applies when the related LIBOR rate fails to appear on a specified screen in an information service, such as the Reuters or Bloomberg service. The screen is the designated display page on that service or a successor source. Ordinarily, the parties do not expect such a failure to happen, and they typically believe that, even if it does happen, it will not happen regularly. However, upon the discontinuation of a LIBOR rate used in ISDA documents or the ISDA definitions incorporated therein, the related fallback rate always will apply if it then is available because there no longer will be a LIBOR rate. As its name implies, the successor source is limited to the succeeding source of the related LIBOR rate and does not provide for the substitution of any successor to the LIBOR rate, itself.

The successor source is as follows:

- The source officially designated by the LIBOR rate sponsor (now ICE, as BBA's successor)
- Or, if no sponsor-designated source, the source designated by the service provider (Reuters or Bloomberg)

Consequently, the provision for successor sources will not result in a substitute for LIBOR rates once those rates are discontinued because there then will be no LIBOR rates to appear at those sources.

LIBOR Substitutes in New Contracts and Amendments

In order for the parties to designate a successor to the LIBOR rate in a new or amended transaction governed by ISDA documents and the ISDA definitions incorporated therein, the provisions below should be included in the related trade confirmation or amendment. Although these provisions will be useful primarily in LIBOR transactions that are scheduled to terminate after LIBOR is discontinued, the provisions also may become useful at any earlier time during which LIBOR becomes so unreliable that it may no longer appears regularly on the specified screen in the related information service.

- "Successor Price Source," which would be:
    - Maybe, one of the U.S dollar rates published by ISDA, such as:
        - "USD-ISDA-Swap Rate," or
        - "USD-Federal Funds-H.15" , or
        - "USD-Prime-H.15," or

- More likely, a repo financing rate for US Treasury securities, such as one of the rates currently under development by the Federal Reserve Bank of New York (and which might be published by ISDA in the future)

- "Successor Price Source Effective Date," which could be:
    - An actual date, such as January 1, 2022 (the day after the currently scheduled US dollar LIBOR discontinuation date)
    - Language, such as:
        - "The calendar day after the date that the UK Financial Conduct Authority discontinues the London interbank offered rate for US dollars." or
        - "The earlier to occur of the [third] consecutive reset date and the [fourth] reset date in any 12-month period on which LIBOR fails to appear on the specified screen in the related information service"

If the Successor Price Source reflects relatively less credit risk than the discontinued LIBOR rate (and even if it is not such a rate), the parties may wish to specify that an interest rate spread or other price adjustment will apply beginning on the Successor Price Source Effective Date. Some of the potential Successor Price Sources may not require LIBOR inputs such as "Designated Maturity," which is the relevant interest period. Other such sources may require the designation of different or additional inputs as of the Successor Price Source Effective Date, including a change in the relevant "Day Count Fraction" from Actual/360 to another measure for calculating interest or the addition of a "Rate Cut-off Date" for purposes of determining interest rates in the days leading up to payment dates, "Compounding" details or other terms.

Conclusions

In 2014, ISDA published a form of Bilateral Amendment Agreement for Certain Rate Swap and Other Transactions for purposes of amending existing transactions to substitute a rate to be used in lieu of a discontinued rate. Although this form can be used as a starting place or initial draft for amendments, it does not address the complexities of changing related terms and other inputs as discussed above. Additionally, the ISDA 2013 Discontinued Rates Maturities Protocol seems to apply only in circumstances where the relevant interest periods for published rates have been discontinued and does not seem to apply when the published rates, themselves, are being discontinued in their entirety, such as in the case of US dollar LIBOR.

At this time, there is uncertainty about the substitutes for LIBOR rates in cleared derivatives and about how this uncertainty will affect clearing determinations made by the parties to prospective LIBOR rate transactions. It is possible that the specification of a Successor Price Source and a related Successor Price Source Effective Date will, at least until uncertainty about substitutes for LIBOR rates in cleared derivatives is resolved, cause a swap having such specifications to not be accepted by a clearinghouse or to include idiosyncratic specifications that will result in the swap not being included among the classes of swaps subject to clearing requirements.

Parties should consult their counsel about the effects of US dollar LIBOR discontinuation on both their cleared derivatives and their derivatives governed by ISDA documents and the ISDA definitions incorporated therein. Hunton & Williams attorneys are available to furnish more information on these matters, to advise you with respect to applicable laws and to assist you with your derivatives transactions.

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