LIBOR transition – Hong Kong and Mainland China

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Banks and their customers are now deep in negotiation over how to amend their documents to take into account the transition from LIBOR to risk free rates (RFR).

In this alert, we summarise the key points that are most regularly considered in Hong Kong*.

1. LIBOR transition - recent FCA announcement

The LIBOR manipulation cases post the global financial crisis in 2008 exposed the benchmark rate weaknesses. Almost five years after Andrew Bailey's first speech in 2017 announcing plans for the Financial Conduct Authority (FCA) not to exercise its power to compel panel banks' submission to determine LIBOR, the FCA announced[1] on 5 March 2021 that all LIBOR settings will either cease to be published or will no longer be representative at specified future dates (summarised below). The FCA announcement is another important global milestone on LIBOR transition. It is clear LIBOR transition is charging ahead at full speed. There is no time to waste.

2021

5 Mar 2021

- FCA announcement

31 Dec 2021

- The following LIBOR settings will permanently cease to be published after 31 Dec 2021:
  - All 7 Euro LIBOR settings
  - All 7 Swiss Franc LIBOR settings
  - Sterling LIBOR settings : overnight, 1wk, 2m, 12m
  - Japanese Yen LIBOR settings: Spot-next, 1wk, 2m, 12m
  - USD LIBOR settings: 1wk, 2m
- The following LIBOR settings will permanently cease to be published after 31 Dec 2021, but subject to consultation (by FCA) be provided post-31 Dec 2021 on a 'synthetic' basis:
  - Japanese Yen LIBOR settings: 1m, 3m, 6m
  - Sterling LIBOR settings: 1m, 3m, 6m

2022

30 Dec 2022

- Japanese Yen LIBOR settings of 1m, 3m & 6m (subject to FCA consultation on post 31 Dec 2021 publication on a 'synthetic' basis) will permanently cease to be published

Where any LIBOR setting is published on a 'synthetic' basis,

- they will no longer be representative of the underlying market and economic reality that such setting is intended to measure, and that representativeness will not be restored by the FCA.
- the FCA's proposed methodology to compute a LIBOR setting synthetically uses a forward looking term rate version of the relevant RFR plus a fixed spread adjustment (calculated over the same period and in the same way as the spread adjustment implemented in the IBOR Fallbacks Supplement and the 2020 IBOR Fallbacks Protocol published by ISDA).

2023

30 Jun 2023

- The following LIBOR settings will permanently cease to be published after 30 June 2023:
  - USD LIBOR settings: overnight, 12m
- The following LIBOR settings will permanently cease to be published after 30 June 2023, but subject to consultation (by FCA) be provided post 30 June 2023 on a 'synthetic' basis:
  - USD LIBOR settings: 1m, 3m, 6m

[1] https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf

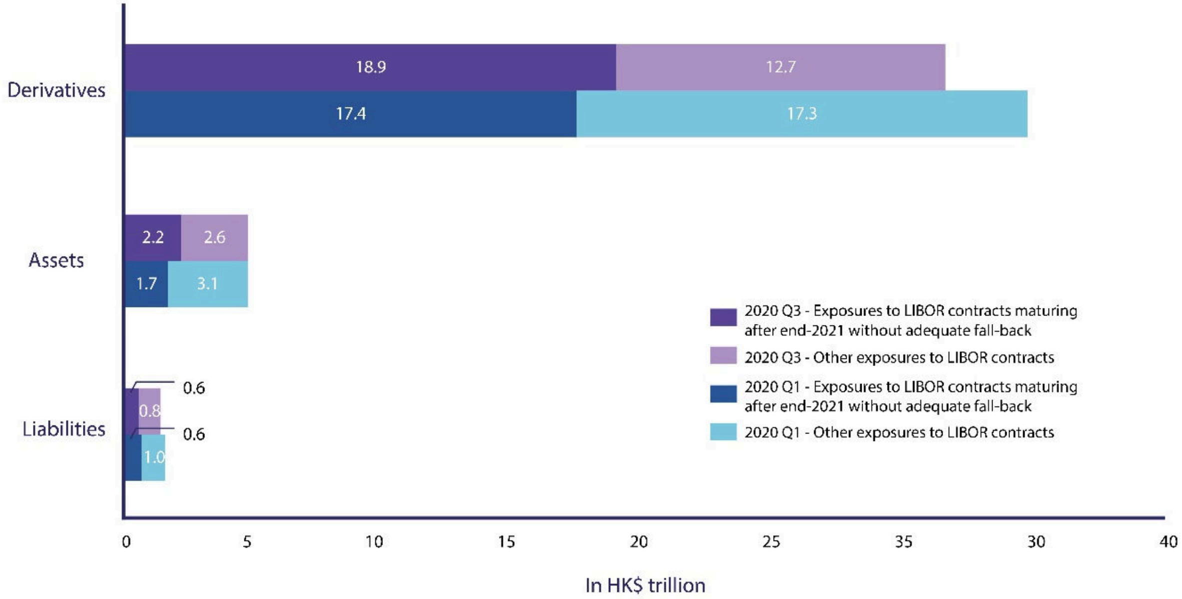
Hong Kong and Mainland China** LIBOR transition

As an international open economy and the world's third largest USD forex trading centre, most debts and bank exposures in Hong Kong are denominated in foreign currencies (in particular USD) and are largely LIBOR-based.

As of September 2020, the Hong Kong Monetary Authority (HKMA) estimated that there were HK$4.8 trillion of assets and HK$1.4 trillion of liabilities in the Hong Kong banking system referencing LIBOR, representing about 30% and 10% respectively of the banking system's total assets and total liabilities denominated in foreign currencies.

The notional value of derivative contracts referencing LIBOR aggregates to HK$31.6 trillion. More than 40% of these LIBOR-linked assets and liabilities and about 60% of these derivatives contracts mature after 2021 and do not have adequate fallback provisions to cater for a LIBOR discontinuation scenario.

The international progress and discussion on LIBOR transition is therefore extremely important and relevant for Hong Kong.



Source: HKMA

Domestic banks in Mainland China also carry out foreign currency businesses based on LIBOR and therefore need to undergo LIBOR transition (*White Paper Participating in International Benchmark Interest Rate Reform and Improving China's Benchmark Interest Rate System* (White Paper) published by People's Bank of China on 31 August 2020). The issue is on a relatively smaller scale compared to Hong Kong with LIBOR exposures maturing after 2021 for 15 major domestic banks amounting to around US$900 billion as of Q2 2020 (according to the White Paper).

In this article, we highlight the common issues market participants in the region come across whilst navigating LIBOR transition and provide a Hong Kong and Mainland China market update on the progress of the transition. This is a practical guide on the latest positions in the local market and reflects our work helping clients create RFR based documents and transition their legacy LIBOR documents to incorporate RFR technology.

2. COMMON NEGOTIATION POINTS

2.1 Compound v simple average

RFRs are overnight rates. The daily payment of interest based on each day's overnight rate is impractical, an average RFR is used to calculate interest over an interest period. Average RFRs also means day-to-day fluctuations in market rates are smoothed.

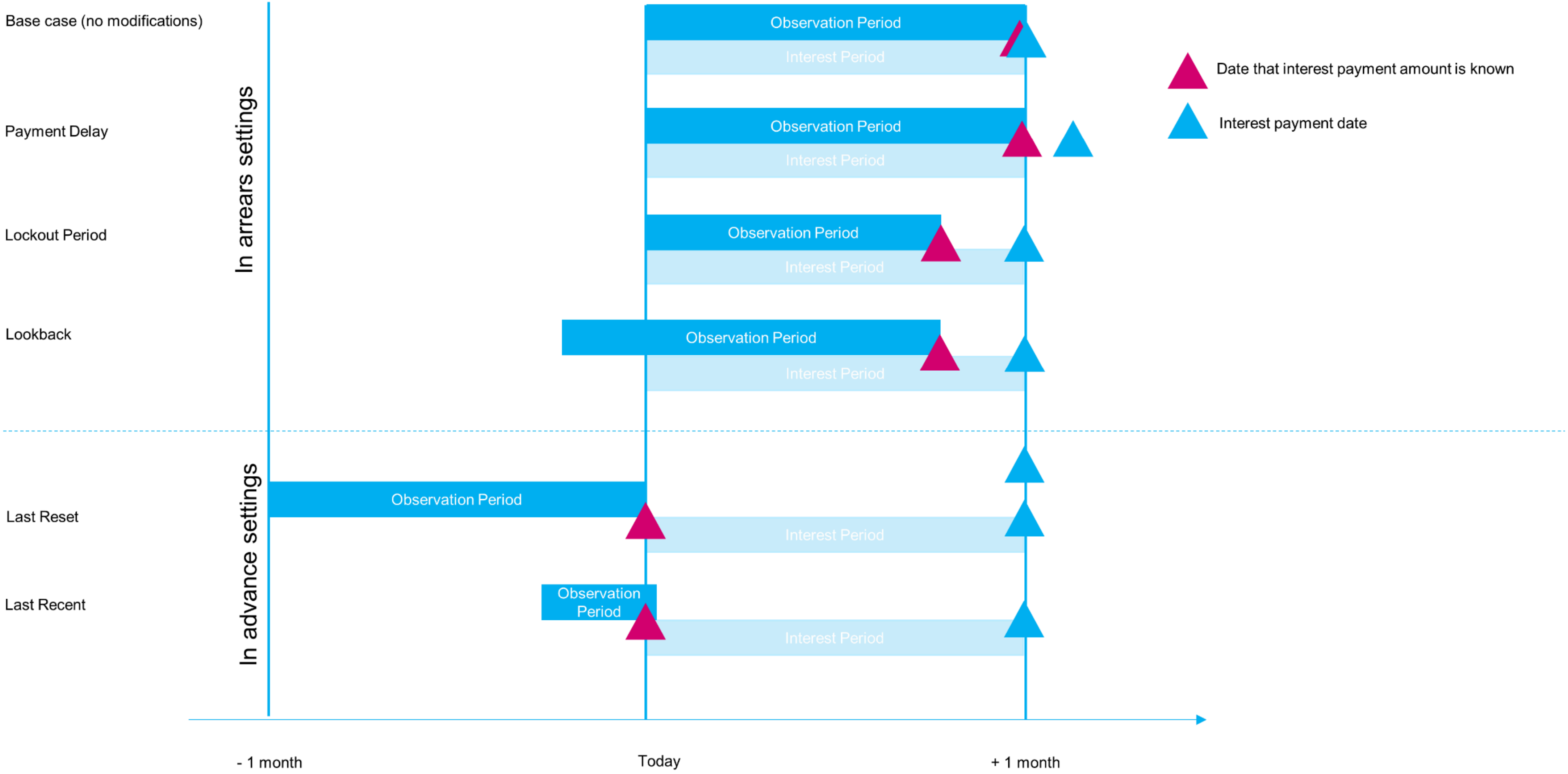
An average RFR can either be calculated using simple interest or compound interest.

Simple daily RFR:	this is the simple arithmetic mean of the daily RFR.
Compounded daily RFR:	recognises that the borrower does not pay interest owed on a daily basis and therefore keeps track of the accumulated interest owed but not yet paid. The additional amount of interest owed each day is calculated by applying the daily RFR to the principal borrowed and the accumulated unpaid interest.

Both methods are used in financial products as the difference between the results of the calculations are generally small. Whilst from an economic perspective, compound interest is more accurate taking into account the time value of money, simple interest is much easier to calculate and banks may find they already have the systems to support the calculation. Ultimately, the method to be used will depend on the preference to reduce basis risk and the practicality of calculation.

2.2 Setting in advance vs in arrears and lookback periods

Unlike LIBOR which is a forward-looking term rate and is publicly available at the beginning of an interest period, RFRs are backward-looking. Most RFRs (other than SARON, which publishes final fixing on the same business day after market close) are published on the next day – that is, they are published on the day after the day on which the reference transactions took place rather than on the day the transaction took place. In the absence of any modifications, a borrower would only have several hours' notice before their payment is due if an in arrears convention for calculating the average RFR is used. The diagram below summarizes some of the common modifications that are available to address this issue:



Base case (no modifications)
Payment Delay
Lockout Period
Lookback
Last Reset
Last Recent
In arrears settings
In advance settings
Observation Period
Interest Period
Date that interest payment amount is known
Interest payment date
- 1 month
Today
+ 1 month

Options for in arrear settings (which involves determining an RFR over an interest or observation period to produce a backward-looking rate):

- ***Option 1 – payment delay*** delay interest payment so that payment is only made after the whole interest period has passed and the average RFR for that interest period can be calculated. There is potential for a mismatch in the last interest period if the interest payment is paid after repayment of the loan principal.
- ***Option 2 – lockout period*** stop updating the average RFR several days prior to the end of an interest period (the lockout period) and apply the RFR of the day before the lockout period to the rest of the interest period. This is the predominant calculation method (predominantly with SOFR floating rate notes). However, the calculation might be considered a little less transparent for clients and more complex to implement operationally. There may also be slightly greater challenges when it comes to hedging the underlying risk.
- ***Option 3 – lookback*** move the period in which the RFR is observed ("the observation period") which is the same number of business days as the interest period) such that it starts and ends several days before the interest period starts and ends. As a result, a calculation of the average RFR is made several days prior to the end of the interest period.

Option for in advance settings (which involves determining an RFR over the interest period prior to such interest period to produce a rate known in advance):

- ***Option 1 – last reset*** the interest payment is determined on the basis of the average RFR of the previous period. The rate is "stale" but it provides absolute certainty to borrowers.
- ***Option 2 – last recent*** a single RFR or an average RFR for a short number of days is taken and applied to an entire interest period. This option produces difficulty in hedging the underlying risk.

The derivatives market based on RFRs, which already exists or is in the process of developing, uses an *in arrears* structure. The cash market based on RFRs so far prefers to use an *in arrears* structure with a lookback often set at the current market recommendation of five business days. That is, the observation period begins five business days before the beginning of the relevant interest period and ends on (but excludes) the day five business days before the end of that interest period.

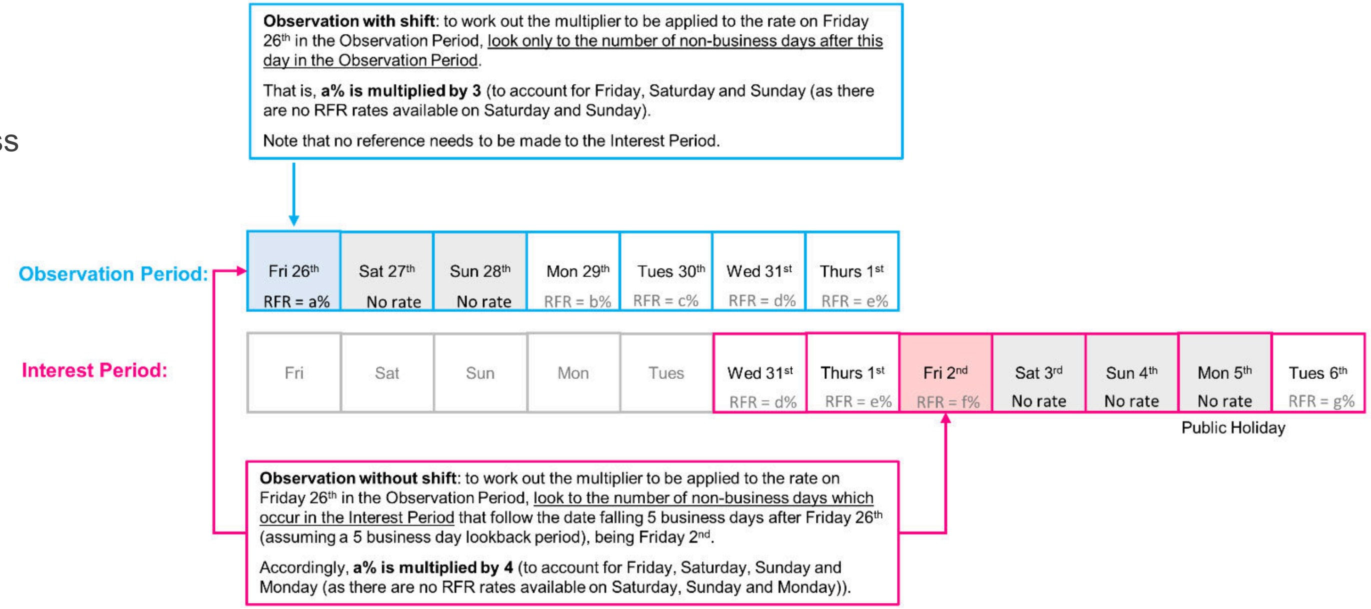
Whilst an in arrears structure with lookback is fast becoming a preferred method, such a methodology may not work for all product types. For example, trade finance products may require an in advance calculation.

2.3 Observation shift vs Without Observation Shift

Where a lookback is used with a compounding formula, non-business days in a period are addressed by applying a multiple to an RFR for any business day if it is followed by non-business days. For example, the RFR for a Friday is multiplied by three (since Saturday and Sunday are non-business days, assuming Monday is not a public holiday).

An issue is where the number of non-business days (on which there is no daily RFR published) in an observation period differs from the number of non-business days that are contained in the relevant interest period.

- ***Option 1 – observation shift method:***
  - The relevant non-business days occur in the observation period. That is, the weighting of daily RFRs is "shifted" to the observation period; and
  - the multiplier is applied to the RFR for any business day during the observation period if that business day is immediately followed by one or more non-business days.
- ***Option 2 – observation shift method:***
  - The relevant non-business days occur in the interest period; and
  - (assuming a typical lookback period of five business days between the interest period and its observation period) the multiplier is applied to the RFR for any business day during the observation period if the day that is five business days after that business day is immediately followed by one or more non-business days.



It is unlikely that the two methods produce significantly different calculations. There are practical differences, however. Operationally, the "shift method" may be easier to calculate, as an observation shift method means there is no impact from any variables outside the observation period, it can be calculated from a published index of the relevant compounded average which is not possible using the "without shift" method.

Generally, loan transactions use a without observation shift method and this is recommended by the Alternative Reference Rates Committee (ARRC) and the Sterling RFR Working Group.

2.4 Credit Spread Adjustment

A switch from LIBOR to an RFR-based alternative rate should not involve any transfer of value from one party to the other. The total amount of interest that a borrower pays after the switch should stay the same. LIBOR and RFRs are, however, calculated using different methodologies. An RFR does not price in bank credit risk or term risk, so inevitably, RFRs will be lower than a term LIBOR in the same currency – an issue for lenders.

To address this, industry working groups recommend the use of a credit spread adjustment to accommodate the differences observed and minimize value transfer to the extent possible. The current market approach for the credit spread adjustment is based on the historical median with five-year lookback period that calculates the difference between LIBOR and the relevant RFR over five years' worth of daily data points. This was to be fixed when fallback language was triggered. Accordingly, as a result of the FCA announcement on the future cessation and loss of representativeness of the LIBOR benchmarks on 5 March 2021, the International Swaps and Derivatives Association (ISDA) has announced[2] that the credit spread adjustment is fixed as of the date of that announcement for all Euro, Sterling, Swiss Franc, US dollar and Yen LIBOR settings.

Despite the fact that a credit spread adjustment is applied to remove any transfer of value, stronger borrowers may argue to resist such an adjustment.

2.5 Whether the waterfall structure should include forward-looking rates

Forward-looking term RFR rates are still currently being developed. ARRC issued a statement[3] on 23 March 2021 indicating it will not be in a position to recommend a forward-looking SOFR term rate by mid-2021 and cannot guarantee it will be in a position to recommend an administrator that can produce a robust forward-looking term rate by end-2021. An issue that parties may consider is whether fallback language should go to a forward-looking rate if it has been developed by the time a rate switch is to occur. Different approaches have been recommended by the various industry associations. Given the discrepancies in the market language for various product types and jurisdictions, parties should consider the hedging implications and strategy when negotiating the fallback waterfall.

ARRC (US)

Published recommended language for, amongst other products, bilateral and syndicated USD-denominated loans. The ARRC recommendation is to use "hardwired" fallback language where the replacement rate will generally follow the following waterfall structure:

i. Term SOFR + credit spread adjustment

ii. Daily simple SOFR (or daily compounded SOFR) + credit spread adjustment

Loan Market Association (LMA)

The exposure drafts published by the LMA, however, do not contain a fallback to an initial forward-looking term RFR.

ISDA

The ISDA 2020 IBOR Fallbacks Protocol proposes a fallback language of daily compounded RFR in arrears + credit spread adjustment, also not referring to any forward-looking RFR.

[2] https://www.isda.org/2021/03/05/isda-statement-on-uk-fca-libor-announcement/
[3] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/arrc-press-release-term-rate-for-publication

3. HONG KONG FOCUS

3.1 HIBOR and HONIA's co-existence

HIBOR
The Hong Kong Interbank Offered Rate, a set of reference rates owned by the Hong Kong Association of Banks, has been used as the primary local benchmark in Hong Kong.

HONIA
As a member of the Financial Stability Board (FSB), the working group on Alternative Reference Rates under the Treasury Market Association (TMA) of Hong Kong followed FSB's recommendation to identify the Hong Kong Dollar Overnight Index Average as the alternative reference rate to HIBOR. HONIA is an overnight interbank funding rate based solely on transaction data.

The HKMA has indicated that there is no plan to discontinue HIBOR. Market participants therefore expect HIBOR to co-exist with HONIA in the near future. This comes as good news for most Hong Kong market participants as it eases the pressure to develop and transition HIBOR products whilst focusing on transitioning LIBOR-based contracts.

3.2 Hong Kong milestones

In July 2020, the HKMA mandated three milestones to encourage firms to transition away from LIBOR:

1 Jan 2021

- Authorised institutions (AIs) should be in a position to offer products referencing alternate reference rates (ARRs) to LIBOR.
- AIs to ensure adequate fallback provisions are included in all newly issued LIBOR-linked contracts maturing after end-2021.

~~30 Jun 2021~~ End-2021

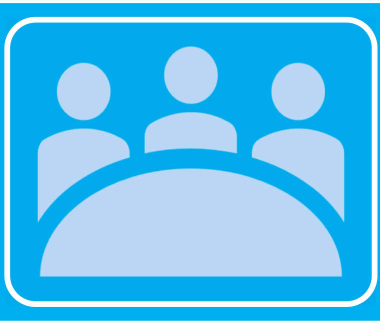
- AIs to cease to issue new LIBOR-linked products that will mature after 2021.

Insufficient liquidity in RFR-based products coupled with the lack of forward-looking term RFRs created concerns amongst market participants in transitioning by mid-2021, a timing earlier than similar milestones in other jurisdictions. For instance, the ICE Benchmark Association indicated earlier that certain LIBOR tenors will continue to be published until 30 June 2023 whilst the HKMA milestone to cease issuance of LIBOR-linked products has been set to be two years prior to such date. For AIs which should by now be familiar with LIBOR transition, the vast amount of internal coordination amongst different departments and systems, including information technology and systems, the lack of client education and awareness and complex documentation prove early adherence to the milestones to be difficult. Transition is also made more difficult when corporates struggle to understand the potential impact on profits and losses brought about by hedging mismatches and potential value transfer issues. On 25 March 2021, the HKMA issued an additional circular to indicate that it is no longer appropriate to stick to the earlier timeline to cease new LIBOR-linked products by the end-June 2021, but AIs should continue to press ahead on LIBOR transition and not issue new LIBOR-linked contracts by the end of 2021.

3.3 Hong Kong market update

Derivatives	• Most AIs in Hong Kong are global financial institutions which adhere to the ISDA 2020 IBOR Fallbacks Protocol (or with most trades referencing the 2006 ISDA Definitions as supplemented by the IBOR Fallbacks Supplement). • All new derivatives entered into on or after 25 Jan 2021 which reference ISDA's standard definitions (as supplemented by the IBOR Fallbacks Supplement) include the robust fallbacks for interest rate derivatives linked to major IBORs. Adherence to the ISDA 2020 IBOR Fallbacks Protocol means that legacy non-cleared derivatives referencing LIBOR (where both parties have adhered) have been amended to incorporate similar robust fallbacks. • ISDA also published various templates for parties which wish to amend their derivatives contracts bilaterally.
Loans	• With the HKMA setting the Hong Kong milestones in July 2020, AIs have developed robust plans for LIBOR transition which incorporates risk quantification and evaluation, systems enhancements and communication plans with their clients. Most clients appear to be aware of the LIBOR transition issue but there is relatively little interest in lending or borrowing based on RFRs. In terms of documentation, most clients previously chose to include the Asia Pacific Loan Market Association (APLMA) form of "Replacement of Screen Rate" language which simply provides for a lower consent threshold to agree a replacement benchmark rate (than would otherwise apply), but not final details or methodologies for calculating a benchmark rate upon LIBOR cessation. As a result of the FCA announcement, clients are now considering amendments to their transaction documents. • The FCA announcement on 5 March 2021 constitutes a "Screen Rate Replacement Event" under the Replacement of Screen Rate language and provides for definite cessation dates for certain LIBORs. We therefore expect corporate borrowers to now actively engage with their lenders on LIBOR transition (including adapting a rate switch approach in documentation (meaning the facility is LIBOR-based at the start and will switch to an RFR-based rate upon a trigger event). APLMA has published exposure drafts which we see lenders and borrowers beginning to adopt.
Notes/ Bonds	• LIBOR transition remains largely irrelevant as most notes issued in Asia are fixed-rate notes. For floating rate notes, we have seen a number of approaches, ranging from the ARRC language for new issuances of LIBOR floating rate notes, to the parties agreeing to appoint a third party to decide on the relevant replacement RFR. Issuances of RFR notes remain scarce in Hong Kong.

4. MAINLAND CHINA FOCUS



International benchmark interest rate reform working group

- formed under the People's Bank of China's (PBOC) guidance after Sep 2019.
- workstreams include research on transition of various LIBOR-referencing products, including bonds, derivatives deposits and loan products, tracking latest updates on international benchmark interest rate reform and monitoring domestic LIBOR exposures closely.
- include 15 major national banks, including the Bank of China (BOC), Industrial and Commercial Bank of China, Export-Import Bank of China and China Development Bank.
- held 5 meetings as of Aug 2020 which discussed the latest updates on LIBOR transition which impact the Chinese domestic market and each member's internal progress on LIBOR transition.

Progress on LIBOR transition

- major banks in the Mainland China have comprehensively assessed the impact of LIBOR cessation, and coordinated with their foreign branches to formulate internal LIBOR transition guidelines and plans.
- PBOC has not set any milestones for domestic banks to ensure cessation of LIBOR-based financial products, but PBOC indicated it will do so according to the benchmark interest rate transition progress domestically.
- examples of developing RFR-based products include BOC's investment in RFR-based bonds and notes, and SOFR-based debt instruments issuance in the US onshore market since 2019. In early 2020, the China Foreign Exchange Trade System launched new derivative products referencing new RFRs where domestic banks had participated in cross currency swaps and interest rate swap transactions referencing SOFR and other RFRs.
- PBOC had also requested the National Association of Financial Market Institutional Investors to revise derivatives agreements and definitions as soon as possible taking into account LIBOR transition, particularly as the NAFMII agreements have not been included as in-scope documents under the ISDA 2020 IBOR Fallbacks Protocol.

Chosen RFR and future development of term DR

- the White Paper provides an overview of existing interest rates in the Mainland repo and interbank market, including Depository- Institutions Repo Rate (DR) which is the expected RFR to be developed and adopted in the future, given such rate best reflects the level of liquidity and funding rates in the banking sector, its relatively high market recognition and its closest resemblance to an RFR.
- the next priority in the development of Mainland China's benchmark interest rate system is to promote the wider use of DR in derivatives transactions and interbank businesses (especially in certificate of deposit issues, interbank lending and deposits). PBOC also indicated that it will look to construct term rates based on the short-term DR.

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*** Any references to "Mainland China" shall be construed to be a reference to "The People's Republic of China which for the purposes of this article only, does not include Hong Kong, the Macau Special Administrative Region or the region of Taiwan".*

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