LIBOR TRANSITION: THE END GAME

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PREAMBLE

We set out in this article some key issues to which banks and corporates need to pay attention in the final stage of London Interbank Offered Rate (LIBOR) transition in the Hong Kong SAR[1] and mainland PRC lending market. If you have any questions or feedback, please get in touch (please see contact details at the end of this article).

WHEN WILL LIBOR END

Four out of the five currencies of the panel-bank based LIBOR (namely, Sterling, Euro, Swiss Franc and Japanese Yen) and the US dollar one week and two month settings ceased to be published after 31 December 2021. US dollar LIBOR settings for overnight, one, three, six and twelve month tenors will continue until 30 June 2023[2]. With fewer than 8 months remaining until the cessation of all remaining tenors of US dollar LIBOR, banks and corporates should act now to prepare for the final stage of LIBOR transition.

LIBOR TRANSITION - THE CURRENT FOCUS

Even though US dollar LIBOR settings for tenors of overnight, one month, three months, six months and twelve months are expected to be published and available until the end of June 2023, banking regulators including those in the United States, the United Kingdom and Hong Kong have mandated that (barring limited exceptions) no new LIBOR contract shall be entered into after the end of 2021. As a result, banks operating in these markets have already been utilising risk-free rates (RFRs) instead of LIBOR in new loans and are becoming more familiar with the application of RFRs. We understand that most banks have adapted to entering into and managing RFR loans using updated documentation templates and internal systems. Having said that, there is some divergence in the preference of RFR calculation methodologies (for example, in arrears, term or other forward-looking RFRs; use of observation shift in in-arrear methodologies, use and determination of credit adjustment spread etc.).

While the People's Bank of China has urged banks in mainland China to proactively transition from LIBOR, it appears that in practice, banks in mainland China are not strictly prohibited from continuing to use LIBOR in new loan transactions. However, with fewer than 8months before the end of LIBOR, the likelihood that the term of a new loan facility will expire after 30 June 2023 is becoming higher, and as a result we believe that there will be increasingly fewer new LIBOR loans going forward.

The transition of legacy LIBOR loans has become the focus of the final stage of LIBOR transition. If a legacy LIBOR loan has a term expiring after the end of June 2023, unless it has hardwired LIBOR replacement provisions[3], there is a risk that the cessation of LIBOR may lead to undesirable[4] or

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[1]Any reference to "Hong Kong" or "Hong Kong SAR" in this article shall be construed as a reference to "Hong Kong Special Administrative Region of the People's Republic of China".

[2] The United Kingdom's Financial Conduct Authority is assessing (taking into account opinions obtained through public consultation) the publication of "synthetic" US dollar LIBOR for one month, three months and six months settings after 30 June 2023. However, "synthetic" US dollar LIBOR will no longer be "representative" based on the Benchmark Regulation (EU) 2016/1011.

[3] "Hardwired" LIBOR replacement provisions in a loan agreement provide for the replacement of LIBOR with an RFR upon the occurrence of specific trigger events without further negotiation. The RFR that replaces LIBOR is based on a pre-defined waterfall of available successor rates. It is expected that a loan agreement adopting a hardwired approach does not require amendments to achieve transition from LIBOR to the relevant RFR (or in a syndicated loan context, a facility agent may be authorised to implement necessary conforming changes to the loan agreement without seeking consent from the syndicate).

[4]For example, some borrowers may find a fall-back to a bank's costs of funds (which may be contained in a loan agreement) to lack objectivity in determining the base interest rate after cessation of LIBOR. Alternatively, a fall-back to the last historical LIBOR may in effect render a variable rate loan to become a fixed rate loan.

uncertain consequences or difficulties in the determination of the interest rate[5].

With fewer than 8 months before the end of LIBOR, banks and corporates should promptly make any necessary amendments to their LIBOR-linked loan agreements:

- For banks, pro-active management of their legacy LIBOR loan transactions not only prevents a large number of enquiries and urgent amendments nearer to the end of LIBOR at the end of June 2023, but also mitigates the risk of uncertainty or difficulty in the determination of interest rates. Banks may also take the opportunity to discuss with borrowers other amendments to the loan transaction which may not be related to LIBOR transition, or to re-finance their legacy LIBOR loans (using an RFR in the new loans).

- For corporates, in addition to the considerations above, continuing interest rate hikes and turbulence in the financial markets may continue to drive up the actual gap between LIBOR and the Secured Overnight Financing Rate (SOFR). Moving from LIBOR to SOFR sooner rather than later could be economically beneficial to corporate borrowers when the transition from LIBOR to SOFR is made based on the historical 5-year median credit adjustment spread (see further below).

WHAT ABOUT HIBOR

HIBOR is commonly used in Hong Kong dollar floating rate loans. The Hong Kong Monetary Authority has indicated that there is currently no plan to discontinue HIBOR. As such, the urgency on interest rate transition relates to LIBOR linked loans.

OTHER ISSUES IN FOCUS

Based on our experience assisting international and Chinese banks, as well as corporates in their LIBOR transition, we observe that banks and corporates could benefit from an in-depth understanding of the practical operation and impact of different RFR terminologies, as well as getting external assistance in drafting or reviewing, and negotiating any necessary amendments to finance documents.

We share our observations below on other key issues stakeholders in the lending market are concerned with:

1. How to amend LIBOR loan agreements

There are two common amendment approaches:

- The first is an "amendment and restatement" of the loan agreement. Each and every relevant clause in the loan agreement will be reviewed and revised to reflect the replacement of LIBOR by the relevant RFR, including all conforming changes. The loan agreement so revised (which is called an "amended and restated loan agreement") will be attached to a relatively simple "cover amendment letter" or "amendment deed", in which the conditions to the amendments taking effect will be set out. The advantage of the amendment and restatement approach is that necessary changes will be precisely reflected in each relevant clause of a facility agreement, and the amended and restated facility agreement is easy to read on a standalone basis. However, the drafting process has to be customised and may take longer. The costs may be higher too.

- The other common type of amendment approach is by way of an "overriding amendment", pursuant to which changes to the loan agreement will be described in a universal and generic manner to effectively replace LIBOR with the relevant RFR, without referring to specific clauses and sections in the loan agreement. Parties will enter into an amendment deed to that effect. The advantage of this approach is that a meticulous review of the loan agreement is not necessary, reducing the time required and the costs of the parties. The form of amendment deed effecting such overriding amendment may also be used to amend a variety of loan agreements even if they are not in identical form.

No matter which amendment approach is adopted, the consent of the relevant parties to the loan agreement will be required. This may include requiring consent from guarantors and security providers that are party to other finance documents[6].

[5] In the United States, federal legislation was passed in March 2022, which enables certain "tough legacy" contracts governed by US law to automatically transition to risk free rates after 30 June 2023. In the United Kingdom, legislation was passed at the end of 2021 to address "tough legacy" contracts or arrangements governed by the laws of England and Wales, Scotland or Northern Ireland, but the scope of application is relatively limited. There is no such legislative intervention under Hong Kong law. Given the popularity of English law and Hong Kong law in the loan market in the Asia Pacific, pro-active actions by contract parties to facilitate LIBOR transition are especially important.

[6] This has to be analysed on a case-by-case basis. Factors to consider include contractual requirements, nature of credit support, and any relevant local law requirements.

2. Recent practices in amending bilateral and syndicated loan agreements

For syndicated loans, if the loan agreement is based on the recommended forms or exposure drafts from the Asia Pacific Loan Market Association or the Loan Market Association, there may be replacement of screen rate clauses to facilitate LIBOR transition. Based on our observation, in the Asia Pacific market, hardwired replacement clauses are not commonly adopted. Most syndicated loan agreements provide for a lower lender consent threshold (for example, majority lenders instead of all lenders) for amendments relating to LIBOR transition. For syndicated loan agreements that require amendments to facilitate LIBOR transition, the "amendment and restatement" approach mentioned above is generally adopted.

For bilateral loans, in particular those uncommitted loans that are repayable on demand, the loan agreement may allow the bank to make unilateral amendments (including amendments to interest rate provisions). For bilateral loan agreements (in particular those in the form of facility letters) that require amendments to facilitate LIBOR transition, the "overriding amendment" approach mentioned above is commonly adopted.

3. The use of Term SOFR

Term SOFR is a forward-looking term interest rate derived from market expectations implied from leading derivatives markets, and is managed by CME Group Benchmark Administration Limited (CME). Similar to LIBOR, Term SOFR setting is published for different tenors[7], and can be determined prior to the commencement of an interest period. Term SOFR has been endorsed by the Alternative Reference Rates Committee (ARRC) to be used in US dollar commercial loans[8]. Because of the similarities between Term SOFR and LIBOR, loan agreements adopting Term SOFR are generally simpler than loan agreements which adopt SOFR in arrears methodologies and use language similar to LIBOR-linked loans.

Participating banks to syndicated or bilateral loans are required to sign an information licensing agreement with the CME to obtain the relevant use licence. An "end user" (for example, a borrower or a guarantor) does not need a use license for Term SOFR to enter into a transaction.

4. Credit Adjustment Spread (CAS)

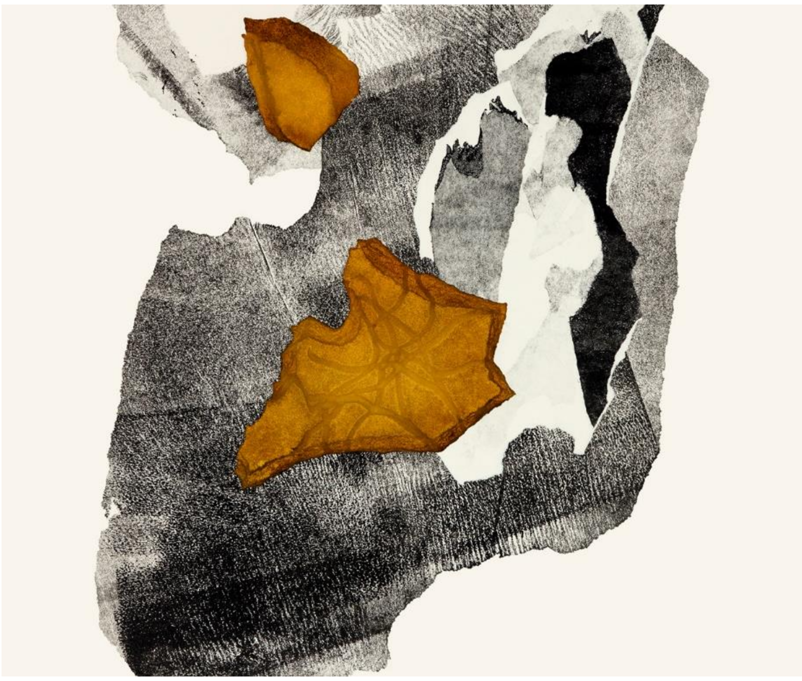
As compared to LIBOR (which is an unsecured interbank lending rate reflecting the credit risk of borrowing banks), SOFR is an overnight financing rate secured by US Treasury securities with minimal default risk, and as such SOFR does not reflect any credit risk premium.

Because of this, a credit adjustment spread (CAS) may be added to SOFR when SOFR is used to replace LIBOR in order to avoid a value transfer between lenders and borrowers as a result of the transition:

LIBOR = SOFR + CAS

Market participants may consider the following factors when deciding whether to apply CAS and (if CAS is applied) how to determine its value:

- While CAS was intended to be used to avoid any value transfer between lenders and borrowers in transitioning legacy LIBOR loans to RFRs, we are seeing a significant number of new RFR loans incorporate a CAS. The use of CAS in new RFR loans at this stage of LIBOR transition could be a useful tool to increase transparency (so that a borrower who is familiar with LIBOR linked facilities can make comparisons more easily), and it could more accurately reflect the different credit risk premium to loans of different tenors.



[7] Term SOFR has four tenors, namely, one month, three months, six months and twelve months.

[8] Please note that even though Term SONIA is available, the Working Group on Sterling Risk-Free Reference Rate has recommended the use of Term SONIA only when there is a robust rationale for using Term SONIA. One example is trade and working capital products which require a forward-looking interest rate for discounting.

- To determine the CAS, ARRC recommends using spread adjustments adopted by ISDA in its 2006 ISDA Definitions Supplement, based on the five-year historical median set on 5 March 2021 (the date on which the United Kingdom's Financial Conduct Authority formally announced the impending cessation of LIBOR)[9]. This CAS determination method, which is based on data covering a relatively long period of time, is seen to be comparatively objective and easy to obtain[10]. It also facilitates entry into hedging for the underlying loan. The disadvantage of such a CAS determination method is that the data are historical and do not reflect recent trends on interest rate changes. As a result a CAS determined based on historical medians may be subject to challenge by borrowers or banks as not reflecting the current market situation.

5. Break costs

In LIBOR linked loans, if a repayment is made other than on the last day of an interest period ("**Intra-Interest Period Repayment**"), the borrower is usually required to pay the bank "break costs", which represent the bank's cost or loss arising as a result of the Intra-Interest Period Repayment:

Break costs =

the amount of interest that the borrower would have paid from the date of Intra-Interest Period Repayment to the last day of the interest period (as if the Intra-Interest Period Repayment had not occurred)[11]

minus:

the amount of interest that the bank would have earned if the bank deposited an amount equal to the Intra-Interest Period Repayment in a leading bank for the remainder of the interest period

The above "make-whole" formula is based on the assumption that the bank borrowed match-funding in the interbank market in order to advance the loan to the borrower. Some borrowers may argue that such assumption is no longer applicable when an RFR (such as overnight SOFR) is used. Market participants should consider the following factors when negotiating break costs clauses:

- If an RFR term rate is adopted, given the relevant RFR term rate for an interest period would have already been determined prior to the start of the interest period and apply to the whole interest period, it is highly unlikely the bank will be able to earn the same interest following the Intra-Interest Period Repayment. It is arguable that using a make-whole formula that is similar to formulas used in LIBOR linked loans would be appropriate in such a situation.

- Even if match-funding is not strictly relevant, banks incur costs when an interest payment is not made on the last day of an interest period. Therefore, in RFR linked loans, break costs may be reflected as the actual and reasonable costs and losses (if any) the bank incurs or suffers as a result of an Intra-Interest Period Repayment.

- It is recommended that borrowers discuss with banks the expected amount and frequency of Intra-Interest Period Repayments, and request that break costs be excluded for Intra-Interest Period Repayments up to certain amount and/or number of times.

If you have any questions or comments, please get in touch with any of your KWM contacts below.

[9]For SOFR, the actual numbers are 0.11448% (11.448 bps) for a one-month tenor, 0.26161% (26.161 bps) for a three-month tenor and 0.42826% (42.826 bps) for a six-month tenor.

[10]CAS for the relevant currencies has been published by Bloomberg.

[11] Some borrowers may request that margin be excluded in this part of the formula.

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