INSIGHTS FOR ASSET MANAGERS

IBORS TRANSITION: ASSESSING THE CHALLENGES FOR HEDGE FUND MANAGERS

12 FEBRUARY 2019

DISCONTINUATION OF IBORS
TOPICS FOR DISCUSSION

IBORs discontinuation

1 **The problem**

- No more IBORs, not just LIBOR (unlikely to want to be a panel bank voluntarily).
- Increasing problem with time.
- Regulators have noted that the outstanding stock of contracts referencing LIBOR and maturing after 2021 is continuing to increase rather than decreasing.

2 **The future state.**

3 **Scope of impact/inventory**

- Affected products.
- Identify problems/issues.

4 **Approaches of your peers and others in the market**

5 **How to move from the present to the future state**

- Refinancing rather than redocumentation/amendment?
- Sharing expertise.

IBOR DISCONTINUATION – LEGAL ISSUES
PREPARING FOR IBOR CHANGES

The IBOR benchmarks are currently key interest rate benchmarks in the global financial system, underpinning a broad range of financial products and contracts. Any changes to IBORs will have significant implications.

Scaling the problem
- Identify existing population of contracts and existing fallback language.

Contract amendment
- Private renegotiation, statutory solution, close-out, or refinancing.
- ISDA protocols

Provide for "zombie LIBOR" scenario
- Triggers and trigger events must be agreed in contemplation of a "zombie LIBOR" scenario in which LIBOR still exists but is not generally used by the market.

Identify value transfer
- i.e. where change of reference rate creates a cost/windfall gain for parties.

Operational
- Ensure ability to calculate rates.

Risk of triggering transition clauses
- Need to ensure orderly transition

Disclosure
- Review existing disclosure/consider how new disclosure will be given.

Risk management
- Identify hedges and other arrangements where non-IBOR contracts may be affected by changes in IBOR hedges.

Antitrust
- Creation of market-wide solutions to market problems may require thorough anti-trust review.

Education and communication
- Consumer and retail business customers may need assistance to understand issues and a careful communication strategy.

Regulatory
- Triggering of margin and clearing requirements?
- Compliance with local benchmarks regulation, governance and controls.

Tax and accounting
- Changes to amount of tax due/acceleration of payments.
- Need to consider impact on hedge accounting and inter-affiliate accounting structures.

PROGRESS WITH IBOR REFORM

Canadian Dollar
Bank of Canada

Old / IBOR rate	New rate
Canadian Dollar LIBOR	Discontinued
Canadian Dollar Offered Rate (CDOR)	CDOR together with a term risk-free rate such as CORRA (Thomson Reuters)

Sterling
BoE WG on Risk-Free Rates

Old / IBOR rate	New rate
Sterling LIBOR	SONIA (Bank of England)

Euro
Europe WG on Risk-Free Reference Rates

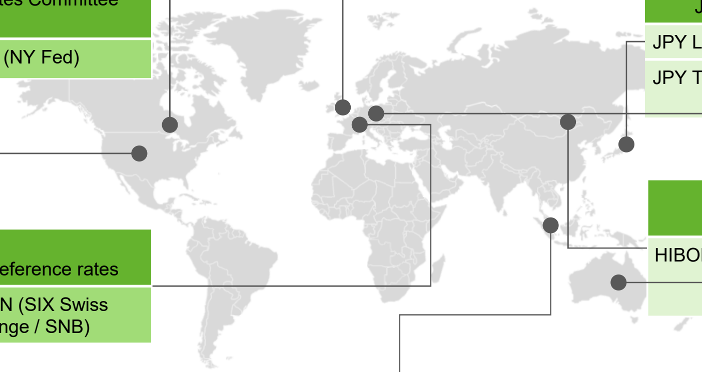
Old / IBOR rate	New rate
EURIBOR	Term ESTER?
EONIA	ESTER

US Dollar
US Alternative Reference Rates Committee (ARRC)

Old / IBOR rate	New rate
US Dollar LIBOR	SOFR (NY Fed)

Japanese Yen
Japan Study Group on Risk-Free Rates

Old / IBOR rate	New rate
JPY LIBOR	TONAR (BoJ)
JPY TIBOR	Reformed TIBOR (JBATA)



Hong Kong Dollar
HKMA

Old / IBOR rate	New rate
HIBOR	Reformed HIBOR (Treasury Markets Association)

Swiss franc
Swiss National WG on CHF reference rates

Old / IBOR rate	New rate
CHF LIBOR	SARON (SIX Swiss Exchange / SNB)

Singapore Dollar
Association of Banks in Singapore (ABS), Singapore Foreign Exchange Market Committee, MAS

Old / IBOR rate	New rate
SIBOR	Reformed SIBOR or alternative rate? (ABS)

Australian Dollar
Reserve Bank of Australia

Old / IBOR rate	New rate
Australian Dollar LIBOR	Discontinued
BBSW	Reformed BBSW (ASX)

Key:

Old / IBOR rate	New rate

IMPLICATIONS UNDER THE BENCHMARKS REGULATION

The European Benchmarks Regulation (EBR) imposes certain requirements on users of benchmarks that are supervised entities.

Supervised entities are not allowed to 'use' a benchmark in the sense of the EBR unless:

- the benchmark is provided by an administrator included in the ESMA register of EU benchmark administrators or included as a benchmark qualifying under one of the third country regimes under the Benchmarks Regulation. For it to be used in the EU, any substitute rate should meet one of these requirements.

Supervised entities must also:

- have robust contingency plans in case benchmarks used by them materially change or cease to be produced
- reflect those plans in the contractual relationship with clients
- include clear and prominent information in relevant prospectuses stating whether the benchmark is provided by an administrator on ESMA's register.

Supervised entities are:

- credit institutions, investment firms
- insurance and reinsurance undertakings
- UCITS, UCITS managers, AIFMs, IORPs
- creditors under (retail) "financial contracts"
- CCPs, CSDs, trade repositories, market operators
- benchmark administrators.

THE CREDIT SPREAD PROBLEM AND TERM RATE PROBLEM

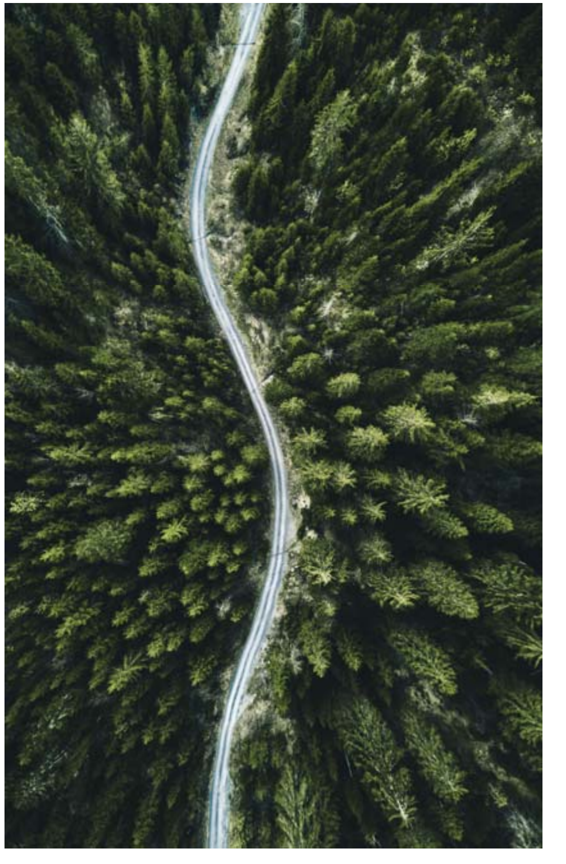
Substitute rates are (nearly) risk-free rates – LIBOR is a credit spread rate equal to risk-free rate plus an element to take account of average bank credit spreads.

For some trades a credit spread is inappropriate – e.g. retail mortgages. For others, it is an integral part of the pricing.

- Which transactions should be RFR, and which RFR+C?
- How is C calculated?
- How to reflect the term element in credit risk?

RFRs are backward-looking – the borrower will not know the amount due on each payment date when they enter into the transaction.

- Is it possible to create a forward-looking rate which provides borrowers with cash flow certainty?
- "Term" RFRs can be calculated in different ways:
  - Compound rates vs average rates
  - Lockout periods and payment lags
  - Local law rules on compounding interest
  - Fragmentation of calculation methodologies



"ZOMBIE LIBOR"

Preparing for a scenario in which LIBOR continues to exist, but is not generally used by the market.

Trigger

- Important to build in a fallback trigger in the event of a "zombie LIBOR".

How likely is "zombie LIBOR"?

- At least two LIBOR-submitting banks have indicated that they and some other submitting banks have accepted that they could and would continue to submit to LIBOR after 2021.

Example 1:

Certain bond fallbacks currently provide an example of this. The terms include as one of the fallback triggers a situation where:

"The number of contributing banks submitting to the LIBOR administrator for ICE LIBOR falls to less than six (6)".

Example 2:

On 25 May 2018, the LMA published a revised version of the "replacement of screen rate clause".

The revised version permits amendments to be made to documents with a lower consent threshold than may otherwise be required in a wider range of circumstances than the existing clause allows.

It also allows amendments to be made to facilitate inclusion of a replacement benchmark which:

- is formally selected as a replacement for LIBOR by the LIBOR administrator or by an appropriate regulator; or
- is otherwise accepted by the relevant markets; or
- is deemed appropriate by the requisite majority of lenders and the obligors.

COMPARATIVE PRODUCT CHALLENGES

ISSUES	DERIVATIVES	VANILLA BONDS	LOANS	SECURITISATIONS
Existing documentary fall backs	ISDA standard IBOR-Reference Banks – failing which bank quotes.	No uniform approach, but may ultimately result in rate becoming fixed at last available fixing.	LMA documents (only applicable for LMA loans): • Reference Banks • Cost of Funds.	As for vanilla bonds.
Potential Documentary Solutions	ISDA working on fallbacks for IBORs to be included in the 2006 ISDA Definitions. These fallbacks will apply to trades entered into after the fallbacks are incorporated into the 2006 Definitions. ISDA considering mechanisms to amend legacy contracts referencing IBORs for which fallbacks have been amended – including a protocol. ISDA Benchmarks Supplement – to facilitate compliance with Art 28(2) of EU Benchmark Regulation (robust written fallback plans).	Some (not universal) attempts to include new fall back provisions and lower voting thresholds.	New LMA clause – optional provision to allow amendments to be made with a lower consent threshold (majority lender only).	AFME negative consent proposal i.e. language being widely included that permits the issuer (via an agent) to propose a new reference rate with a resumption of investor consent in the absence of investor objections.
Some Transitional Challenges	• Identify appropriate credit spread methodology and term structure • Minimise/eliminate value transfer at time fallback is applied • Minimise market disruption • Minimise/eliminate potential for manipulation.	• Need to amend bonds. May not get requisite majority • Need to deal with new payment mechanics, e.g. calculation dates, day count fractions • Need to calculate value transfer • Competition issues • Risk Factors • MIFID II product governance concerns • Need to match reference rate changes with relevant derivatives? • Changes to IT/Infrastructure.	• Need to amend legacy contracts • Need to deal with new payment mechanics, e.g. calculation dates, day count fractions • Need to calculate value transfer • Lenders or majority lenders (as required) may not agree • Competition issues • Need to match reference rate changes with relevant derivatives? • Need to coordinate across currencies in multicurrency facilities • Changes to IT/Infrastructure.	• Products likely to include multiple IBOR linked components – notes, hedging, underlying loans • Ensuring preservation of transaction economies between each component • Risk of each component following different fallback • Need to amend bonds. May not get requisite majority

ISDA CONSULTATION ON TERM AND CREDIT SPREAD ADJUSTMENTS

RESULTS OF FIRST ISDA CONSULTATION (DECEMBER 2018)

Term Adjustment: Compounded Setting in Arrears Rate

- RFR observed over the relevant IBOR tenor and compounded daily during that period.

Advantages:

- Reflects actual daily interest rate movements during the relevant period.
- Calculated as an average and therefore less volatile than spot overnight rate.
- Easy to understand by market participants.
- Mirrors the structure of an overnight index swap referencing an RFR.

Disadvantages:

- Information required to determine the rate will not be available at the start of the relevant period.
- Actual interest movements may not reflect prior expectations of interest rate movements.

Credit Spread Adjustment: Historical Mean/Median Approach

- Calculated based on mean or median spot spread between the relevant IBOR and the adjusted RFR determined over a lookback period prior to the fallback trigger. Relevant period subject to consultation (5yr/10yr/other).
- One-year transitional period will mitigate any sudden cliff-edge changes. During the transitional period, a linear interpolation between the spot IBOR and adjusted RFR will be used to calculate the spread. Spread will reflect look-back spread following the transitional period.

Advantages:

- Reflects current market conditions at the time fallback takes effect and transitions to longer-term average market conditions gradually.
- Captures the tendency of interest rates to fluctuate around a long-term mean.
- Minimises the effect of market distortions and market manipulation.
- Based on readily available information.

Disadvantages:

- Requires long historical data of IBOR fixings and adjusted RFR fixings. Sufficient historical data may not be available for an RFT (e.g. SOFR)
- Historical market conditions may not match market expectations for future market conditions.

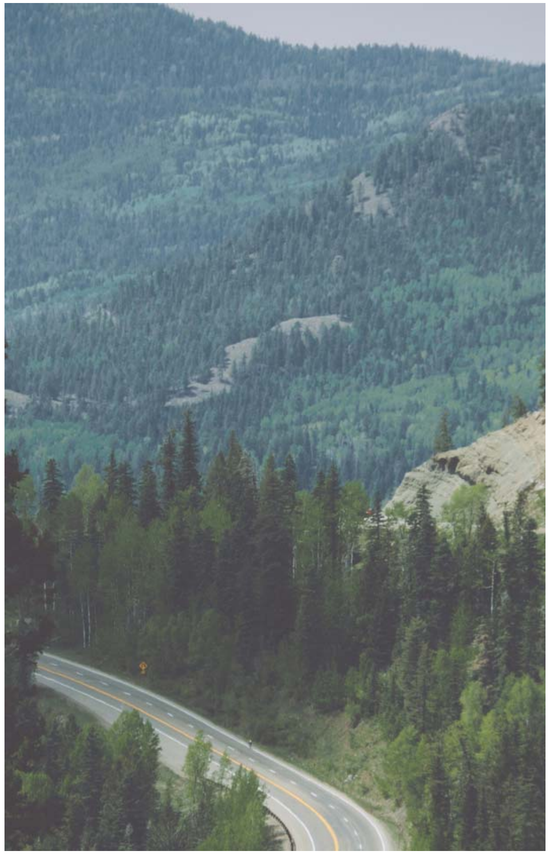
KEY ISSUES
LITIGATION AND REGULATORY ENFORCEMENT RISK

Advice on governance
- Avoiding conflicts of interest.
- Guarding against anti-competitive conduct.
- Centralising complaints and disputes.

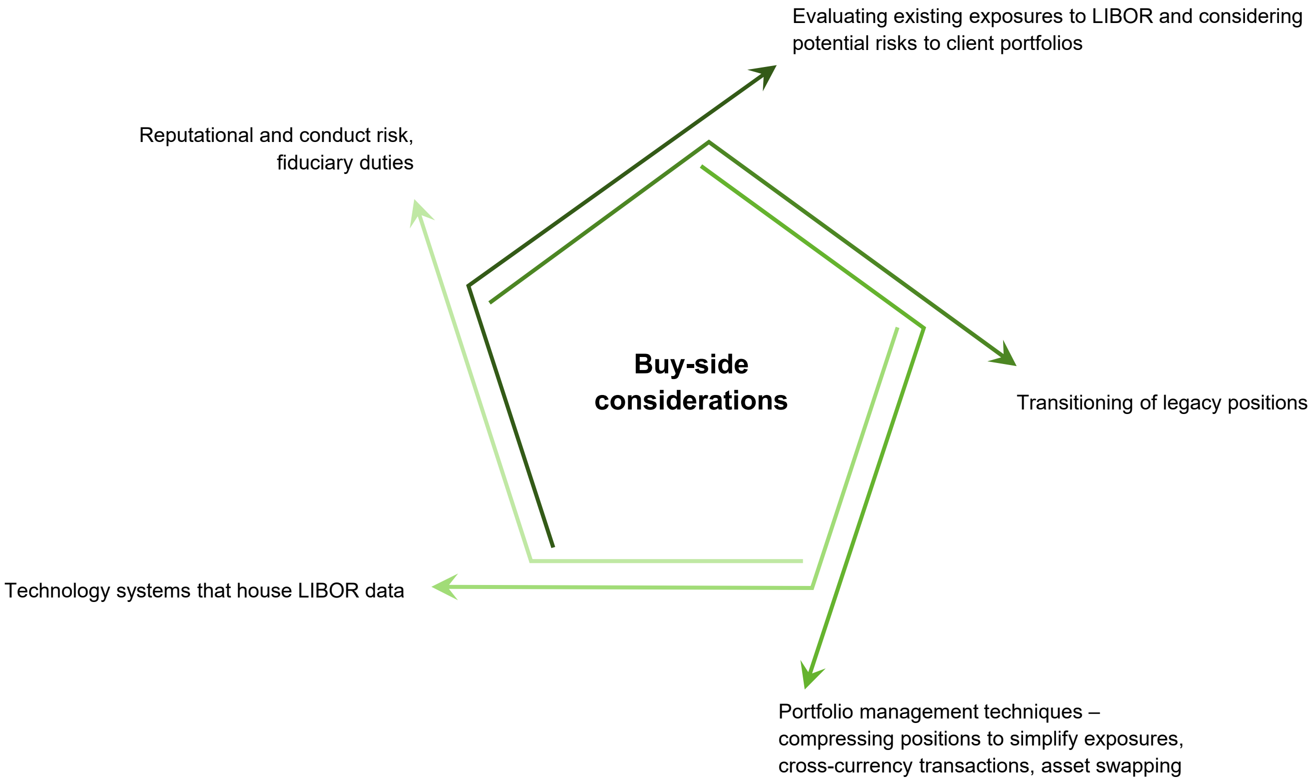
Treating customers fairly
- Clarity of communication.
- Impact analysis.
- Symmetry of approach.
- Industry engagement.

Client engagement
- Protecting against misrepresentations and duties of care.

Litigation risk assessment
- Effectiveness of contractual amendments.
- Arguments based on implied terms.
- Course of dealing defences.



BUY-SIDE CONSIDERATIONS



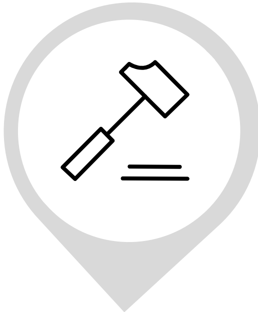
PLANNING AND IMPLEMENTATION

Training and knowledge

- Internal education to promote awareness.
- Continuing to monitor developments, particularly ISDA work on derivatives.

Systems

- Assessment of systems readiness and any updates that could be required.



Legal and compliance

- Inventory of transactions and investments that reference LIBOR.
- Updating of existing contracts.
- Assessment of contracts for new transactions.
- Review of reputational and conduct issues.

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INSIGHTS FOR ASSET MANAGERS

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FINANCIAL MARKETS TOOLKIT
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Insights for Asset Managers

'Insights for Asset Managers and Funds', a series of calls offering a practical overview of the issues faced by the asset management and funds sector in today's international legal, regulatory and commercial environment. Each call lasts for around 30 minutes and focuses on a specific topic, with participants able to submit questions in real time via Webex during the call.

Online recordings of these calls are available below.

Issues discussed in the Insights for Asset Managers calls include:

- New rules on asset segregation: what will they mean for managers of AIFs and UCITS? (December 2018)
- #Metoo: a discussion of issues arising for firms and investors (December 2018)
- The implications of LIBOR transition for asset managers (October 2018)
- OTC Derivative initial margin for buy-side firms (September 2018)
- Marketing investment funds post Brexit: assessing the impact on managers (September 2018)
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- The GDPR – What Asset Managers Need To Know (November 2017)
- MIFID2 Issues for Asset Manager: Broker and Distributor Documentation (October 2017)
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