LIBOR NO MORE: HOW ALTERNATIVES MANAGERS SHOULD IMPLEMENT THE TRANSITION

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In recent months, we have seen a barrage of co-ordinated messages from the UK authorities to chivvy the industry into action to ensure minimal disruption and mitigate any associated conduct risks arising from the termination of LIBOR by the end of 2021.

On 16 January 2020, the FCA, the Bank of England and the Working Group on Sterling Risk-Free Reference Rates ("RFR Working Group") published transition targets for 2020, stating that "firms need to accelerate efforts to ensure they are prepared for LIBOR cessation by end-2021" and adding that "2020 will be a key year for transition".

This was followed on 27 February 2020 by a Dear CEO letter from the FCA to all asset management firms, setting out their expectations for managing the transition.

The background to replacing LIBOR

Two primary reasons lie behind the case to replace the London Interbank Offered Rate ("LIBOR") as the key benchmark for wholesale borrowing: first, since the financial crisis there has been a structural decline in the use of the interbank market as a source of funding; second, the setting of LIBOR incorporated a fragile system for the quoting of rates which was perceived to be vulnerable to manipulation.

In April 2017, the RFR Working Group recommended a reformed version of the Sterling Overnight Index Average ("SONIA") as the long-term replacement of LIBOR for sterling markets under the administration of the Bank of England.

SONIA is anchored to an active and liquid market in wholesale overnight rates and is perceived to offer a much more robust proxy to the risk-free rate.

There has also been international coordination in generating replacement benchmarks in the other key currencies currently employing LIBOR: US dollar, Euro, Swiss Francand Japanese Yen. Thus, we move to the Secured Overnight Financing Rate ("SOFR") for US dollars; the Euro Short-Term Rate ("ESTR") for Euros; the Swiss Average Rate Overnight ("SARON" for Swiss Francs; and the Tokyo Overnight Average Rate ("TONAR") for Japanese Yen.

What are the UK authorities' immediate priorities?

The targets announced by the RFR Working Group in January are intended to support a smooth transition to SONIA and other alternative rates and include some specific milestones for asset managers –we take "milestone" to mean somewhere between guidance and obligation:

- From 2 March 2020: market makers should switch from LIBOR to SONIA for sterling interest rate swaps, so asset managers should now take new positions in the latter where possible.
- End of Q3 2020: for asset managers to cease investment in sterling LIBOR products which mature beyond 2021, as well as launching new products or performance fee measures which are linked to LIBOR.
- Q1 2021: the target date for asset managers to have significantly reduced exposure to sterling LIBOR products in their client portfolios.

What are the FCA's chief concerns?

Beyond achieving a smooth transition to SONIA and other relevant benchmarks without significant market disruption, the FCA identifies a number of key conduct risks during the implementation period. Firms' LIBOR transition plans thus need to take account of the following:

- **Product performance:** whether legacy LIBOR exposures in client portfolios will perform as expected, particularly after the end of 2021.
- **Product governance:** whether any new products with LIBOR exposures will adhere to the principles of the product governance rules (for example, whether the charging structure is sufficiently transparent and understandable).
- **Planning and accountability:** whether firms have established proportionate transition plans which have been agreed by their governing bodies (including appropriate accountability and updated Statements of Responsibility submitted to the FCA).
- **Clients' best interests:** whether firms are proactively replacing LIBOR-exposed instruments within their portfolios with those that reference alternative rates and/or amending the constitutional documents of existing products which in some way reference LIBOR to include fall-back provisions.
- **Conflicts of interest:** whether firms are mis-representing past performance, even if advertently, and whether clients are being disadvantaged by adjustments in performance fees.

What are the main challenges for asset managers?

Credit strategies clearly are likely to contain the most significant exposure to LIBOR referenced products and hence present the greatest challenge, but the following checklist will be relevant in some degree to other strategies as well:

- **Loan documentation:** for any sterling or other LIBOR-based credits, a review of the underlying documentation such as the loan facility agreement should be undertaken to identify if a replacement for LIBOR has already been identified. This can then feed into portfolio income monitoring tools to ensure accurate interest calculations (always helpful when calculating interest coverage tests for instance).
- **Loan agency role:** managers engaged in the rapidly expanding direct lending space, who have taken on the loan agency role for floating sterling loans, will have to identify the new base rate and ensure that those rates can be set in accordance with the criteria in the agreements (e.g.x days before reset date). This will also most likely have to be agreed with the borrower.
- **Interest rate hedging:** hedging out interest rate risk, swapping interest rates,or engaging in perfect asset swaps, are also potential areas of particular focus in identifying LIBOR replacements. Any alterations to such agreements may need discussions with counterparties to identify the ideal replacement.
- **Other operational issues:** firms should review all outward payment streams to investors to ensure that no payments to investors are based upon, or reference, LIBOR. These include tranches of the CLOs, credit-linked notes, or references to LIBOR as part of a return hurdle.

What other steps are the UK authorities taking to accelerate the transition?

The Bank of England has been at the forefront of additional measures to encourage market participants to get ahead of the switch, recently announcing that:
- It will publish a compounded SONIA-linked index from July 2020 which will help firms construct compounded SONIA rates in an easy-to-use, consistent format.
- It is consulting on the publication of daily "screen rates" for specific period averages of compounded SONIA rates, thus removing the need for agents to perform these calculations.
- It plans to increase the haircuts on LIBOR-linked collateral which it lends against from October 2020.

Will Covid-19 affect the timetable?

At the moment, the UK authorities are sticking with their message that firms cannot rely on LIBOR's existence beyond the end of 2021. The Bank of England, the FCA and the RFR Working Group are issuing regular updates, most recently a statement on 29 April. In this they acknowledge the challenges presented by the current operating environment which they recognise may affect some interim milestones.

What are other regulators saying?

As mentioned earlier, the replacement of LIBOR across major currencies has been a multi-national endeavour.

Of particular interest is that the SEC's Office of Compliance Inspections and Examinations ("OCIE") highlighted exposure to LIBOR as one of its exam focus areas in 2020: "OCIE encourages each registrant to evaluate its organization's and clients' exposure to LIBOR, not just In the context of fall-back language in contracts, but its use in benchmarks and indices; accounting systems; risk models; and client reporting, among other areas."

Similarly, the Hong Kong Monetary Authority wrote to local institutions in March 2019 to remind them of the risks associated with the transition to alternative reference rates.

The difference with the UK is that US dollar assets typically reference LIBOR whereas HK dollar assets reference the Hong Kong Interbank Offered Rate ("HIBOR"). The Hong Kong Dollar Overnight Index Average ("HONIA") has been designated as the appropriate replacement.

What should firms be doing now?

1. Establish a project team to plan and oversee the transition (front office, legal, operations, investor relations, compliance).
2. Get sign-off from the governing body including allocation of senior management responsibility.
3. Educate the front-office in the broader considerations in making the switch to LIBOR alternatives.
4. Engage operations team on identifying and mitigating embedded LIBOR exposure.
5. Brief legal on updating product and investor documentation.
6. Brief investor relations on any amendments to product information and marketing materials.
7. Ensure risk teams take into account the impact that the proposed changes will have on the market and whether they need to consider changing their scenario analysis or model testing as a result.
8. Keep clients appropriately informed of such changes as they are developed and implemented.
9. Monitor compliance with regulatory obligations and FCA priorities.

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