CLIENT NOTE

LIBOR, EURIBOR, SOFR, SONIA: WHAT IS GOING ON?

BIG CHANGE IS COMING!

Change is always a challenge and sometimes, it can even be painful! There are plenty of things in our daily routine that we conventionally use, and we never think that they may disappear. We are so used to them that our entire lives are built around them. When this happens, we immediately start seeking substitutes.

The finance world is no different. There were concepts that the finance world has been using without considering that one day we would wake up in an entirely different reality where these concepts are no longer available.

The same happened on July 27, 2017 when Andrew Bailey, the Chief Executive of UK Financial Conduct Authority announced that from the year 2022, the LIBOR rate will no longer be published. This has created a big turmoil among both the financial industry and the corporate world.[1]

LIBOR is phasing out gradually and these are important times for lenders and borrowers to figure out what's next. What are some of the tools out there for your financial agreements? This note is an attempt to bring in more clarity on the topic.

[1] https://www.fca.org.uk/news/speeches/the-future-of-libor

Of course, the Armenian financial and corporate sector could not remain unaffected. This is indeed becoming an important agenda item for the legal industry as well, because LIBOR was an integral part of Armenian lending practices. The purpose of this note is to brief our clients on what has happened, what to expect and how to smoothly transition towards 2022.

WAS LIBOR ONLY AN ACRONYM?

LIBOR is an acronym the global financial market depends on. Every day around 11 a.m., thousands of people wait for that number with their hearts pounding. However, this image is to be changed after 2021.

Initially established in 1986 by British Bankers Association (BBA) as an average interest rate at which banks in the UK were willing to pay to borrow from other banks, nowadays, LIBOR is calculated by Intercontinental Exchange (ICE) based on the estimates of interest rates given by major global banks and underpins more than $300 trillion of financial contracts, ranging from interest rate derivatives to mortgage and student loans.

LIBOR, calculated for 5 different currencies (American dollar, British pound sterling, European euro, Japanese yen, Swiss franc) and for 7 different time frames (overnight, 1 week, 1 month, 2 months, 3 months, 6 months, 12 months), serves as a reference rate and as a benchmark rate. It is the primary reference rate for short-term interest rate financial contracts like swaps and futures.

Little did the founders of reference rates imagine that LIBOR would reach the level of prevalence that it did and meanwhile would become subject to manipulations that turn out to be one of the reasons for the discontinuation of LIBOR!

In 2012, the global financial market was shaken by the news of the LIBOR scandal. As LIBOR has not only been a global benchmark standard for interest rate, but also an indicator of financial strength. The scandal was that major banks colluded and manipulated the LIBOR rates. They submitted artificially low LIBOR rates to keep them at their preferred levels and to project their financial strength amidst market uncertainty.[2]

[2] https://www.globalresearch.ca/the-history-of-the-london-inter-bank-offer-rate-libor-financial-fraud-and-market-manipulation/5318478

Subsequently, it was the announcement by Andrew Bailey, the Chief Executive of the UK's Financial Conduct Authority, that the FCA will no longer compel or encourage panel banks quotations for the purposes of calculating LIBOR after 2021 that made the world tremble again.[3]

WHAT'S NEXT

To make the disappearance of LIBOR less hurtful, each central bank or financial regulator is currently in search of alternatives to replace LIBOR rates.

SONIA (Sterling Overnight Interbank Average Rate) is administered by the Bank of England and since 2018 has undergone several reforms aiming to improve it as an alternative benchmark to LIBOR for the sterling financial markets.

SOFR (Secured Overnight Financing Rate) was established by the ARRC (Alternative Reference Rate Committee) as an alternative rate to the USD LIBOR. The SOFR was selected by the Alternative Reference Rates Committee (ARRC) chaired by the New York Federal Reserve in 2017. The SOFR is the average rate at which institutions can borrow US dollars overnight while posting US Treasury bonds as collateral. Similar to a mortgage rate, SOFR is a secured borrowing rate in the sense that collateral is provided in order to borrow cash. The SOFR differs from the US LIBOR in that the latter is a rate for unsecured borrowing (where no collateral is posted).

Quite naturally, all financial institutions are now working towards replacing a reference to LIBOR in their transaction documentation with the alternative, such as SONIA or SOFR.

Two scenarios are possible.

In many cases, transaction documentation was addressing circumstances when for some reason the reference rate (i.e. LIBOR) would not be available. These clauses are conventionally called "market disruption event clause", which would essentially enable the lenders to apply alternative rates when LIBOR rates were not available.

[3] Although the world is currently troubled by LIBOR, it is also needed to focus on other reference rates, such as EURIBOR, which will most probably soon meet the same fate. https://www.globalresearch.ca/the-history-of-the-london-inter-bank-offer-rate-libor-financial-fraud-and-market-manipulation/5318478

Loan Market Association (LMA) recommends plenty of provisions that will help to be prepared for upcoming changes, such as “replacement screen rate” clause. In 2018, the LMA published a revised form of replacement screen rate clause, which permits to convert the screen rate into a replacement benchmark, which is formally selected as a replacement for the Screen Rate by the 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 obligors. Compared to the previous form of replacement screen rate clause, the revised form, answering to present challenges, empowers with greater flexibility: it permits amendments with a lower consent threshold and applies at any time or upon a “Screen Rate Replacement Event”. As a result, lenders with similar clauses in their transaction documentation have less to worry about, because the announcement and the publication of alternative rates could perfectly fall within the matrix available by virtue of market disruption clause or replacement screen rate clause.

Things get significantly more complicated when no such clause is provided under the transaction documentation. In our experience, such situations specifically exist, when a local financial institution sub-loans to a local company financial resources attracted with a LIBOR plus margin rate, without "passing through" the "market disruption" regime into local law documentation. This would mean that in the event of unavailability of the reference rate, the foreign lender would be able to use an alternative rate by force of market disruption event clause. In the absence of a market disruption event clause in the local law documentation the local lender would not be able to apply a LIBOR alternative, thus, exposing itself to a risk of loss as a result of a combination of these transactions.

To address this risk, there are a number of actions local lenders should take. First and foremost, local lenders should try to renegotiate their loan agreements and introduce a mirror-image of what they have in the documentation with the provider of foreign financing. Alternatively, the local lenders should carefully review their agreements to see if there are other clauses on which they can rely (e.g. market MAE, change of circumstances, etc.). These clauses typically enable the lenders to request early repayment of the loans. There are a number of other solutions that the local lenders could use depending on the structure of their transaction documentation.

HOW CAN WE HELP?

Our team has extensive experience in helping lending institutions in designing complex instruments and negotiating complex loan documentation with both foreign lenders and local borrowers. We can assist you in addressing this challenge by minimizing the risks that arise from the disappearance of LIBOR. So please, do get in touch when you want to get sophisticated advice.

NOTE: This material is for general information only and is not intended to provide legal advice.

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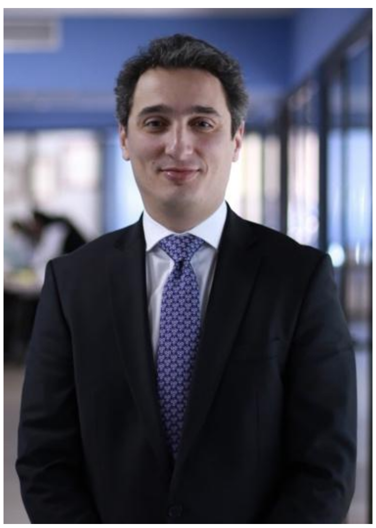

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