

Transition from LIBOR to Alternate Reference Rates — New Fallback Language

By [Cindy Sim Xin Yee](#) and Lee Wan Xin*



9 September 2020

The London Interbank Offered Rate (**LIBOR**)¹ is globally recognised as a key interest rate benchmark across a wide range of financial transactions, which include derivatives, securities, loans and mortgages. Outstanding financial contracts referencing LIBOR have an exposure of more than USD300 trillion.² The banking industry in Malaysia itself has a considerable LIBOR exposure of RM857 billion as of 30 June 2019.³

In the wake of the LIBOR scandal involving manipulation of interest rate submissions, both the regulators and financial institutions have demanded a shift from LIBOR to alternate reference rates (**ARRs**) that are based on observed market prices rather than expert judgment. It was in 2017 that the UK's Financial Conduct Authority (**FCA**) announced its intention to retire the LIBOR benchmark interest rate setting scheme (**LIBOR Retirement**) by 2021.⁴ Reliance on LIBOR could no longer be assured beyond this date.

Given the significant LIBOR exposure from the banking industry in Malaysia, the clock is ticking for financial market participants to strategise and accelerate their efforts to ensure a smooth transition from LIBOR to ARR.

Existing fallback language insufficient to cater for LIBOR Retirement

One of the biggest challenges the financial institutions are grappling with is how the existing contracts that refer to LIBOR and are due to continue beyond the end of 2021 (known as legacy contracts) will work post-migration. The existing fallback language⁵ in the legacy contracts has been deemed insufficient to address this dilemma.

Legacy fallback language was originally intended to provide an interim solution when LIBOR is unavailable on a temporary basis. Often times, LIBOR is first defined in the loan agreement by reference to the offered rate for deposits in the relevant currency having the relevant maturity that appears on a designated screen page. Examples of such a designated screen page can be found on Bloomberg or Reuters. The trigger of the fallback is when the rate does not appear on the designated screen, which can happen due to a computer system glitch or

* **Cindy Sim Xin Yee** (sxy@lh-ag.com) is a partner with the firm's Corporate Department. Lee Wan Xin (lw@lh-ag.com) is an associate with the Corporate Department and is part of a team headed by Cindy Sim Xin Yee.

¹ LIBOR provides an indication of the average rate at which the panel banks can borrow unsecured loan from one another in the London interbank market for a given period, in a given currency. It is calculated based on five currencies and serves seven different maturities (overnight, one week, and 1, 2, 3, 6 and 12 months) by the ICE Benchmark Administration. LIBOR is determined based on submissions by a panel of banks using available transaction data and their expert judgment.

² Bank Negara Malaysia (2019). *Risk Developments and Assessment of Financial Stability — Market, Liquidity and Funding Risk*. Retrieved from https://www.bnm.gov.my/ar2019/files/fsr2019h2_en_ch1b.pdf

³ *Ibid*

⁴ Andrew Bailey (2017). *The future of LIBOR*. Retrieved from Speech by Andrew Bailey, Chief Executive of the FCA, at Bloomberg London: <https://www.fca.org.uk/news/speeches/the-future-of-libor>

⁵ The fallback language within a contract refers to the provisions that set out the process to identify a replacement rate should the original benchmark (e.g. KLIBOR) be unavailable.

temporary market disruption. In such a case, the fallback provisions may allow for the application of an alternative base rate, such as the LIBOR rate used in the previous interest period, the other reference bank quotations, or the cost of fund of the lending financial institutions.

These fallback provisions are not designed to cope with the permanent discontinuance of LIBOR due to various reasons, some of which are as follows:

- Mere substitution of ARR's without considering the nature of transactions may materially vary the structure and economics of the underlying financial products.
- Reference bank rate fallback provisions (which rely on a number of reference banks providing quotations for a rate to be calculated) will not be feasible as the financial institutions will be cautious to assume the liability of providing such quotations to be applied to contracts on a permanent basis.
- Falling back on the cost of funds rate after the LIBOR Retirement might not be practically viable for both financial institutions and customers as it requires the financial institutions to disclose the basis of calculation that includes price-sensitive information, which is further exacerbated by the customer's lack of comprehension of technical jargon used. The matter is further complicated in a syndicated financing where the facility agent in a syndicated financing would have to obtain the cost of fund rate from each respective lender within the syndicate and interpret each calculation method.
- Resorting to the historic LIBOR publication in the event of a permanent discontinuation of LIBOR effectively freezes the benchmark rate at the date of the LIBOR Retirement, converting the LIBOR floating rate loan into a loan with fixed contractual interest rate. As a result, one of the counterparties to a LIBOR contract may suffer material losses while the other receives windfall gains, potentially creating an undesirable arbitrage.

Developing new fallback language

Given the inadequacies of the legacy fallback provisions, it is recommended that the financial institutions consider amending the legacy contract to include unambiguous language that contemplates the permanent cessation of LIBOR and actionable framework for eventual transition to ARR's. Regulatory authorities and public and private sector working groups in several jurisdictions such as the Alternative Reference Rates Committee (**ARRC**) and the International Swaps and Derivatives Association may provide an insight into the standard intended to be adopted by the major industry bodies.

The new language should specify a set of trigger events for the fallback, identify the use of an ARR and make provisions for spread adjustments. A sound fallback provision should ensure that the parties to the legacy contract could return to the same economic position prior to the trigger event once fallback provisions are triggered.

Selection of ARR's

The ideal selection of ARR's should ensure that the borrowers are not exposed to a higher rate or cost than what LIBOR would have been, or otherwise introduce inferior terms. It would be desirable for parties to adopt a replacement rate that is aligned with the established market consensus, recognised by relevant industry bodies as an appropriate solution as well as reached through appropriate consultation with the stakeholders.

It is insufficient to merely amend the documents by substituting references to LIBOR with the agreed ARR as there are consequential amendments that have to be done. Several non-exhaustive examples include moving from months to day count (one month vs 30 days), the adjustment to the length of interest accrual periods and the frequency updating the rates. It will be useful to include a further assurance clause under which all parties agree to make such necessary or desirable amendments to the contract to ensure proper implementation of the ARR.

Next steps

Once the approach on amending the fallback provisions is decided, the financial institutions would be well placed to start engaging and communicating with customers and clients to ensure that the public is well informed of the financial institutions' approach and methodologies of the transition. A review exercise of the amendment provisions and consent requirements in the legacy contracts should also be undertaken. Care should also be given to allow for sufficient turnaround time for the process of obtaining consent, especially for transaction documents that involve multiple parties.

Bank Negara Malaysia recognises that there is an urgent need for our banking industry to implement a robust process for identifying and preparing for the transition risks. In this regard, Bank Negara Malaysia has since established key signposts for the transition. The financial institutions are required to engage existing borrowers to renegotiate contracts and incorporate fallback provisions for existing legacy contracts by the third quarter of 2020 and to ensure that all LIBOR derivative contracts and loan contracts have the fallback provisions incorporated by the second quarter of 2021.

Currently, Bank Negara Malaysia has yet to identify any ARRs. In the US, the Secured Overnight Financing Rate (**SOFR**) has been identified by the ARRC as the replacement benchmark rate for their LIBOR-based contracts.⁶ As a huge proportion of the foreign currency loans in Malaysia is denominated in US dollar, it remains to be seen whether Bank Negara Malaysia will follow suit.

Pending further guidelines from Bank Negara Malaysia on the transition, expert assistance with strategic planning to understand and proactively deal with the issues will help to smoothen the transition from LIBOR to ARRs.

⁶ ARRC. *Transition from LIBOR*. Retrieved from <<https://www.newyorkfed.org/arrc/sofr-transition#pacedtransition>>

Corporate Partners



Bella



Aniza



Megat



Aaron



Weng



Steven



Raphael



Cindy