HSBC Issuer Services

Part 1
LIBOR transition in the Loan market

The pivotal role of the agent in supporting borrowers and lenders

HSBC | Linklaters

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Mathias Kocher
Head of Loan Agency and Project & Export Finance, Client Services
HSBC Issuer Services

Key takeaways

- LIBOR transition is likely to create a number of challenges for loan market participants, including around the variety of different formulae used to compound overnight reference rates which will replace LIBOR
- Amongst other key elements related to the transition, amendments to legacy documentation could also prove to be a significant, complex task for which borrowers and lenders need to start taking action
- Through regular client engagement and robust technology systems, providers such as HSBC Issuer Servicers, working closely with specialised law firms and industry bodies, are supporting customers with their LIBOR transition programmes

Did you know…

What are other regulators doing beyond the UK?

- Other regulators including those in the US, Singapore, Japan, Switzerland and Canada are also moving away from their respective IBOR benchmarks. In place of IBOR, regulators are planning to adopt alternative risk free rates (RFRs), in what will have major implications for borrowers and lenders
- EURIBOR will continue for the foreseeable future. There is no plan to discontinue HIBOR

The transition away from LIBOR (London Interbank Offered Rate) to alternative risk free rates (RFRs) is shaping to have major ramifications for the loan market and its participants. HSBC, in collaboration with Linklaters, outlines the consequences these changes will have on lenders and borrowers, while highlighting some of the key steps they should consider on the short to medium term.

How will the UK IBOR transition be effectively enforced?

LIBOR (London Interbank Offered Rate) is the interest rate benchmark underpinning around $350 trillion in financial contracts including derivatives, bonds, securitisations, mortgages and loans.

On March 5, 2021, the UK’s Financial Conduct Authority (FCA) confirmed the cessation or loss of representativeness of all 7 euro LIBOR settings; all 7 Swiss franc LIBOR settings; all Sterling and Yen tenors and the 1-week and 2-month US dollar LIBOR settings, from December 31, 2021. From June 30, 2023, the FCA has said that LIBOR settings for US Dollar overnight, 1-month, 3-month, 6-month and 12-month will cease too[1].

In parallel, the FCA is consulting on whether to continue certain tenors on a “synthetic basis”, however these synthetic rates are likely to apply only to a limited category of complex legacy cases which are not able to transition.

Note:
1. HSBC GBM – IBOR reforms

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What are the key drivers behind the IBOR transition?

A number of factors led to the need to transition from LIBOR. The 2012 LIBOR rate-rigging scandal has been a key catalyst, leading authorities to consider firm, sustainable measures to avoid a repeat, hence the shift to risk free rates (RFRs).

In addition, the market activity on which LIBOR has historically been based – namely interbank unsecured term borrowing – has shrivelled in size as banks edged away from unsecured short-term financing following the 2008 crisis, in favour of alternative funding sources such as bonds and repos. As the benchmark upon which LIBOR is based is now only a fraction of its original, the benchmark rate for some tenors may not always be representative.

RFRs such as SONIA (Sterling Overnight Index Average) for instance, which measures the rates paid by banks on overnight funds are preferred to IBORs for several reasons. The Bank of England has repeatedly stressed that SONIA corresponds to a large active and liquid underlying market. However, because SONIA is an overnight rate, it does not include the term bank credit component, which means that it is not directly equivalent to LIBOR.

How will the transition impact loan market participants?

"The IBOR reform is the most significant transformation to impact the market in the last thirty years," said Mathias Kocher, Head of Loan Agency and Project and Export Finance, Client Services, at HSBC Issuer Services.

The IBOR transition will have a transformative impact on the global loan market as the benchmark rates on which loans are paid will be fundamentally altered when they are underpinned by RFRs instead of LIBOR. Indeed, RFRs are backward-looking overnight rates based on historic transactions and they do not incorporate the term premium embedded in IBOR[1]. In contrast, IBORs are term rates and are forward-looking in nature[2].

Transitioning existing contracts and agreements which have historically referenced IBOR to the incoming alternative RFRs will mean that any adjustments for credit and term differences will need to be incorporated into the new contracts to make them equivalent to LIBOR.

What challenges could this pose for borrowers and lenders?

"The reforms have confirmed how pivotal a role LIBOR has played in the way loan markets have operated over the last thirty years. If one looks at lending agreements and loan transactions in general, the interest rates underpinning them are central. If you amend the interest rates, it creates all sorts of issues," noted Edward Chan, Banking Partner at Linklaters.

Identifying a method for calculating a rate suitable for the loan market has been challenging, although market participants in the UK seem to have accepted that compounding is the most sensible option to take.

Notes:
1. HSBC GBM – IBOR reforms
2. HSBC GBM – IBOR reforms

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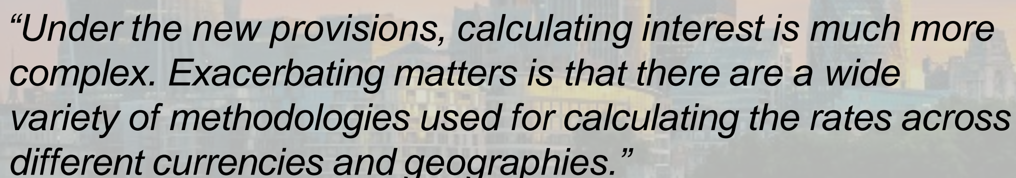

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Jeremy Stokeld
Banking Partner at Linklaters

In the US and Asia, the direction of travel is still being refined. Compounding is the process by which daily rates are compounded over a period correlating to the length of the interest period.

"Under the new provisions, calculating interest is much more complex. There are now a number of different formulae on how to compound overnight reference rates, while there are also issues with rounding. Exacerbating matters is that there are a wide variety of methodologies used for calculating the rates across different currencies and geographies," explained Jeremy Stokeld, Banking Partner at Linklaters.

What issues could emerge when transitioning legacy documentation?

Unlike a derivative trade where there are two counterparties to a transaction which is subject to an ISDA agreement, the loan market is far more complex. "In the loan market, there is little in the way of standardisation. Loan agreements can be upwards of 150 pages long, so the amount of work, processes and counterparties involved is much greater, " said Stokeld.

This process is made infinitely harder by the fact that there are often multiple lenders, especially on syndicate deals.

"At least majority consent is needed to amend legacy contracts to reflect RFRs. The complexity of the amendment process will depend on different factors such as, but not limited to, the currencies involved, the number of lenders in the transaction, the type of financial covenants in the document." added Kocher.

Irrespective, given the tight time-frames involved, it is essential that impacted market participants start working on amending their legacy contracts to account for RFRs. Fortunately, efforts by industry associations such as the LMA (Loan Market Association) to develop common templates should make it easier for the market to shift away from LIBOR towards the RFRs.

How can agency and trustee providers help clients navigate the IBOR reform?

As a long-standing provider of agency services, HSBC has been driving efforts with its clients and partners to ensure these legacy loan contracts do get updated.

"HSBC is coordinating discussions between borrowers and lenders to enable them to map out a common transition plan," said Cindy Wong, Director and IBOR Transition Project Transaction Management Lead at HSBC Issuer Services.

Cindy Wong
Director, IBOR Transition Project Transaction Management Lead
HSBC Issuer Services

"In addition to engaging with our clients about IBOR transition plans, HSBC has built in-depth expertise in relation to RFR products and is able to provide operational capability and knowledge to help customers transition. On the Issuer Services side, HSBC has been heavily involved in forums organised by industry groups such as the Loan Market Association. The bank is also having extensive communications with regulators and ratings agencies about market trends and conventions," added Wong.

How is HSBC leveraging technology to support clients with their transitioning process?

"HSBC is using the market leading system for our loan platform. Along with other banks, we have been working with the vendor over the last 18 months to ensure the functionalities support the administration of RFR transactions. As a result, we are already administering a number of transactions using RFRs.

This transition is an opportunity to look at the way certain processes are done and where technology can actually be used to automate part of it. Distributed Ledger Technology for instance, improves the way information is sent and consumed between the parties. Through automation, we can mitigate risk, create efficiencies and reallocate resources to more value add activities", added Kocher.

Related articles:

- IBOR Reform Overview - HSBC
- IBOR Soundbites - Linklaters

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- Contact: issuer.services.europe@hsbc.com

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- Visit www.linklaters.com
- Follow Linklaters on LinkedIn
- Contacts: edward.chan@linklaters.com; jeremy.stokeld@linklaters.com

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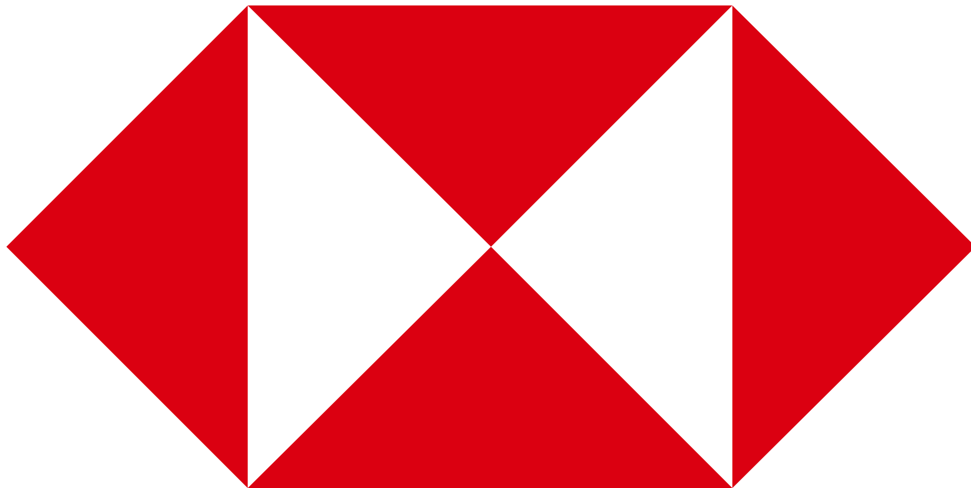

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