# HKMA TURNS UP THE HEAT AND ANNOUNCES CONSULTATION ON IBOR TRANSITION

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Legal Briefings – By **William Hallatt, Hannah Cassidy, Gareth Thomas, Dominic Geiser and Isabelle Lamberton**

On 12 February 2019, the Hong Kong Monetary Authority (**HKMA**) announced in a briefing to the Legislative Council Panel on Financial Affairs that the Treasury Markets Association (**TMA**) will hold a long-awaited consultation this quarter on alternative reference rates.

The announcement follows signals from regulators globally that firms should transition away from the London Interbank Offered Rate (**LIBOR**) and other IBORs to alternative, risk-free, reference rates.

While there is no immediate plan to discontinue the Hong Kong Interbank Offered Rate (HIBOR), the HKMA noted that "as a FSB member, [the HKMA] has an obligation to put in place an alternative reference rate as a contingent fall-back", tentatively suggesting the HKD Overnight Index Average (HONIA) as the most suitable alternative.

The outcome of this consultation will be a turning point for financial services firms preparing for life after LIBOR, and has important implications for the contractual design and incorporation of "fall-back" provisions in existing derivative, structured finance and syndicated lending contracts.

# A BACKGROUND OF UNCERTAINTY

The need to revise fall-back provisions arises from the fact that, in many legacy contracts, existing fall-back provisions are designed to respond to short-term disruptions in the market, as opposed to the scenario where the relevant IBOR is permanently discontinued.

If amendments do not occur then, in the case of LIBOR-linked contracts, it could lead to the frustration of up to US $350 trillion in financial instruments.

This, of course, presents a monumental challenge for firms, both in terms of volume and complexity.

The HKMA's announcements follow a recent speech by Edwin Schooling Latter, Director of the Markets and Wholesale Policy at the Financial Conduct Authority (**FCA**), who commented that although "[h]aving the right fallback triggers means having the right safety belt", regulators still "cannot provide … certainty about what the end-game for LIBOR will look like".

When designing fall-back provisions, this uncertainty presents two key roadblocks, as it still remains to be seen:

- when, and how, IBORs will cease. This has important implications for deciding on the right "trigger" point to move away from IBORs to a replacement fall-back rate; and
- whether the industry can agree on what replacement fall-back rate should be used. The International Swaps and Derivatives Association (**ISDA**) has made promising progress consulting on preferred alternative rates in the derivatives market, but for syndicated lenders and debt capital market participants, the task will be much more difficult.

This uncertainty gives rise to significant litigation and regulatory risks, which should both be kept in mind when consulting and negotiating with regulators and counterparties.

# LITIGATION RISKS

As seen in the final ISDA consultation report, litigation risk was at the forefront of many respondents' minds when taking into account their preferred benchmark fall-backs.

A key risk for loan and bond market participants when negotiating revised rates with counterparties is that the contract amendment process will become a zero-sum game, leaving both winners and losers. Counterparties who "lose out" may seek relief through litigation.

What then, are the main scenarios that could give rise to litigation in this context?

### Potential mis-selling claims

First are disputes which may arise in relation to legacy contracts containing inadequate fall-back mechanisms in the event of an IBOR ceasing, but which are not amended by the parties during the transition from IBOR (for example, because the counterparties have reached a stalemate in negotiating amendments).

In many securities transactions, fall-back provisions refer to the last available LIBOR. If LIBOR is discontinued permanently, this would turn many floating rate deals into fixed rate deals, and could give rise to mis-selling type claims.

For example, if a bond is marketed and sold today as a 7-year floating rate bond, but (because of its terms and a potential discontinuation of LIBOR in 2021) that bond operates as a 3-year floating rate bond, thereafter switching to a fixed rate for the remaining 4 years of the term, there is a risk that an investor might claim that it has been mis-sold the product.

### Valuation issues

More generally speaking, amending IBOR-linked contracts to reference a replacement rate, while the relevant IBOR still exists, will require parties to negotiate and agree commercial terms to address, among other things, the differences between the IBOR and the replacement rate. This could potentially give rise to litigation around issues including contractual interpretation, implied terms and frustration.

Even when negotiated in good faith and at arm's length, institutions may run the risk of a claim from a counterparty who will be able to see (for as long as the IBOR continues) what the outcome would have been had it remained on their original terms. This level of concern increases to the extent that a fiduciary duty, retail investor or borrower is involved.

## REGULATORY RISKS

In Hong Kong, there is very little guidance from regulators on how firms should manage the transition away from IBOR. Details on the upcoming consultation with the TMA have yet to be released.

However, it is clear that regulatory scrutiny will grow, with regulators seeking to intervene in areas where transition preparation is seen to fall short.

### IBOR transition as a misconduct issue

The HKMA has made reference to a "Dear CEO" letter issued by the UK Prudential Regulatory Authority and FCA, which illustrates that regulators expect firms to demonstrate their transition plans and confirm the senior manager who will be responsible for those plans and their delivery.

In Hong Kong, firms whose transition preparation is deemed inadequate may be subject to enforcement action for a breach of the *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission*, in particular General Principle 2 (due skill, care and diligence), General Principle 3 (capabilities) and General Principle 9 (responsibility of senior management).

There are also clear implications for senior management (including Managers-in-Charge), particularly those overseeing the firm's transition plan.

**Mitigating risks: the need for investor engagement**

When developing transition plans, financial institutions with less sophisticated counterparties, or which have entered into a large number of IBOR-referencing contracts with non-financial institutions, will need to ensure that they clearly explain fall-back provisions and the need for renegotiation to their counterparties.

## CONSULTATION BEGINS: WHAT NOW?

As the consultation phase with the HKMA and TMA begins, preparing for an additional level of regulatory scrutiny will be valuable in minimising any further hurdles when designing and negotiating fall-back provisions.

To mitigate the risk of the regulators taking action further down the road, firms should – as the FCA has asked UK firms to do – "undertake a comprehensive risk assessment of the potential prudential and conduct impacts associated with transition".

The good news is some firms may be able to leverage plans already in place to comply with the requirements of article 28(2) of the *EU Benchmarks Regulation* on contingency planning, which requires that firms produce and maintain robust written plans setting out the actions they would take if a benchmark materially changes or ceases to be provided.

## UK INSIGHTS

Herbert Smith Freehills has been following industry developments relating to the discontinuation of interest rate benchmarks globally on a cross-practice basis.

In a recent bulletin, our Banking Litigation and FSR practices discuss their insights on current market developments, potential litigation and key regulatory risks from a UK perspective.

## KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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