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LIBOR – THE DEATH OF A DEAR FRIEND

MARCH 2023 INSIGHT

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On 30 June 2023, participants in the banking and financial services sector and the lawyers that advise them will lose a dear friend, the London Inter-Bank Offered Rate (LIBOR). LIBOR is essentially a benchmark interest rate set by a panel of banks in London on a (relatively) daily basis, and represents the interest rate at which such banks could obtain loans from other banks in various currencies and for various durations. LIBOR has been the most commonly used benchmark rate used in floating rate loans, floating rate notes, OTC derivatives and other forms of financial instruments for several decades. So why must we say goodbye to it and what happens next? Before addressing those issues, let’s consider what LIBOR is in a little more detail.

Fixed Rates v Floating Rates

In Cambodia, loans are typically what we refer to as “fixed rate” loans. This means that the interest charged on a loan is fixed at a certain percentage (e.g., 8% p.a.). The disadvantage of a fixed rate loan from a lender’s perspective is that they are locked into the relevant fixed rate for the term of the loan. If interest rates go up, the cost of obtaining funds for the bank (through loans obtained by it as a borrower itself, or through interest offered on deposits) will go up too but there will be no corresponding increase in the receivables from fixed rate loans made by it. With high-levels of inflation in many countries across the world in recent years, we have seen a corresponding increase in interest rates. This is not something that banks with portfolios comprised mainly of fixed rate loans will be happy with as they are locked into rates of interest that are lower than market rates.

Floating rate loans, on the other hand, are loans that provide for interest to be calculated by reference to a benchmark rate (set by the market) with an additional fixed rate “margin” being applied to reflect the creditworthiness of the borrower.

It is not entirely clear where or when floating rates originated and this Insight is not intended to be a historical investigation of the same. However, while floating rates appear to have originated in Europe, it was not until the mid-1970s that floating rates started to appear in the U.S. and not until the mid-1980s, when the British Bankers Association (BBA) was asked by banks in London to create a benchmark rate of interest which led to the BBA Interest Settlement Rates (BBAIRS) being published in January 1986 in respect of USD, GBP and JPY. Over time, the name of this rate was

changed to BBA-LIBOR and many new floating rates were introduced covering different currencies and durations and published by different "information providers"[1].

Floating rates in respect of different currencies and durations are determined and published on each day in the relevant market on which the markets are open. They are intended to be a rate at which banks in the relevant interbank market could obtain funds in the relevant currency and for the relevant duration from other banks in that interbank market. By way of example, consider the following:

6M-USD-LIBOR

This is the rate of interest that a bank in the London Interbank market will be offered (**LIBOR**) by other banks for a loan to it that is denominated in **USD** for a period of **six months**. This is probably the most common rate used in Cambodia for floating rate loans which are typically made to Cambodian borrowers by offshore lenders. There are, of course, many other floating rates available. For example, EURIBOR is the benchmark rate applicable to the interbank market in the EU for euro-denominated financial instruments.

The relevant duration (referred to as the "designated maturity" in the context of OTC derivatives) should match the duration of the interest periods under the relevant loan agreement or exposure being hedged by an OTC derivative especially because the longer the period, the higher the interest rate. Typically, the rates published will be an overnight rate, a monthly rate, a quarterly rate, a semi-annual rate and an annual rate (though, as discussed below, other durations may be published).

To understand how a floating rate loan works, it is important to understand that each interest period is treated separately for the purposes of calculating the interest payable on an interest payment date. For example, if a USD-denominated floating rate loan has semi-annual interest payments, the lender will, on a day falling a few days before the start of each interest period (usually referred to as an "interest determination date"), be required to ascertain the rate of 6M-USD-LIBOR published on that day and that rate (plus the margin) will be the interest rate that applies to the relevant interest period.

How LIBOR is calculated (the cause of death)

LIBOR is and always has been a rate determined by obtaining quotations from banks in the London interbank market. On each market day (just before 11 a.m. GMT), the administrator of LIBOR, ICE Benchmark Administration, Ltd. (IBA), surveys a pool of 15 of the largest banks in the London interbank market in relation to their respective cost-of funds by asking the following question in relation to various currencies/durations:

"*At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11 a.m. London time*?"

IBA then takes the responses of the panel banks and, after applying a methodology that it is too long and complicated to discuss here, arrives at an average rate of LIBOR for the various currencies and durations. These rates are then published by entities that hold an IBA license permitting them to publish the rates.

The key point here is that the data comes from banks that provide quotations; not historical data regarding actual trades. As such, LIBOR has often been criticized as being a fictional rate that does not track actual rates at which banks actually borrow in the London interbank market. More fundamentally, the process is open to manipulation and for panel banks to quote higher or lower rates to make gains on trades or to make themselves look more creditworthy.

[1] Thomson Reuters and Bloomberg are the most famous information providers. Bloomberg, for example, and publishes rates on special terminals that can only be accessed by those willing to pay the license fee of approximately US$25,000 a year per user.

Such manipulation was engaged in by a large number of banks across the globe from London to Singapore and from Melbourne to New York, the most infamous example being that of Barclays Bank plc in 2012 which was fined GBP290m and saw several of its employees being jailed.

Some attempts were made to restore integrity to LIBOR over the years following the so-called "Barclays Scandal". In the UK, George Osbourne, the then Chancellor of the Exchequer, commissioned Martin Wheatley, the then Chief Executive of the Financial Conduct Authority (FCA), to conduct an independent review of LIBOR. The results of that review are set out in the Wheatley Report which was published in September 2012 and the key recommendations were:

- to make the setting of LIBOR a regulated activity with the FCA as the relevant supervisory authority;
- for the BBA to hand over its role as LIBOR administrator to an entity determined by tender (the successful bidder was Intercontinental Exchange, Inc. (ICE)); and
- to make certain changes to the data required to be submitted by panel banks and the nature of that data that would mitigate against the risk of manipulation.

In some ways, the changes that occurred to LIBOR in the years immediately following 2012 were analogous to the changes that occur to a patient that is transferred from a provincial hospital to a bigger hospital in the city. However, despite the more advanced facilities and the more highly-skilled doctors, our dear friend, LIBOR still suffered from an incurable case of being based on quotes rather than actual trade data. Moreover it had been tossed around like a rag-doll by rogue traders and was irreparably tarnished as a benchmark rate. The end was nigh.

The Search for an alternative

Over the ensuing years regulators around the globe started looking at alternatives to LIBOR as, in addition to the problems discussed above, fewer banks were providing quotations and the perception of it as a market rate lessened. In 2017, the FCA announced that LIBOR would be phased out in 2021 and that market participants should look for an alternative benchmark rate. For the next few years, there was a flurry of activity in the UK, the U.S. and other countries around the world to develop and decide on alternative reference rates (ARRs).

The outcome of this activity was that regulators (together with market participants) formed committees to determine which rate should replace LIBOR. One such rate is the Sterling Overnight Index Average (SONIA) administered by the Bank of England and used by banks for GBP-denominated loans. The other rate, which is of far more importance to us in Cambodia, is the Secured Overnight Financing Rate (SOFR). In light of the FCA's announcement regarding the phasing out of LIBOR, the Federal Reserve Board and the New York Fed convened meetings with participants in the private sector under the auspices of the Alternative Reference Rates Committee (ARRC) which finally determined that SOFR should replace LIBOR in relation to USD-denominated loans and other financial instruments.

At this point, it is useful to note three aspects of SOFR:

- SOFR is published by the New York Fed on its website at around 8 a.m. ET on each business day.
- SOFR is effectively the interest rate at which banks in the U.S. can borrow cash overnight where the loan is collateralized by treasury securities (a repo transaction).
- In calculating The New York Fed obtains actual trade data from the Delivery-versus-Payment system offered by the Fixed Income Clearing Corporation (FICC) rather than quotes.
- SOFR is an overnight rate. Due to some concern that SOFR was not the appropriate rate to use for longer durations, the CME Group has developed synthetic term rates for durations of 1,3,6 and 12 months.

The drawn-out euthanasia of LIBOR

The stage was thus set for LIBOR's life-support to be switched off. However, this was to happen in two stages:

- **31 December 2021** – the last day on which LIBOR was published for every currency except USD and only for durations of 1 day, 1 month, 3 months, 6 months and 12 months (the 1 week and 2 month durations were discontinued).

- **30 June 2023** – the last day on which any LIBOR rate would be published.

It is the second of these dates that is critical to Cambodia as floating rate loans tend to use 3 month or 6 month USD-LIBOR and many of these loans continue beyond 30 June 2023.

The impact of LIBOR's discontinuance in Cambodia

The discontinuance of LIBOR will have an impact on legacy transactions, new transactions and even on the laws and regulations in Cambodia.

(a) Legacy transactions

Existing (legacy) transactions (whether they be loans, OTC derivatives or other financial instruments) will need to be amended to reflect the discontinuance of LIBOR. In the case of OTC derivatives that reference LIBOR, International Swaps and Derivatives (ISDA), the main global trade association for OTC derivatives and publisher of market-standard documentation, has done a lot of work on creating fallback provisions and protocols that provide adhering parties with mechanisms to ensure a smooth transition from LIBOR to an ARR. Similar work has been conducted by the Loan Market Association (LMA) in respect of loans referencing LIBOR.

In Cambodia, there has been a hesitancy to adopt the recommendations of ISDA and the LMA and parties have opted to either switch to a new benchmark rate (e.g., a SOFR synthetic term rate) or agreeing some other method for determining the interest rate that will apply to the remainder of the term (e.g., that the interest rate that is applicable on the last day of publication will be the rate applicable to the remainder of the term). The former option would be more appropriate than the latter option where a loan term goes substantially beyond 30 June 2023 (the "**Cut-Off Date**") and the latter option would be more appropriate where a loan term expires shortly after the Cut-Off Date as the likelihood of substantial volatility in interest rates is less likely. Unlike in the U.S. where there is legislation dictating what will happen to legacy trades[2], parties in Cambodia appear to be free to select whichever rate or mechanism they like.

Of course, there are important considerations that flow from the amendment of transactions to incorporate a new benchmark rate. Switching to a synthetic term SOFR rate in a loan agreement for example requires, in addition to the obvious amendment of the rate itself, consideration of:

- interest determination dates and the business days on which, and time at which, the rate is published;
- the fallback rates to be used in case the synthetic term SOFR rate is not published on an interest determination date;
- how to interpolate rates in the case of short/long interest periods;
- market disruption clauses;
- the mechanisms for determining break costs and redeployment costs in the event of cancelations of commitments or prepayments;
- basis risk that arises from having different provisions in the loan agreement and a forward rate agreement, interest rate swap or cross-currency swap used to hedge currency or interest rate risk;

[2] See the Adjustable Interest Rate (LIBOR) Act (2022) and 1775 (AG34) Reg ZZ - Regulation Implementing the Adjustable Interest Rate (LIBOR) Act passed by the Board of Governors of the Federal Reserve which became effective on 27 February 2023.

- consequential amendments to security agreements or filings made with the relevant government authorities and departments in respect thereof; and
- the impact of such a switch on loans with related parties and ensuring they are not restructured in a way that they are no longer on arms-length terms.

It is important to appreciate that no laws have been passed in Cambodia regarding the discontinuance of LIBOR. As such, any contract that refers to LIBOR as a benchmark rate will need to be carefully reviewed and/or amended. It may be that the relevant contract contains fallback provisions that can accommodate the discontinuance of LIBOR but this is unlikely as fallback rate provisions often only deal with temporary failures to publish the benchmark rate; not the discontinuance of the benchmark rate itself.

(b) New Transactions

Banks and financial institutions are free to set the rates of interest that will apply to their loans[3] (subject to certain restrictions on the maximum rates that can be charged) and are therefore still free to select LIBOR as the benchmark rate for its financial transactions but given that LIBOR will cease to be published on 30 June 2023, there is little point in doing so and it is recommended that a synthetic term SOFR rate be used. This would indeed seem to be the rate that the markets have adopted for USD-denominated transactions in Cambodia and indeed, the global financial markets generally.

(c) Laws and Regulations

While a bank or financial institution is free to use whichever benchmark rate it wishes in determining interest rates for the purposes of transactions it enters into, there is one circumstance in which it is bound to accept LIBOR. This is in the case of transactions that it enters into with the NBC.

At the time of being granted a banking license in Cambodia (which is for an indefinite duration) a specialized bank, commercial bank or microfinance institution (including a microfinance deposit taking institution) is required to make a deposit of a certain percentage of its registered capital or minimum registered capital with the NBC[4]. The relevant regulations issued by the NBC that require such deposits to be made also provided initially that where the deposit was made in USD, it would bear interest at the Singapore Interbank Offered Rate (SIBOR).

Interestingly, the NBC issued Prakas[5] No. B5-014-002 on Utilizing LIBOR instead of SIBOR Rate on 8 January 2014 which provided that all transactions with the NBC by banks and other financial institutions that required the NBC to pay interest using SIBOR as the relevant benchmark rate would from then on require that interest be paid using LIBOR as the relevant benchmark. No such prakas appears to have been issued by the NBC in anticipation of LIBOR's discontinuance. The author understands that a notice has been issued by the NBC to licensed banks and financial institutions informing them that the benchmark rate will be switched from LIBOR to SOFR but cannot confirm whether such a notice has indeed been issued nor whether such a notice, if it exists, simply specifies SOFR as the replacement benchmark rate or specifies a synthetic term SOFR rate. In any event, as new entrants to, as well as existing participants in, the banking and finance sector in Cambodia will want certainty regarding the interest that will accrue on their sizeable deposits with the NBC, it is hoped that a prakas regarding the switch in benchmark rate will be made publicly available soon.

Conclusion

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[3] See Article 1 of Prakas No. B7-09-213 on the Liberalization of Interest Rate Settings issued by the NBC on 9 September 2009.

[4] See for example Prakas B7-01-136 on Bank's Capital Guarantee issued by the NBC on 15 October 2001.

[5] A *prakas* is a regulation issued by a supervisory authority such as, in the case of banks, the NBC.

It is with a great deal of sadness that some of us will bid farewell to LIBOR. It has been the most prominent benchmark rate in the history of financial markets with the World Bank estimating that at one time it was the rate underpinning approximately US$400 trillion of financial transactions across the globe[6]. When the author was starting his career in London at Bankers Trust, an investment bank, LIBOR was one of the first (of many) concepts that baffled him and the comfortable familiarity he developed with it has now been replaced by a feeling of loss and nostalgia fueled by the fact a benchmark rate determined in London is being replaced by a benchmark rate determined "on the other side of the pond".

SOFR is a fundamentally different rate to LIBOR both in terms of the way data is obtained and what that data reflects. It is therefore critical for banks in Cambodia to understand the nature of SOFR, the way in which synthetic term SOFR rates are derived and more importantly, the impact it will have on legacy and new transactions. Time is running out.

This Insight is not intended to constitute legal advice and may not be considered as constituting the same. For advice on how the discontinuance of LIBOR will impact your business and/or financial transactions, please do contact us.

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[6] See https://treasury.worldbank.org/en/about/unit/treasury/ibrd-financial-products/libor-transition