



Markets Brief

LIBOR Transition for DIFC-issued Debentures

Issue No. 22 – September 2020

Introduction

In this edition of the Markets Brief, the DFSA sets out information for Issuers and Reporting Entities of debt securities on prospectus disclosure requirements and continuing obligations relating to the transition from LIBOR.

Guidance

Please note that the contents of this communication are not intended to be Guidance as contemplated by the Regulatory Law 2004 and the contents should neither be interpreted, nor relied upon, as Guidance. You should refer to the DFSA Rulebook for Guidance or contact the DFSA if you require individual guidance.

Technical explanations given in this brief are for illustrative purposes and should not be considered or relied upon as legal advice. We recommend that independent legal advice is obtained if you are unsure about any aspect of

the DFSA Markets regime which may apply to you.

Defined terms are identified in this Brief by the capitalisation of the initial letter of a word or each word in a phrase and are defined in GLO.

Background

The Benchmarks Regulation

Market participants will be aware that the Benchmarks Regulation¹ was published in the Official Journal of the European Union (EU) on 29 June 2016 and came into effect on January 2018. The Benchmarks Regulation introduced a common framework to ensure the accuracy and integrity of indices used as benchmarks in financial instruments and financial contracts. Among other things, it requires benchmark administrators to be authorised or registered, it prevents certain uses by EU supervised entities of benchmarks of administrators unauthorised or unregistered in the EU, it requires contributors who provide input data to

¹ REGULATION (EU) 2016/1011 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and

Regulation (EU) No 596/2014 (referred to as the Benchmarks Regulation)

the administrators to adhere to the code of conduct on a continuous basis and it requires data provided by contributors to pass representativeness, relevance and appropriateness tests.

LIBOR (London Inter-Bank Offered Rate) Transition

On 27 July 2017, the Financial Conduct Authority, United Kingdom, (FCA) confirmed that it will no longer persuade or compel banks to submit rates for the calculation of the LIBOR benchmark after 2021 given the significant decrease of relevant active underlying markets. As a result, more recently in 2019, the FCA warned that LIBOR was likely to cease at the end of 2021 and that it could fail the Benchmarks Regulation 'representativeness' test at end-2021, reinforcing the position that continuation of LIBOR in the near future is not guaranteed.

LIBOR Transition Risk

The above developments could have a material impact on debt securities linked to or referencing a benchmark, if the methodology or other terms of the benchmark are changed either in order to comply with the requirements of the Benchmarks Regulation or when the banks stop submitting data to the LIBOR administrator, ICE Benchmark Administration Limited. In the latter case, the cessation of the benchmark, among other things, could have an effect on the volatility of the published rate of LIBOR or otherwise render the calculations referencing LIBOR impossible. Therefore, Issuers of securities with maturities beyond 2021 should consider if there is any relevant information about the LIBOR transition impact on the floating interest rates that should be

disclosed in the prospectus or disclosed by way of a market announcement.

The DFSA also cautions against the further issue of any LIBOR-related financial products or securities, which run beyond the end of 2021 deadline or any IBOR-related financial products where the existence or other vital aspects of the IBOR are uncertain.

Disclosure Obligations for Issuers

When we considered international best practice, we found that issuers, in addition to describing the detailed LIBOR transition risk, have also cautioned investors by way of a disclosure that if LIBOR is discontinued or becomes unavailable in the future, the interest (or profit) rate referenced to LIBOR will be determined for the relevant period in accordance with a fall-back provision set out in the transaction documents or an alternative arrangement that will be in place. The fall-back provision or arrangement refers to the possibility that the interest (or profit) rate could be set by reference to another rate such as a successor rate or an alternative rate as described in the prospectus. As a result, securities holders were reminded of the possibility that the underlying terms and conditions of documents such as the trust deed and transaction documents (those underpinning Sukuk) would need to be amended, which could affect the securities holders' existing contractual rights when a fall-back provision is triggered.

We encourage Issuers to consider these best practice disclosures, and also wish to remind them of their specific obligation under the Markets Rules (MKT) to describe any market disruption events that might affect the rate of

interest (or profit) that is not fixed.

Accordingly, we wish to remind all new and existing Issuers (whose prospectus or issuance programme has yet to be updated accordingly) of their obligations under MKT to disclose relevant risk factors that may affect their ability to fulfil obligations. Issuers are reminded to include material information such as the fall-back provisions and how the contractual terms and conditions might be affected as a result of triggering these provisions.

In addition to complying with the MKT requirements, adequate and timely disclosures will protect actual and potential investors and help maintain a fair, informed and orderly debt securities market.

Alternative Reference Rates (ARR)

On 29 November 2017, the Bank of England and the FCA announced that from January 2018 its Working Group on Sterling Risk-Free Rates has been mandated with implementing a broad-based transition to the Sterling Overnight Index Average (SONIA) over the next four years across Sterling bond, loan and derivative markets, in order that SONIA is established as the primary Sterling interest rate benchmark by the end of 2021.

Meanwhile a number of G20 jurisdictions, in particular the central banks in the UK, USA, Japan, Switzerland and the EU, have been working jointly with the financial industry to overhaul some of the existing Interbank Offered Rates (IBOR) and replace them with more appropriate and representative ARR. This has coincided with the changing structure of the inter-bank market where secured lending has largely replaced the unsecured

transactions.

Issuers should consider to what extent the upcoming transitions will affect their business and prepare to replace the outgoing LIBOR or IBOR with suitable available ARRs, while bearing in mind the complexities related to replacement stemming from the market liquidity in new ARR-based products and the different nature of these rates relating to, for example, unsecured vs. secured, backward vs. forward looking and term rates vs. overnight only aspects.

Sukuk and ARR

ARR may not be viable for all Shari'a compliant Sukuk structures owing to the differences of how LIBOR and ARR are calculated. We note that LIBOR, a forward-looking term rate used to calculate interest at the start of a calculation period, may not be the same as the ARR. The latter are backward-looking overnight rates that, if applied to a particular calculation period, can only be determined towards the end of that period, which could pose an issue for certain types of Islamic contract such as a Murabaha, a cost plus/mark up pricing contract. Pricing has to be determined at the time when an asset is sold. If the pricing can only be determined at the end of the sale period, or a later date based on RFRs, there is risk that the RFRs may not satisfy the Shari'a requirements for entering into a Murabaha contract in full.

Issuers who have or are planning to issue Sukuk based on the Murabaha contract are reminded to disclose the fall-back or alternative arrangements they have in lieu of LIBOR or other inter-bank offered rates and the details about how RFRs might impact their obligations under the transaction documents.

General Reminder for Reporting Entities

DFSA wishes to remind Reporting Entities that they have obligations under the MKT rules to notify the DFSA in advance of any change in the rights attaching to securities which are listed, in the case of debt security, any change in the rate of interest. Thus, a reporting entity on the occurrence of such event will need to contact the DFSA to discuss the continuing obligations and/or conditions that it needs to fulfil when a benchmark rate ceases to be used at any point in time.

Further Information

In the meantime, if you have any question in this regard, please contact the following individuals from the DFSA Markets Team:

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The DFSA Markets team can be also reached on markets@dfsa.ae or 04 362 1585. The DFSA will not advise a particular course of action or provide (legal) advice, but it is prudent to keep the DFSA informed of ongoing developments in relation to the Reporting Entity.

Contact us

Visit the DFSA website www.dfsa.ae for:

- other editions of the Markets Brief;
- access to DFSA-administered legislation and the DFSA Rulebook, including the full text of the Markets Law 2012 and Markets Rules; and
- the Code of Market Conduct (in the

Sourcebook Modules part of the DFSA website).

For any other general enquiries:

- Telephone +971 4 362 1500
- Email markets@dfsa.ae

Feedback

We appreciate your feedback and welcome any suggestions that you may have. Please email us at markets@dfsa.ae