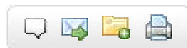
Libor update: What is happening as a matter of fact and law?

Jul 01 2019 Patrick Clancy



The UK regulator, the Financial Conduct Authority (FCA), has made clear that the continuation of Libor beyond the end of 2021 is uncertain. The current panel banks have agreed with the FCA to continue to submit rates to calculate Libor until the end of 2021. Submitting banks now dislike doing this because of the potential liability that comes with it.

So, there is a risk that one or more submitting banks will wish to cease submitting rates when they can (i.e. with effect from the start of 2022). If too many do this, then Libor will not be capable of being determined and published in the existing manner in compliance with current regulations and publication may need to cease.

If Libor ceases to be published, all the pre-existing transactions based on Libor will be affected: of these transactions, some currently have benchmark fallback arrangements which are expected to be adequate in this situation, but many do not. One task is to ensure that new transactions have adequate fallback arrangements. A separate task is to remediate those pre-existing transactions which do not have adequate fallback arrangements.

Is there a viable replacement rate?

Separate committees were tasked in relation to each of US Dollars, Swiss Francs, Euro, Sterling and Japanese Yen with examining the situation and consulting with the relevant market to determine what rate would be a suitable base for floating rates in the relevant currency. The rates which have been chosen, Secured Overnight Financing Rate (SOFR), Swiss Average Rate Overnight (SARON), Euro Short-Term Rate (ESTER), Sterling Overnight Index Average (SONIA) and Tokyo Overnight Average Rate (TONA), are markedly different from Libor, as they are all based on backward-looking overnight risk free-rates (RFRs).

Libor is, by contrast, a forward-looking rate incorporating elements of risk, including bank and liquidity risks). New transactions using floating rates could use the RFRs as their base, but it is not yet clear how best to bridge the gap between such an RFR and Libor to use the RFR as a fallback to Libor across all the markets.

What will be the impact on legacy agreements?

The derivatives market is working towards its own market-wide solution for pre-existing transactions, in the form of a protocol, under which there would be a transition from Libor in a particular currency to the relevant RFR, with a spread adjustment or lump-sum payment to compensate (on a one-off basis) for the inevitable change in value, for any particular derivative transaction, of the move from Libor to the RFR.

The underlying presumptions here are that the derivatives markets do not need a forward-looking element to a fallback rate and that the parties to a derivative transaction will, in the end, be comfortable with this solution, even though the spread adjustment or lump-sum payment (because they are fixed at a point in time) will turn out to favour one or other party as the difference between the RFR and Libor increases or decreases in the future.

The position is not as straightforward in the loan and bond markets. For borrowers under loans and bonds, the forward-looking nature of Libor has significant benefits (and so a fallback to a backwards-looking overnight rate has few attractions) and there is little support for a solution where the borrower may turn out to be a loser under a spread adjustment. Furthermore, the mechanisms for making changes to the rates in loans and bonds have to operate on a per-loan or per-bond basis and are not susceptible to a protocol-style approach.

Another issue for borrowers under these instruments is that, if they have any associated hedges in the derivatives market, the change to those hedges (under the protocol mentioned above) may result in the borrowing and the hedge no longer matching

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each other, which will raise a number of questions, including as to hedge accounting.

New transactions in the bond and loan markets are still, at the moment, predominantly using Libor as the floating rate base, in part because the markets are not yet familiar with the RFRs.

There is now much improved fallback language to include in the documentation (for a fallback to RFRs), but it remains to be seen whether these markets will generally adopt the language promoted by various committees or will develop alternatives that may better suit them.

Will the frustration of legal contracts be an issue?

If Libor becomes unavailable, there will certainly be contracts using Libor for which one or other party will claim that the contract is frustrated. The size of the issue is uncertain. If a floating rate market based on RFRs and other alternative rates develops quickly, so that future transactions use a non-Libor benchmark from the outset, then the volume of Libor-based contracts will naturally reduce over time as loans and bonds are repaid or refinanced.

As noted, a number of Libor contracts may have adequate fallback language, for example, loan agreements which fallback to the lending banks' cost of funds (though that may not be useful if the initial lending banks have sold out to non-banks such as collateralized loan obligations (CLOs), so the frustration question will arise only in relation to a sub-set of bonds and loans (assuming that the derivatives markets do in fact adopt the protocol approach).

What are the mitigants?

Time is a critical factor here. Market participants and end-users are still getting to grips with the implications of at least three inter-related areas: the possible future cessation of Libor; the widespread adoption and use of RFRs as the floating rate base; and the technicalities of moving any existing transaction from one to another. And the time by which we must all be ready is currently set to expire at the end of 2021, which is likely too close for a significant RFR-based market to develop in that time.

So, a significant mitigant would be for the FCA to make clear that it would be prepared to oblige Libor panel banks to continue to submit after 2021: current regulation provides that this coercion can last for a maximum of two years.

It is also possible that some of the most widely-used Libor settings (for example, three and six-month dollar Libor) could continue to the published after 2021 by agreement between relevant panel banks and the Libor administrator, Ice Benchmark Administration.

There is a chance that a benchmark administrator may come up with a new benchmark that is much more of a Libor look-alike than the RFRs. The use of a Libor look-alike as a fallback would make the transition from Libor to such a rate much easier than to an RFR-based arrangement, but it would need very wide market support to act as a significant mitigant.

Libor could perhaps be worked out differently, that is, not based to any great degree on panel bank rate submissions determined by their expert judgement. If this were possible, then Libor in some settings, could continue to be published.

Finally, legislation could mandate a solution. This is highly difficult, as it would probably require legislation in Europe/the UK, the United States, Switzerland and Japan in any event, and that would likely not address issues arising under contracts governed by yet other governing laws. If the markets reach a consensus on the appropriate solution for any particular Libor rate setting, then legislation which imposed that solution on contracts within the scope of that legislation might help, but new law and regulation generally has a long lead time and some unexpected and unwelcome knock-on consequences.

What should non-banks do to prepare?

Non-banks should analyse their exposure to Libor, by currency and instrument and determine a profile for that exposure by time. It is possible that the derivatives markets and the cash markets will treat a cessation of Libor in different ways, so gross and net exposure in different markets may also be important.

All market participants should consider using alternative rates for new transactions. Non-banks should also continue the dialogue with their financiers over (a) the proposals that the market is considering, (b) regulatory developments and timetables and (c) the development of trading and hedging products relating to alternative benchmarks and the basis risk between such benchmarks and Libor.

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