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Reference Rate Reform

The LIBOR endgame non-event

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Executive Summary

- Despite concerns and fears to the contrary, 31 December 2021 passed as a non-event in the LIBOR transition process.
- Several reasons explain the perceived calm, and indicate that we are not past the hill yet
  - The largest financial institutions have been preparing for years
  - The transition towards ARRs does not constitute a big bang - but an ongoing process
  - Synthetic LIBOR availability for Sterling and Yen settings, as well as the reformed EURIBOR
  - Later USD LIBORs cessation timetable and regulatory loopholes.
- Topics that continue to dominate the transition discourse include CAS, the use of term versus in-arrears rates, USD LIBOR issuances, and US 'tough legacy' legislation.

1 Introduction

Just like with the Y2K transition over two decades ago, a lot has been said and written about 31 of December 2021, in the context of the LIBOR transition. However, market participants may have been taken aback by the apparent calm around -and after- the tipping date.

> *"Publication of 24 LIBOR settings has ended, and the 6 most widely used sterling and Japanese yen settings will be published using a changed methodology from today."*
>
> *Financial Conduct Authority, 04 January 2021*

A number of reasons can explain the perceived calm:

- **The largest financial institutions have been preparing for years**

  Since the FCA announced its intention to cease panel submissions on LIBOR in 2017,[1] financial institutions and other market participants have invested heavily in order to transition away from LIBORs and towards alternative reference rates (ARRs).

- **The transition towards ARRs does not constitute a big bang - but an ongoing process**

  While 24 of the 35 LIBOR settings ceased to be published on 1 January 2022, legacy financial contracts continue referencing the agreed upon LIBOR fixing until their next reset date.

  In addition, synthetic Sterling and Yen LIBOR rates[2] have been made available for all contracts except for cleared derivatives. For Euros, EURIBOR has been reformed and will continue to be published for the foreseeable future.

  Last but not least, activity has already started shifting to RFRs, whether as part of the 'SOFR First' initiative,[3] CCP discounting and PAI switches, or the FCA's ban on new GBP LIBOR issuances effective already since 31 March 2021.[4]

- **5 out of 7 USD LIBOR settings will continue to be published until 30 June 2023**

  The most heavily referenced USD LIBOR settings will continue to be published until 30 June 2023, therefore offering a longer transition window for legacy USD contracts.

  While these USD LIBOR settings are not intended for use in new issuances, their continued availability and regulatory divergencies (local and international) may allow for continued use until they are ultimately retired.

[1] https://www.fca.org.uk/news/speeches/the-future-of-libor
[2] https://www.fca.org.uk/news/press-releases/fca-confirms-rules-legacy-use-synthetic-libor-no-new-use-us-dollar-libor
[3] https://www.cftc.gov/PressRoom/PressReleases/8409-21
[4] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2021/march/transition-from-libor-to-risk-free-rates.pdf

2 Topics that continue to dominate the transition discourse

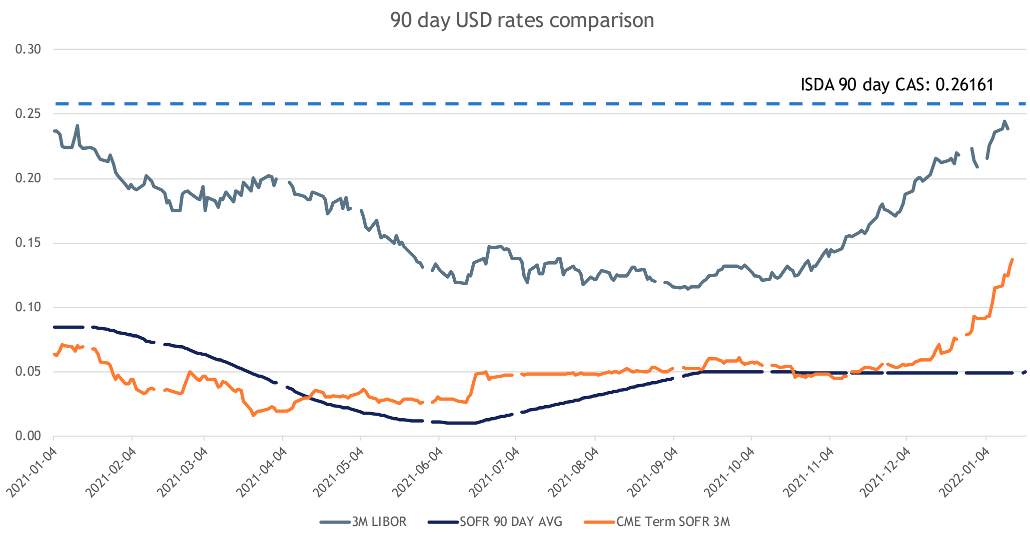
A number of topics dominate the transition process, including CAS, the use of term versus in-arrears rates, USD LIBOR issuances, and US 'tough legacy' legislation.

Credit Adjustment Spread (CAS)

The objective of the CAS is to reflect the historic basis between LIBOR rates and their respective adjusted Risk Free Rates (RFRs). While the CASs based on the ISDA methodology and published by Bloomberg[5] have been fixed since 5 March 2021 (and the relatively similar USD cash product fallbacks published by Refinitiv[6]), their use is far from ubiquitous.

The current low interest rate environment means that ISDA methodology CASs (calibrated against the 5 year median basis) are higher than the spot basis between the respective rates. The following graph provides a visual comparison of 90 day rates for USD and the 90 day ISDA CAS.

[5] https://assets.bbhub.io/professional/sites/10/IBOR-Fallbacks-LIBOR-Cessation_Announcement_20210305.pdf
[6] https://www.refinitiv.com/en/financial-data/financial-benchmarks/usd-ibor-cash-fallbacks



As a consequence, and in order to avoid value transfers between borrowers and lenders, bespoke CASs are often observed in the market.[7] Bespoke CASs may be based on spot spreads, prospective spreads, or any other methodology agreed between the contracting counterparties.

A number of observations are worth noting:

1. Based on the scanning of various publicly disclosed transactions, a nascent CAS convention seems to be surfacing, at least for Term SOFR linked transactions:

   - 10bp for 1M Term SOFR
   - 15bp for 3M Term SOFR
   - 25bp for 6M Term SOFR.

2. In the case of loan exposures hedged by ISDA-covered IRS, the use of ISDA's fallback CAS in the loan contract may be preferred, to avoid hedge ineffectiveness upon fallback trigger.

3. While ISDA CASs *currently* appear high, one needs to pay attention to future interest rate trajectories, especially in the context of rising inflation expectations.

4. Whether for legacy contracts falling back to ARRs or new issuances referencing RFRs, pricing managers should pay attention to the countercyclicality of risk free rates. Unlike LIBORs which tended to climb up in periods of stress, RFRs track

[7]https://www.lma.eu.com/application/files/7516/3827/6840/List_of_RFR_referencing_bilateral_and_syndicated_loans_November_2021.pdf

Central Bank policy rates and therefore are expected to drop in downturns, therefore putting pressure on asset-liability margins.

Lastly, and having moved in circles, the debate as to whether CAS is explicitly disclosed remains open. Most banks prefer to embed CAS in the product margin (i.e. quote RFR + margin), however several transactions have explicitly disclosed the CAS applied. This has been primarily due to borrower pressure, as an explicit CAS offers an additional price negotiation lever.

Term RFRs or RFRs in arrears?

With the exception of the Swiss Franc, all other LIBOR currencies offer term alternatives.

However, the use of Term RFRs has been restricted, more so in the UK, but also in the US. The objective of such usage restrictions is to prevent an ‘inverse pyramid’ situation, whereby the Term RFR (a derivative rate of the overnight RFR) is more heavily used than the O/N rate underlying its construction.

The following table summarises the Term RFRs (and IBORs) available in each LIBOR currency, as well as the approved use cases (where applicable).

Alternate reference rate	Secured Overnight Financing Rate (SOFR)	Sterling Overnight Index Average (SONIA)	Euro Short Term Rate (€STR) or EURIBOR	Swiss Average Overnight Rate (SARON)	Tokyo Overnight Average Rate (TONA)
Term rate	Term SOFR Published by CME Group, endorsed since July 2021	Term SONIA Published by IBA, Refinitiv since January 2021	Not available yet EURIBOR is an alternative	No term rate available	TORF available as of April 2021 TIBOR is an alternative
Term RFR approved use cases	▪ Middle market loans ▪ Trade Finance ▪ Multi-lender facilities ▪ End user facing hedging derivatives ▪ Securitisations of assets referencing term SOFR ▪ ARRC fallback users	▪ Mid Corporate ▪ Small & Micro Enterprises ▪ Retail mortgages ▪ Wealth/private bank ▪ Trade & working capital ▪ Islamic Finance	▪ Unknown yet	▪ Not applicable	▪ No explicit restrictions (but TONA should be the main alternative benchmark)

Practically, borrowers, lenders and derivative market participants need to take the following into consideration:

- Is the use of Term RFRs explicitly permitted as per the respective use cases?
- Can the systems handle in-arrears conventions?
- Can the various rates be properly risk managed?
- How will Term Rates behave, vis-à-vis overnight RFRs, in a rising interest rate environment?
- Does the borrower want to hedge the underlying loan exposure, given that Term RFR derivatives cannot be actively traded in the interdealer market and their use is restricted to “end user” hedges?

USD LIBOR availability

With the exception of the 1 week and 2 month USD LIBOR settings which ceased to be published on 31 December 2021, the remaining -more heavily referenced- settings will continue to be published until 30 June 2023.[8]

While the extended publication of said USD LIBOR settings is intended for legacy contracts only,[9] the enforcement of such rules depends on local regulatory and legal constraints.

Paradoxically even within the USA, where the banking regulatory agencies have explicitly prohibited new issuances based on USD LIBOR, entities regulated by the SEC – like private credit or non-bank originators– can theoretically still originate new LIBOR loans.[10]

It is also worth noting that drawdowns on committed facilities issued before 2022, as well as LIBOR loans underwritten in 2021 but syndicated in 2022, can still reference USD LIBOR!

[8] https://www.fca.org.uk/news/press-releases/announcements-end-libor
[9] https://www.fsb.org/2021/06/fsb-issues-statements-to-support-a-smooth-transition-away-from-libor-by-end-2021/
[10] https://www.ft.com/content/56c76bd6-aafb-4162-a26f-4c312a47ff59

'Tough legacy' legislation

While the UK and the EU have enacted targeted benchmark regulations, the US legal landscape is still incomplete.

The New York State Senate has passed Bill S297B[11] for contracts governed by NY State law. The main provisions of the bill can be summarised as follows:

- Prohibits parties from refusing to perform contractual obligations or declaring a breach of contract as a result of the discontinuance of LIBOR or the use of a replacement
- Establishes that the replacement is a commercially reasonable substitute for and a commercially substantial equivalent to LIBOR
- Provides a safe harbour from litigation for the use of the recommended benchmark replacement.

However, Federal Bill HR 4616 (Sherman's Bill, or "Adjustable Interest Rate (LIBOR) Act of 2021", or 'tough legacy' bill) has only passed the US House of Representatives but not the Senate.

The following table summarises the current state of LIBOR transition-related legislative solutions in the USA, UK and the EU.

	United States	United Kingdom	European Union
Benchmark regulation	**No**	**Yes** ▪ BMR UK	**Yes** ▪ BMR EU
Restrictions in use of benchmark	**No**	**Yes** ▪ Article 21A (UK BMR)	**Yes** ▪ Article 21A (EU BMR)
Legislative solution	**Yes** ▪ NY State - Bill S297B ▪ Federal (proposed) - Bill HR 4616	**Yes** ▪ UK Critical Benchmarks Bill	**Yes** ▪ EU BMR, 13 Feb 2021 amendment
Legislative solution scope	▪ Not limited to US law contracts	▪ Limited to UK law contracts and UK supervised entities	▪ Limited to EU law contracts ▪ Unless 3rd country law does not offer legislative fix and parties are established in EU
Legislative solution currency	**Yes** ▪ USD LIBOR only	**Yes** ▪ GBP LIBOR, JPY LIBOR **Possibly** ▪ USD LIBOR **No** ▪ EUR LIBOR, CHF LIBOR	**No** ▪ Not specified in the regulation ▪ At the European Commission's discretion
Legal safe harbour	**Yes** ▪ NY State: explicit ▪ Federal: expected	**No** ▪ Express contractual continuity ▪ No express protection from claims	**Yes** ▪ Permanent cessation only
Synthetic LIBOR	**Probably No**	**Yes**	**No**

[11] https://www.nysenate.gov/legislation/bills/2021/S297

3 Conclusion

We have crossed a big milestone, but we are not there yet! However, the end of LIBOR is coming closer, day by day.

John C. Williams, President and CEO of the Federal Reserve Bank of NY, once said: “Some say only two things in life are guaranteed: death and taxes. But I say there are actually three: death, taxes, and the end of LIBOR.”

Leaving taxes aside, just like with death it’s better to experience a benchmark transition only once in our lifetime.

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