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Libor Phaseout Considerations

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The Financial Conduct Authority of the United Kingdom plans to phase out the London Interbank Offered Rate (LIBOR) by the end of 2021. Created almost 50 years ago on August 15, 1969 -- the opening day of the Woodstock music festival -- LIBOR began as a floating, market-determined interest rate for syndicated loans, but over time has become the benchmark interest rate for an estimated $350 trillion in outstanding financial arrangements around the world. These contracts include public and private loans and bonds, consumer financial products such as credit cards, mortgages and student loans, and some $200 trillion in interest-rate derivatives.

Due to manipulations in the LIBOR market and concerns that the determination of LIBOR is based on fewer and fewer interbank transactions, and therefore is an increasingly unreliable benchmark for the global financial markets, regulators worldwide have been working to develop alternative benchmarks.

In the U.S., the Alternative Reference Rates Committee (ARRC), a private industry group convened by the Federal Reserve Board and the New York Federal Reserve Bank to plan the market's transition away from U.S. dollar LIBOR, has selected SOFR (the Secured Overnight Financing Rate) as the new interest-rate benchmark for U.S.-dollar denominated transactions in bond and loan markets.

Differences between LIBOR and SOFR

First, LIBOR is an inter-bank, unsecured lending rate, whereas SOFR is based on overnight transactions secured by U.S. Treasury securities, and, as such, is considered a "risk-free" benchmark alternative. As a result, LIBOR is generally higher than SOFR, often by 20 basis points or more, which difference tends to widen out at times of stress in the credit markets. Therefore, a simple switch from LIBOR to SOFR, without additional adjustment, would mean a lower interest rate, so in an existing transaction a transition from LIBOR to SOFR would require an upward adjustment -- referred to as a "replacement benchmark spread" -- to ensure that the pre- and post-amendment rate levels are comparable. The negotiation between creditors and borrowers of the amount of the replacement benchmark spread may present a challenge, because SOFR, which is tied to the securities repurchase (repo) market, is at times subject to significant volatility, particularly at month-, quarter- and year-ends. In the U.S., the ARRC is expected to recommend a specific methodology for determining the replacement benchmark spread, but creditors and borrowers will be under no obligation to accept it.

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Second, while LIBOR is available for various tenors (e.g., one-month, three-month, six-month), SOFR is currently only available as an overnight rate on the website of the SOFR benchmark administrator (the Federal Reserve Bank of New York). For now, the lack of forward-looking term SOFR makes market participants reluctant to agree to use SOFR in their loan agreements. While private parties are developing forward SOFR curves for different periods (the CME Group, for example, currently publishes one-month and three- month SOFR futures), it will take time for curves to be developed and gain widespread market adoption.

Amending Existing Contracts

Perhaps the greatest challenge to the transition from LIBOR to SOFR will be to amend the contractual terms of existing financings that are due to mature after the LIBOR transition date. An estimated $35 trillion of currently outstanding LIBOR - linked financial transactions expire after 2021 (in comparison, the U.S. national debt is $22 trillion).

Loan documents for LIBOR-based loans may provide a definition of LIBOR, with that definition providing certain "fallbacks" in case LIBOR is no longer determinable based on the method provided in the document (generally a designated display page on a Reuters or Bloomberg rate screen). However, these fallbacks are generally triggered only when LIBOR is unavailable (for example, if for some reason LIBOR is not displayed on the designated rate screen on the interest-rate determination date), but do not consider a scenario where LIBOR no longer exists. Loan agreements also typically contain provisions that apply an alternate base rate in the event that either (a) LIBOR cannot be determined, (b) dollar deposits are not being offered in the London interbank market or (c) LIBOR no longer reflects the lender's cost of funding a loan. Those alternate base rates are often based on the prime rate, the fed funds rate (plus a margin) or some other agreed upon rate. However, these alternate rates were generally added as a short-term solution for a temporary disruption, not as long-term replacements for LIBOR, as those rates are often significantly higher than LIBOR. Even so, while fallback language is still being developed, it will be difficult for the market to adopt adequate language until the uncertainties surrounding SOFR are resolved.

The FDIC addressed the LIBOR transition issue in its Winter 2018 edition of “Supervisory Insights”. The FDIC noted that FDIC examiners will not be examining financial institutions for LIBOR transition planning or criticize risk management of loans or deposits merely because they use LIBOR as a reference rate. Also, the FDIC encouraged banks to assess the comprehensive effect of the risks associated with a transition in reference rates on the whole institution, including such arenas as information technology, management information systems, accounting, governance, compliance, and internal control structures.

Final Thoughts

While 2021 may still seem well in the future, the adjustments that market participants will need to make are significant, and these adjustments may have to be undertaken while replacement rates and fallback provisions remain unresolved. The time to review your institution's LIBOR exposures and related documentation, and to map a path forward, is now.