TRANSITING FROM LIBOR

Introduction

Interbank offered rates and in particular, the London Interbank Offered Rate, or LIBOR, have been at the heart of the financial system for the past decades.

For the most part, LIBOR has satisfied two of the three features of an ideal reference rate identified by the Bank for International Settlement; LIBOR is usable beyond the money market and serves as a benchmark for term lending and funding.

However, LIBOR fell well short on the first principle, namely that reference rates provide a robust and accurate representation in the core money market. This was due to a weakness in the way that LIBOR was prepared. Panel banks were originally requested to report non-binding quotes instead of actual transactions. In addition, the interbank market has been relatively weak since the financial crisis and very few transactions form the basis of the submissions for longer tenors. Both have contributed to making LIBOR especially vulnerable to rate manipulation.

There have been numerous attempts at reforming LIBOR to make it less susceptible to rate manipulation including by basing submissions on actual transactions. However, even with the subsequent reforms carried out in the administration and submission methodology of LIBOR, the reality is that the unsecured interbank market has never recovered to its pre-financial crisis level.

In December 2017, the European Commission recognised LIBOR's role as a systemically important benchmark by designating LIBOR as a critical benchmark under the EU Benchmark Regulation[1]. The Financial Conduct Authority (FCA) of the UK was given powers to compel banks to contribute data to LIBOR under the EU regulation. However, the FCA has indicated that it expects a transition to occur to alternative rates by the end of 2021 so that it would not be necessary to use its powers of compulsion after that period.

Authorities in jurisdictions overseeing major currencies have identified alternative rates with the intention to eventually replace LIBOR and other interbank offered rates.

Beyond LIBOR

With over USD 370 trillion in financial contracts tied to LIBOR, it is key that the transition to alternative rates causes the least amount of disruption to legacy contracts.

At the request of the Financial Stability Board, the International Swaps and Derivatives Association launched a consultation regarding fallback options to be inserted into contacts. Unlike the derivatives market, agreeing to a fallback mechanism may prove trickier in the loan and bond markets.

In the US loan market, following a market-wide consultation, the Alternate Reference Rates Committee (ARRC) convened by the Federal Reserve Rate of New York released fallback language for a transition when LIBOR is no longer usable. The ARRC recommended two alternative fallback approaches. The first is a hardwire approach specifying the replacement rate and spread adjustment that will apply upon the

[1] Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016' (OJ L171, 29.06.16, p.1)

occurrence of a trigger event. Alternatively, the ARRC also proposed an amendment approach allowing the parties to agree to a benchmark replacement rate and adjustment spread if a trigger event occurs.

The Loan Market Association has already published a revised version of the Replacement of Screen Rate clause which can be used by parties who have identified a replacement benchmark rate and wish to amend their loan documentation to incorporate the use of that benchmark.

With the global reach of the transition, banks, local and international, should take the first step of identifying the legacy exposures that reference LIBOR so that they can be migrated to new benchmarks. Understandably, the bespoke nature of the contracts which underpin the loan market results in this being a time-consuming process.

A change in the reference rate will also necessitate changes in the operational systems of banks. At best, this can take several months to execute. The dilemma for banks rests in the difficulty they face in investing to upgrade their operational systems if certain fundamental features of the proposed risk-free rates, such as the availability of forward-looking term rates, are not yet finalised.

With the deadline of 2021 approaching and its far-reaching consequences, banks should monitor developments closely and identify their legacy contracts which will need to be amended. For instance, in the UK, the FCA and the Prudential Regulatory Authority enquired on the preparations by banks and insurance companies to manage the transition away from LIBOR. They also requested that banks and insurers nominate an individual responsible for the transition within their organisation. This is a sensible approach and a good first step for any global or local financial institution affected by the likely winding down of LIBOR.

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