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Momentum Building for LIBOR Replacements

The Biggest Challenge: How to Deal with Legacy Transactions

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SPECIAL TO BANKER & TRADESMAN

Imagine you sign a contract and later learn that one of its key financial underpinnings will be replaced by something unknowable. That is the reality if you enter into a financial transaction involving the London Interbank Offered Rate, or LIBOR.

LIBOR is a benchmark interest rate used in over $350 trillion of financial transactions around the world. It is used to determine the interest rate on most adjustable-rate financial products, such as corporate and consumer loans, mortgages, derivatives, bonds and securitizations. LIBOR is scheduled to be phased out of existence by the end of 2021.

Thirty-five versions of LIBOR are calculated every business day for the U.S dollar, the euro, the British pound sterling, the Japanese yen and the Swiss franc, with varying maturities for each currency (from overnight to 12 months). LIBOR quotes are based on daily submissions from a panel of banks in London. Banks estimate how much it would cost them to borrow from other banks on an unsecured basis.

Beginning in 2008, a rate-rigging scandal compromised the integrity of LIBOR. Banks and individual bankers were accused of manipulating their LIBOR submissions for their own benefit. Banks paid billions of dollars in fines, individuals went to jail and regulatory authorities stepped up their efforts to root out fraud in the determination of LIBOR.

After years of increased regulation and input from regulators and market participants, LIBOR's chief regulator announced in 2017 that LIBOR would be replaced by the end of 2021. Interbank lending had plummeted since the financial crisis of 2008. It no longer made sense to base a benchmark rate on banks' estimated costs to borrow from one another when little interbank lending was occurring.

> **Hardwired replacement rates and replacement spreads do not exist today. They involve components that are still to be determined by regulatory authorities.**

Regulators want to transition to a replacement benchmark rate based on actual transactions, not fictional estimates. The hope is to create a reference rate less likely to be manipulated and more representative of market conditions.

In the United States, the leading candidate to replace U.S. dollar LIBOR is the Secured Overnight Financing Rate (SOFR). The Federal Reserve Bank of New York began publishing it in April 2018. SOFR measures the cost to borrow cash overnight based on repurchase agreement transactions secured by U.S. Treasury securities.

SOFR is the brainchild of the Alternative Reference Rates Committee (ARRC), a group of governmental agencies and market participants sponsored by the Federal Reserve to identify alternative reference rates and develop an implementation plan for the replacement of LIBOR.

LIBOR Fallback Language

The ARRC is also hard at work on the herculean task of dealing with legacy transactions and new transactions involving LIBOR. The ARRC hopes to develop best practices to transition to a new reference rate in existing and new contracts involving LIBOR. To date, the ARRC has solicited feedback from market participants on how to replace LIBOR in floating rate notes, syndicated business loans, bilateral business loans and securitizations.

The ARRC's proposed fallback language defines the trigger events that cause the replacement of LIBOR and permits the selection of a successor rate and a replacement benchmark spread (to account for the difference between LIBOR and the new reference rate) upon the cessation of LIBOR. SOFR is likely to be (and so far has been) lower than LIBOR because unlike LIBOR, SOFR is based on secured debt and is nearly risk-free.

The fallback language generally follows two approaches. An "amendment approach" permits parties to agree on a mechanism to amend the documents in the future to replace LIBOR. This approach gives maximum flexibility to deal with change when it happens and does not force par-

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ties to predict the replacement rate and spread adjustment. However, this approach may not be feasible when trying to amend many financial transactions simultaneously, and parties may not agree if market conditions at the time favor one party over another. Some market participants believe that an amendment approach could be a precursor to a "hardwired approach."

A hardwired approach permits parties to agree today on a waterfall of replacement benchmark rates and spreads that would go into effect, without having to amend the documents later. This approach provides clarity; the parties know upfront they will receive a version of SOFR and a benchmark replacement spread. This permits many loans to transition to a LIBOR replacement simultaneously and discourages one party from trying to take advantage of another based on where we are in the market cycle. However, the hardwired replacement rates and replacement spreads do not exist today. They involve components that are still to be determined by regulatory authorities.

There are still many open issues involving the transition away from LIBOR, but the momentum is building for its demise.

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