

The Transition Away From USD LIBOR for Swaps: A Report for U.S. Market Participants

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INTRODUCTION

With the Financial Conduct Authority (the “FCA”)ⁱ announcing in July 2017, essentially, its intent to no longer persuade or compel panel banks to make LIBOR submissions by the end of 2021, the future of LIBOR, and its role in the trillions of dollars of interest rate products that use it as a benchmark, including over-the-counter (“OTC”) interest rate swaps, has become more uncertain. LIBOR is a benchmark rate that measures the price at which certain members of the London interbank market will lend money to each other short-term and unsecured (when in reference to such lending in U.S. dollars, “USD LIBOR”).ⁱⁱ A very common use of LIBOR is in OTC interest rate swaps between banks and commercial end-user counterparties. The OTC interest rate swap effectively converts the more available or cheaper floating rate on loans into a fixed rate – this is a fixed-to-floating interest rate swap, and in the U.S. the floating leg is almost always denominated by USD LIBOR.

The reputation of LIBOR has suffered as a result of several panel banks agreeing to large settlements around the world, including settlements with the U.S. Commodity Futures Trading Commission (“CFTC”), Department of Justice, and FCA, in connection with claims of manipulation, attempted manipulation, and related offenses with respect to LIBOR.ⁱⁱⁱ LIBOR submissions have also drawn the attention of regulators and market participants because of their heavy reliance on the submitting parties’ expert judgment instead of actual transactions.^{iv} These events have helped create the political will to replace LIBOR as the standard interest rate benchmark in the U.S., as well as in the U.K. and Europe. The phase-out of LIBOR appears set to take place over the next four years, with the end of 2021 as possibly the latest date that the FCA will continue requesting that panel banks contribute submissions towards the determination of LIBOR. It is possible that at the end of 2021, or perhaps earlier, LIBOR will cease to be an effective rate for market participants. However, it is also conceivable that the FCA could extend its timeline or that panel banks will continue to contribute prices voluntarily, thus extending the LIBOR phase-out indefinitely. Further, other global regulators may intervene in some way to alter the timeline of the transition. Therefore, notwithstanding the FCA’s recent statement, the timing of LIBOR’s replacement is very much in flux.

Regardless, industry groups and market participants must prepare for LIBOR to be phased out. For existing interest rate swaps, particularly those that extend to 2021 or beyond, the issues include how to treat such swaps if LIBOR is phased out, and whether any current measures can be taken to account for costs and risks associated with the transition away from LIBOR. For new swaps, the issue is whether and how to draft the swap’s terms to account for the eventual phasing out of LIBOR.

LIBOR REPLACEMENT

In the United States, the Alternative Reference Rates Committee (“ARRC”), convened by the Federal Reserve, is working to establish a new rate as an alternative to USD LIBOR, and to adopt a plan that results in the liquidity of the chosen rate in futures and swaps markets.^v A new and currently unpublished broad Treasuries repo financing rate (being referred to now as the “Secured Overnight Funding Rate” or “SOFR”)^{vi} has been selected by ARRC as the preferred benchmark rate to replace USD LIBOR in new financial products.^{vii} SOFR measures the cost of secured overnight loans that use government debt as collateral, known as repo transactions. Two important differences between SOFR and USD LIBOR are: 1) SOFR is based on secured debt, whereas USD LIBOR is based on the price of unsecured lending; and 2) SOFR measures an overnight rate, whereas USD LIBOR measures the price offered at a series of short-term periods from overnight to one year. It is still unclear how SOFR, based on overnight transactions, can or will effectively replace the longer-term, USD LIBOR maturities, such as the popular 1-month and 3-month USD LIBOR rate. Note also that despite the initial preference for SOFR, ARRC has the ability to alter its course if the transition to SOFR presents unforeseen issues. That being said, for the remainder of this paper, we will assume that SOFR (or some variation of it) will ultimately become the benchmark interest rate for USD-denominated transactions; however, unless the context provides otherwise, the analysis would be the same if another rate became the preferred replacement.

The timeline for phasing out USD LIBOR still contains uncertainties, though roughly the transition should take place as follows. During the near term, expect ARRC to continue planning on the transition from USD LIBOR and work with the Federal Reserve Bank of New York to publish SOFR. To this end, in August 2017, the Board of Governors of the Federal Reserve System requested public comment on its proposal for the publication of SOFR. After the new rate is published, the next step is developing a market for derivatives that reference SOFR. Once there is sufficient transaction volume in exchange-traded SOFR-denominated futures and swaps, the new data will facilitate reliable benchmark curves and a market shift from USD LIBOR to SOFR can naturally occur. Because the market is underpinned by the hedging requirements of end users, it will be critical for the success of SOFR for it to gain acceptance in the wider loan market.

FALLBACK PROVISIONS

Currently, OTC interest rate swaps have fallback provisions for instances where USD LIBOR is not available. These fallbacks were negotiated under the assumption that USD LIBOR could become temporarily unavailable, not considering the possibility that USD LIBOR may become permanently unavailable. Under the terms of most swaps, if USD LIBOR becomes unavailable, quotes from “reference banks” are used as a fallback. It is unclear, however, whether reference banks would continue to provide quotes indefinitely. Therefore, similar to the approach in previous LIBOR transitions, either amendments to or voluntary terminations of existing swaps may be necessary prior to USD LIBOR becoming permanently unavailable. Because of the significant differences between LIBOR and SOFR, amending existing interest rate swaps could prove difficult, even after the establishment of the new benchmark rate. If that is the case the parties may determine the looming disappearance of USD LIBOR will so materially change the swap that they mutually agree to a no-fault termination. Upon termination, the parties could then enter into a subsequent arms-length swap transaction. This may be an attractive option if the parties are amending an underlying credit agreement to replace USD LIBOR with a new rate.

If LIBOR ever ceases to be functional, termination of existing contracts, if not mutually agreed to by the parties, may present legal challenges. Depending on whether the swap uses the 1992 or 2002 ISDA Master Agreement, a termination under the force majeure provision may be available. While the 1992 ISDA Master Agreement does not contain such a provision, the 2002 ISDA Master Agreement does. The

inaccessibility of USD LIBOR and the failure or shortcomings of the contractually agreed fallbacks might be able to be construed as a qualifying event under such a provision. Regardless of the presence of a force majeure provision or similar language, the existence of USD LIBOR could be interpreted to be so essential to interest rate swaps that its disappearance and the failure of the fallback provisions constitute a cause to terminate the swap. The swap, in essence, as an instrument to convert an interest rate based on USD LIBOR to a fixed rate, would no longer exist, arguably justifying termination. In such event, an accounting for the financial cost of the termination to either counterparty would also be appropriate, though it may be difficult to assess.^{viii} Ideally, market participants will negotiate a solution before any disruption of USD LIBOR occurs. Contested terminations would be costly, harm existing relationships, and disrupt the market.

Market conformity is preferable to achieve a relatively smooth transition to a post-USD LIBOR marketplace. The costs related to and complexity in dealing with varying alternative approaches will be unduly high, and produce unnecessary risks to market participants. Therefore, expect trade organizations to take the lead on creating standardized solutions and frame a path to voluntarily amend or close out legacy transactions. Even if such standardized solutions are further negotiated, it is more efficient to begin negotiations with a market structure.

BASIS RISK

For most end-user counterparties, the main issue a transition to a new benchmark floating rate will present is simply whether they will continue to have a perfect hedge for their underlying rate-based obligation. As long as the hedged obligation and the interest rate swap are denominated by the same rate, the counterparty should be able to achieve the goal of having a fixed rate with no basis risk. Any scenario where the obligations under a credit agreement and the interest rate swap that hedges such obligations are not based on the same benchmark would create basis risk. Managing basis risk is difficult and costly, particularly for end-users who may only enter into a handful of swaps and do not have the resources to manage a complex interest rate portfolio.

CONCLUSION

The transition away from LIBOR to a new floating reference rate creates a variety of issues. For banks and end-users that enter into swaps to convert a floating interest rate into a fixed rate, the major issues include how to interpret terms in existing swaps, what amendments, if any, will need to be effected, and whether there will be a need to close out legacy contracts. By getting out in front of these issues, market participants can avoid costly and potentially risky scenarios regarding their interest rate derivative portfolios.

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ⁱ The FCA regulates the financial services industry in the U.K.

ⁱⁱ This paper is focused on the possible transition away from USD LIBOR, though many of the concepts are equally valid with respect to LIBOR denominated in other currencies. While in certain places “USD LIBOR” is referenced to indicate that the discussion considers only USD LIBOR, with respect to references to “LIBOR,” while the focus is still on activities being conducted in U.S. dollars, such references should be read as meaning all forms of LIBOR, including USD LIBOR.

ⁱⁱⁱ As of February 3, 2017, the CFTC had issued penalties totaling \$3.4 billion in connection with interest rate benchmark abuses, mostly involving LIBOR. See the CFTC’s website for more information, at www.cftc.gov.

^{iv} The decrease in actual transactions presents a problem because “expert judgment” submissions, are subject to high levels of scrutiny and potential liability due to the perception that expert judgments can easily be altered to affect the markets or prices for interest rate products.

^v *Interim Report and Consultation of the Alternate Rates Committee* (May 2016), available at <https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2016/arrc-interim-report-and-consultation.pdf?la=en>.

^{vi} Formerly known as “Broad Treasuries Financing Rate.”

^{vii} See ARRC press release dated June 22, 2017, available at <https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Jun-22-2017.pdf>.

^{viii} See *Interim Report and Consultation of the Alternate Rates Committee* at pg. 6 n.10 (“Derivative contracts in general do not have robust backups in the event LIBOR ceased to be published, and untangling the numerous cross-institution financial obligations that would result from such an event would be operationally complicated and could be legally contentious. In the interim, individual banks would have no firm certainty about the value of their positions as it would be unclear what rate should be paid or what rate would be received on any contract. The value of these contracts would depend on the movement of interest rates since the time that they were entered into.”).