Replacing U.S. Dollar LIBOR Rates – Recent Developments

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U.S. financial regulators and the International Swaps and Derivatives Association (ISDA) are getting close to proposing final replacement rates and computation methods for the U.S. dollar London Inter-bank Offered Rate (LIBOR). LIBOR and other non-U.S dollar LIBOR floating rates are scheduled to be discontinued by the end of 2021, along with many other interbank offered rates (IBOR) in other jurisdictions. There is also a risk that LIBOR rates will become unrepresentative even before that date. Final proposals for replacement rates and mechanisms to amend existing documentation for LIBOR should be issued by ISDA in the next two to three months.

The Alternative Reference Rates Committee ("ARRC"), a Federal Reserve/industry group that sets U.S. policy on LIBOR replacement, has chosen the secured overnight financing rate ("SOFR") as the basis for the LIBOR replacement rates. SOFR is basically a daily average of U.S. Treasury overnight repo rates. SOFR differs from LIBOR in two important respects: (1) it is a risk-free, secured financing rate rather than an estimate of an unsecured rate reflecting the credit risk of lending to large banks, and (2) SOFR is a historical rate, not a rate based on expectations of future interest rates.

ISDA has recently decided for swap transactions that problem (1) will be addressed by adding a benchmark adjustment to the SOFR rate. ISDA's contractor (Bloomberg) will compute the average daily differences between SOFR and each tenor of LIBOR over the five-year period before discontinuation of LIBOR. The differences will probably be in the range of 25 bp to 100 bp based on tenors ranging from 1 month to 12 months. The appropriate average computed as of the discontinuation date will be added without change to every SOFR computation, forever, to get the replacement rate for a specific tenor. ARRC is likely to use the same benchmark adjustments for LIBOR replacements for non-swap transactions. Bloomberg will begin reporting rolling five-year averages of the benchmark adjustments in the first quarter of 2020 to give the industry indications of where the adjustments are going.

ISDA and ARRC are not completely in agreement as to how to address problem (2). ARRC hopes that a forward-looking SOFR rate derived from futures transactions in SOFR-based interest rate trades can be used so that SOFR mimics LIBOR. In other words, the implicit SOFR rate computed from one-month, three-month or other tenors of futures trading would be applied to the same tenors of LIBOR rates. This way, the SOFR rate for an interest period would be known at the beginning of the period, just as it is for LIBOR. Unfortunately, the market for those interest rate trades is still thin. ISDA has decided not to rely on implicit forward-looking rates; instead, SOFR will be computed at the end of each interest period using the actual SOFR for each day of the period. Thus, the borrower will not know the interest rate for the period until the end of the period. Further, ISDA will compound the daily SOFR rates as part of adjusting the overnight SOFR to a term basis. To ease computation, the daily rates used for each period will begin two banking days before the start of the period and the last daily rate used will be the rate two banking days before the end of the period.

ISDA will recommend use of the overnight SOFR, compounded daily over a period equal to the current interest period and ending two days before the end of the interest period, and further adjusted by adding in the appropriate benchmark adjustment (the "ISDA-recommended rate"), to replace LIBOR.

ARRC recognizes that the forward-looking rate may not be available or accepted by the industry, and in those events, its preferred alternative is the ISDA-recommended rate. A major question is whether the industry will converge on the ISDA-recommended rate in the next few months.

Bloomberg will publish computations of the ISDA-recommended rate for each LIBOR tenor on every business day and Bloomberg intends to charge for use of its computations.

Documentation

Although both the ARRC and ISDA have proposed documentation to convert LIBOR-based rates to SOFR-based rates, pickup has been spotty. The primary reason is that both the ISDA approach (the ISDA 2018 Benchmarks Supplement Protocol) and the published ARRC approaches (for floating rate loans, securitizations and mortgages) are exceedingly complex and do not propose an actual formula for the replacement rate. They contain waterfalls of recommended alternatives to a LIBOR rate but do not specify what the rate will be in each alternative.

ISDA has stated that it will propose an IBOR protocol in early 2020 ("ISDA 2020 IBOR Fallbacks Protocol**")** which will trigger when either LIBOR is discontinued or UK authorities declare that LIBOR rates are no longer representative of actual funding (*i.e.*, too few banks continue to participate in the LIBOR reporting scheme). Under the protocol, existing LIBOR-based swaps will convert to the ISDA-recommended rate described above and in the case of swaps using non-U.S. dollar LIBOR or other IBORs, to the industry agreed replacement rate for those IBORs. It is anticipated that the protocol will also allow adherents to apply the new SOFR-based rates to other transactions, such as those under non-ISDA master agreements such as master repurchase agreements and possibly loan agreements as well. Many industry participants are holding off on amending existing agreements in anticipation of using the ISDA protocol to alleviate the re-papering burden.

While industry participants have hoped that ARRC will take similar action, it has not announced any similar initiative to lessen the burden of re-papering existing LIBOR-based instruments.

For new transactions going forward, ISDA will amend its definitions in early 2020 to provide that LIBOR-based rates will convert to the SOFR-based rates on cessation of LIBOR or an announcement that LIBOR is unrepresentative (a pre-cessation event). This change will not apply to non-ISDA agreements and transactions. Thus, parties entering into new non-ISDA master agreements will have to (a) specify a LIBOR-based rate and incorporate the ISDA protocol or definitions to modify the rate when LIBOR ceases, (b) use the existing, over-complex recommended language to create a waterfall of LIBOR alternatives and possibly specify use of the ISDA-recommended rate as the first alternative, or (c) look at the Bloomberg computations, decide that SOFR plus a benchmark adjustment is a reasonable rate, and move directly to a SOFR-based rate. Alternative (c) creates basis risk where a borrower has offsetting LIBOR-based income, so financial borrowers may be reluctant to use it. While the ISDA 2020 IBOR Fallbacks Protocol will provide a legal solution for the transition from IBORs, market participants need to ensure that they also understand the economic impact of their adherence.

We continue to monitor this ever evolving environment and will provide further updates as they become available. Questions regarding the matters discussed in this client update may be directed to either Joseph Heyison at joe@charleslawpllc.com or GuyLaine Charles at guylaine@charleslawpllc.com. This client update is prepared for the general information of our clients and other interested persons. It is not, and does not attempt to be, comprehensive in nature. Due to the general nature of its content, it should not be regarded as legal advice. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to castle@charleslawpllc.com.