Preparing for a World without LIBOR

By Denise LeMay,
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Since the 1980s the London Inter-Bank Offered Rate ("LIBOR") has been a key benchmark for a wide range of financial products and today underpins some $200 trillion in financial contracts. But it appears LIBOR's days are numbered, as starting in 2021 its phase-out is scheduled to begin in earnest. This has significant implications for companies that presently have debt tied to LIBOR and those that plan to take on debt indexed to LIBOR in the future.

It's a complex transition with a lot left to be decided so, unfortunately, many questions cannot be answered definitively right now. However, the broad outlines of the post-LIBOR landscape are emerging and there are some sensible steps that company executives can take now to prepare for what comes next.

What we know about the LIBOR transition

Let's start with what we know. After the financial crisis, regulators passed numerous banking and money market fund reforms that ended up reducing demand for interbank short-term loans, which is the basis of LIBOR. The decline in loans used to determine the rate reduced the ability of LIBOR to accurately reflect market rates, which sent regulators looking for a new benchmark. Contributing to LIBOR's demise was a scandal that came to light in 2012 in which some global banks manipulated LIBOR to benefit their derivatives traders.

With this as a backdrop, the Federal Reserve Board's Alternative Reference Rates Committee ("ARRC"), led by the Federal Reserve Bank of New York, determined the market needed a replacement rate for LIBOR, one that accurately reflects prevailing market rates and is not susceptible to manipulation. To this end, ARRC voted unanimously in June of 2017 to replace LIBOR with the Secured Overnight Funding Rate ("SOFR") in the United States. SOFR is based on transactions in the Treasury repurchase market, where banks and investors borrow or loan Treasuries overnight.

One of SOFR's major benefits is the depth and robustness of the Treasury repurchase market, with around $800 billion traded daily. SOFR is also based on observable transactions, rather than estimates, which makes it more difficult to manipulate. And since the Treasury repurchase market weathered the global financial crisis, it's believed that SOFR will be reliable in a wide range of market conditions. By April 2019 several institutions had already priced SOFR-linked securities, including Fannie Mae.

What we don't know about the LIBOR transition

Now let's consider some of the many things we don't know. Although the current plan is for SOFR to replace LIBOR, we still don't know when a hard switch will occur - also known as the "cessation date." We also don't know exactly how the index based on SOFR will be calculated. Since SOFR is an overnight rate, ARRC must decide how to calculate longer-dated maturities—one-month, three-month, six-month, 12-month, etc.—so the market can use SOFR as an easy replacement for LIBOR.

Moreover, since SOFR is a secured rate and LIBOR unsecured, ARRC expects that SOFR be lower than LIBOR, which means outstanding LIBOR-based loans that fall back to SOFR after the cessation date will require a spread-premium adjustment. At this point we don't know how that premium will be calculated.

For companies that use floating-rate LIBOR loans with swaps to hedge against interest-rate risk, there's the added component of not yet knowing how derivatives (i.e., synthetic interest rates) currently linked to LIBOR will be converted or how future swaps will be calculated when LIBOR is discontinued. The swap market is overseen by the International Swaps & Derivatives Association ("ISDA") and it will make its LIBOR replacement decisions separate from ARRC. Although the two groups work closely together, in fact ISDA is a member of ARRC, there is no guarantee both will arrive at the same conclusion. Ultimately banks need to satisfy borrowers that the underlying LIBOR Index on both their bilateral loans and derivative instruments can match; thus maintaining a perfected hedged transaction that functions efficiently.

What can be done to prepare for LIBOR transition

Even with all these unknowns, there are concrete actions a company can take to prepare, whether it's a small healthcare practice, a regional real estate developer, or a public company. For companies planning new debt issuance or a refinance in the near term, it's important that any loan tied to LIBOR has broad, robust adjustment or replacement language so the loan can convert to a new index when necessary. This is especially important for companies with a corresponding swap transaction. A loan's fallback language needs to align with their derivative fallback language to minimize any operational, legal and basis risk. To help with this AARC released recommended fallback language for different types of loan and debt products including syndicated transactions and bilateral loans earlier this year.

For companies with outstanding LIBOR debt that will extend beyond 2021, it's important they work with their attorneys, treasurers, and bankers to take an inventory of those agreements and examine the contract language to understand which documents will need to be updated when LIBOR phases out. People's United Bank is reviewing loan documents to understand the transition's impact, closely monitoring emerging regulatory guidelines, and has developed LIBOR replacement language that takes ARRC's guidelines into consideration and which we feel is appropriate for all LIBOR-based loan transactions. But currently People's United Bank does not have plans to update previously executed documents with fallback language until more information is available.

The number of unknowns around the transition away from LIBOR can seem overwhelming. But ARRC and banks know that market players need clear guidelines and ample time to prepare for the transition. We believe, therefore, that appropriate guidance will be forthcoming and the transition manageable.

In the meantime, the best course of action is to prepare based on the information we have. For most that means reviewing your contracts now, identify which are tied to LIBOR, and for those contracts assess which terms will need to be amended so you can speedily insert appropriate language into your LIBOR contracts when the timing is appropriate given your own unique circumstances.

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