The transition away from LIBOR

A project management toolkit

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Introduction

It was widely regarded as 'the world's most important number' before Andrew Bailey, the chief executive officer for the UK's Financial Conduct Authority (FCA) and the regulator for the London Interbank Offered Rate (LIBOR), outlined its deficiencies and announced in 2017 that it would no longer compel LIBOR panel banks to publish the rates after 2021, making clear that reliance on LIBOR could no longer be assured beyond this date.[1] Although the ICE Benchmark Administration Limited's (IBA) announced its intention to allow most USD LIBOR to continue significantly beyond the end-2021 deadline, nobody should take this as a reason to delay the transition. Regulators at the US Federal Reserve, Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) issued direct supervisory guidance last year that lenders should stop linking new loans and other financial instruments to LIBOR as soon as practicable, but in any event by the end of 2021.

The transition away from LIBOR and other Interbank offered rates (IBOR) benchmarks created an uncertain future for banks and corporate treasures that many have preferred not to think about over the last two years. However, the Federal Reserve Board and state regulators have now confirmed that they will start to assess LIBOR transition plans as part of the regular examination process.[2] With the deadline fast approaching (and yes, there is a lot to be done), there are now programmes being instituted at financial services firms to study the impact of LIBOR's permanent cessation, although the broader market and mid-market firms are yet to make any real progress.[3]

This paper is aimed for the benefit of financial services companies, corporate treasury departments and other end-users of LIBOR and other IBOR products. Despite knowing of its importance, few people understand LIBOR's wide-reaching impact, the efforts that are currently underway across industry groups and what they need to do to eventually transition to an alternative risk-free rate (RFR). The paper includes a refresher on LIBOR fundamentals, an analysis on the industry's preparedness and a discussion on the approach to contract analysis and repapering that is required for transition of contracts to an RFR. As programme managers, lawyers and operations experts embark on the path to LIBOR transition, they would benefit from combining a project-management based approach with technology-enabled solutions discussed in this paper.

The opinions expressed are as of August 2021 and may change with subsequent regulatory developments. We will aim to cover relevant updates in follow-up legal insights.

[1] https://www.fca.org.uk/news/speeches/the-future-of-libor
[2] https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1912231
[3] https://www.wsj.com/articles/regional-banks-face-bumpy-road-away-from-libor-11575464400

Refresher: What is LIBOR?

Why is it going away?

LIBOR is a benchmark interest rate for seven maturities (overnight to 12 months) quoted in five currencies (U.S. dollar, the Euro, British pound, Japanese yen, and the Swiss franc) by a panel of 11 to 16 banks surveyed for each currency. The result is the average of the interest rates these banks charge to provide unsecured funding to other banks for a given period in a specific currency. Given its workings as an underlying rate for a wide range of financial products that are intricately tied to LIBOR, it penetrates all corners of a corporate treasurer's life, from contracts, accounting practices, debt instruments, capital raising, tax procedures, etc. by several accounts, there is more than USD 370 trillion of existing financial contracts and products pegged to LIBOR worldwide.[4]

In 2012, investigations into LIBOR revealed widespread manipulation of rates by multiple banks with issues dating as far back as 2003. The investigations resulted in billions of dollars in fines for some of the panel banks and raised a question mark on LIBOR's existence and its use going forward. This action deterred the panel banks from continuing their involvement and as LIBOR is submitted voluntarily, the number of contributing banks decreased steadily post the investigation. This eventually led to the FCA's announcement of the discontinuation of the LIBOR rates at the end of 2021.

In one way, LIBOR is the liveliest walking dead number on the planet. It has been suggested that LIBOR could effectively end before Jan 1, 2021 if the number of panel banks reporting LIBOR, currently between 11 and 16, falls below four. But many financial experts have cautioned us that the panel of contributors may not shrink all the way down. In such an instance, the index would still be alive but as a bad representation of lending rates (famously dubbed as the 'Zombie LIBOR' market condition, a sure to sell-out Halloween costume in 2021) that could cause confusion and harm, particularly to legacy contracts that extend beyond 2021. The CFTC and ARRC have repeatedly urged market participants to initiate due diligence and take inventory of their existing contracts referencing LIBOR in order to initiate transition plans to alternative risk-free rates.[5] The FCA has negotiated with current panel banks and agreed for them to continue contributing data towards LIBOR rate generation through the end of 2021.[6]

How is the market preparing for this change?

Based on the guidance from regulators globally, new and legacy contracts tied to LIBOR should be analysed and amended to a definitive RFR that would go into effect once LIBOR is no longer available. Over the past couple of years, trade groups and rates committees have played an important role in corralling market participants, and instituting a consultation process to decide on suitable RFRs along with relevant fallback clauses for amending contracts. Listed below are working groups in key jurisdictions and the RFRs they've recommended so far.

[4] https://www.bloomberg.com/professional/blog/libor-370-trillion-headache-gets-accounting-watchdog-relief/
[5] https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement121119
[6] https://www.fca.org.uk/news/speeches/the-future-of-libor

	Working Group	Reference Rate	Date RFR Selected	Administrator	Description
 United States	Alternative Reference Rate Committee (ARRC)[7]	Secured Overnight Financing Rate (SOFR)	June 2017	Federal Reserve Bank of New York	Secured rate that covers multiple overnight repo market segments
 United Kingdom	Working Group on Sterling Risk-Free Reference Rates	Sterling Overnight Index Average (SONIA)	April 2017	Bank of England	Unsecured rate that covers overnight wholesale deposit transactions
 EU	Working Group on Euro Risk Free Rates	European Short Term Rate (ESTR)	May 2018	European Central Bank	Unsecured rate that captures overnight wholesale deposit transactions
 Japan	Study group on Risk-Free Reference Rates	Tokyo Overnight Average Rate (TONA)	December 2016	Bank of Japan	Unsecured rate that captures overnight call rate market
 Switzerland	Working Group on Swiss Franc Reference Rates	Swiss Average Rate Overnight (SARON)	October 2017	SIX Exchange	Secured rate that reflects interest paid on interbank overnight repo
 Canada	Canadian Alternative Reference Rate Working Group	Canadian Overnight Repo Rate (CORRA)	July 2018	Bank of Canada	Volume weighted average of overnight repo transactions

The ARRC in the US has recommended contract fallback language for floating rate notes (FRNs), bilateral and syndicated loans, securitised products, variable-rate student loans and adjustable rate mortgages that reference U.S. dollar LIBOR, incorporating the feedback from its consultation process (See Appendix A for details).[7] Over the past year, ISDA has conducted a number of consultations with market participants on issues related to development of fallbacks that could be included in derivative contracts to ensure contract continuity. The proposed ISDA IBOR Fallbacks Protocol and Supplement became effective on January 25, 2021, and it was a vital step toward significantly reducing the risk of market disruption in the non-cleared derivatives market. The fallbacks will apply to all new derivatives contracts that reference ISDA's standard interest rate derivatives definitions as well as all legacy non-cleared derivatives if the counterparties have bilaterally agreed to include them or both have adhered to the IBOR Fallbacks Protocol. According to the ARRC, as of March 12, 2021, there were 13,540 adhering parties to the IBOR Fallbacks Protocol. The FCA estimates that just over 85% of uncleared sterling LIBOR-linked swaps now have effective fallbacks in place because both parties have adhere to the protocol, while 99.7% have at least a one-sided adherence. However, the use of protocol or a hard-wired approach is unlikely to work for loan markets or finance-linked hedging transactions where loan terms are not as standardised as ISDA agreements, and may involve participation from multiple lenders, borrowers, guarantors, etc. Such transactions may need to follow an amendment approach.

[7] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/LIBOR_Fallback_Language_Summary

The market itself has continued to report a surge in new trades using SONIA and SOFR (RFRs for the UK and U.S., respectively) for derivatives, futures and new issuances of floating rate notes but the transition from LIBOR to RFRs in the loan market and certain other industries has been slower.[8] A key reason behind this lag is the fact that LIBOR and the RFRs are not the same economical instrument. SONIA and SOFR are backward-looking rates that are settled overnight, with the final interest payment known only when the interest period expires. However, lenders and borrowers prefer forward-looking term rates like LIBOR where total interest payable is determined at the start of the interest period. Additionally, some RFRs are secured and carry less credit risk as overnight rates in comparison to LIBOR and other IBORs where the risk for a borrowing bank to default is baked in. Owing to these differences, the market participants continue to look for credit and term rates adjustments to RFRs that would make it economically comparable to LIBOR. These adjustments are necessary and should be adequately implemented to ensure that the transition from LIBOR does not purport to favor one party over another based on the existing market circumstances.[9]

Planned LIBOR cessation dates (Source: FCA update, 5 March 2021)

Settings	Cessation date
All 7 Euro LIBOR settings	December 31, 2021
All 7 Swiss Franc LIBOR settings	December 31, 2021
Spot, 1-week, 2-month, and 12-month Japanese Yen LIBOR settings	December 31, 2021
Overnight, 1-week, 2-month, and 12-month sterling LIBOR settings	December 31, 2021
1-week and 2-month US dollar LIBOR settings	December 31, 2021
Overnight, 1-month, 3-month, 6-month, and 12-month US dollar LIBOR settings	June 30, 2023
1-month, 3-month, and 6-month SYNTHETIC Japanese Yen LIBOR settings	December 30, 2022
1-month, 3-month, and 6-month SYNTHETIC sterling LIBOR settings	TBD

[8] https://www.cmegroup.com/trading/interest-rates/secured-overnight-financing-rate-futures.html
https://www.isda.org/a/7T6ME/Industry-Road-Map-Final.pdf
[9] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report

The path to transition

Guide to implementation: A process driven and risk-based plan

LIBOR's ubiquity and the nearing sunset is a call for institutions to create well-crafted transition plans that account for certain contingencies. Regardless of the agreement on a specific RFR, the process to assess LIBOR exposure remains the overarching issue in launching a transition plan. Additionally, organisations may need to include a number of related activities based on their portfolio assessment that are discussed in detail below. This suggested path is not meant to be an exhaustive list of menu items, and workstreams discussed here could be implemented concurrently while incorporating new developments in the coming months.

Project management primer for LIBOR transition

Inventory creation & exposure assessment	Monitor updates & finalise resourcing plans	Diligence & remediation preparation	Outreach, renegotiation & governance
Organise a steering committee *(internal stakeholders across divisions and external advisors)* for analysis & impact assessment	Keep track of industry developments related to proposed ARRC triggers, fallback language, issuance of ISDA protocols	Identify and analyse all LIBOR-related contracts for potential fallback terms if LIBOR or another IBOR is permanently discontinued	Outreach to counterparties and renegotiate impacted contracts
Programme governance *(stakeholder communications & interviews)*	Plan internal and external project teams to conduct diligence and manage negotiations	Develop strategy for LIBOR remediation based on counterparty exposure, product type and risks identified during contract analysis	Implement business process changes and financial system updates
Assess LIBOR exposure across systems and create an inventory across asset class	Analyse recommended fallback language *(Appendix A)*, consider suggested approach *(e.g., hardwired vs. amendment from ARRC)* for specific products and analyse benchmark rates for organisational suitability)	Develop alternative business plans for LIBOR exposure reduction	Project governance & stakeholder communication

Exposure assessment

Organise a committee with internal stakeholders and advisors for enterprise-wide planning, coordination and communication across your organisation, and with potential counterparties and regulators. Understanding exposure to LIBOR across a portfolio of contracts should be the foremost objective. This analysis should be structured by product type; derivatives, loans, bonds, floating rate notes and other financial contracts.

Monitor updates and resourcing plans

Track key industry updates, regulatory developments and related objectives (e.g. RFRs determination and adjustments, fallback language developments from ARRC, ISDA protocols, etc.) as rate committees continue further consultations, and more guidance is forthcoming in the coming months. This could be done in conjunction with other key steps outlined here. Adequate groundwork achieved by analysis of the proposed fallback language, amendment methods, RFR suitability, etc. at this stage will enable firms to build projections, and accordingly mobilise remediation teams for an effective launch.

Diligence and remediation preparation

This transition poses a challenge in that many financial contracts tied to LIBOR extend beyond 2021 in the form of legacy contracts. A comprehensive programme should include the plan to analyse legacy referenced contracts and transition those to RFRs as well as the negotiation of new contracts with RFR products.

Given the large volume of impacted contracts, time-sensitivity and prohibitive costs associated with this effort, technology and process implementation for LIBOR transition will be key. Organisations should strongly consider leveraging contract analytical tools that could be integrated into their diligence process to accelerate the review of their contracts and test for the sufficiency of the fallback provisions.

Teams should consider creating a playbook that contains a list of known contract clauses from credit agreements as well as the recommended fallback provisions (e.g. ARRC's recommended fallback language) to be included into amendments and new agreements with maturity dates post-2021. For example, a number of contracts, including credit agreements referencing LIBOR, have traditionally contained fallback language to address the potential unavailability of LIBOR only on a temporary basis. A common fallback indicates that if LIBOR is not available, an alternate rate like an interpolated rate from a designated reference bank is to be used, or upon a "market disruption event," LIBOR loans are to be converted into base rate or prime rate loans. These fallbacks are generally intended to address situations where LIBOR is made temporarily unavailable and would therefore fail to provide a solution to the permanent discontinuance of LIBOR. Most over-the-counter derivatives do not yet provide for the possibility that LIBOR quotes will not be available and are awaiting the issuance of an ISDA protocol. The ability to identify fallbacks across template agreements and create a rule-based action plan in the form of a playbook may help manage transitions in a timely and cost-effective manner.

Conclusion and key takeaways

- Regulators should ensure and monitor that LIBOR is not used in new contracts beyond 2021.
- The need for global and regulatory coordination is important because of the interconnectedness across products, sectors and markets.
- Organisations, to the extent possible, should not wait and use existing rates and supporting tools to launch transition by repapering contracts and/or adhering to necessary protocols. An early start and process-based approach will help them minimise disruption to business, preserve liquidity and avoid litigation risks.
- Policymakers and the various RFR working groups will continue efforts on legislation and synthetic LIBOR settings to provide a solution to transition tough legacy contracts from LIBOR.
- Staying up-to-date with IBOR developments is key. The industry will have a successful benchmark transition if organisations are educated on all alternatives and options.

Appendix

Recommended fallback clauses and related updates

Products and contract types	Sample fallbacks and updates[10]
Derivatives	The proposed ISDA IBOR Fallbacks Protocol and Supplement became effective on January 25, 2021, and it was a vital step toward significantly reducing the risk of market disruption in the non-cleared derivatives market. The fallbacks will apply to all new derivatives contracts that reference ISDA's standard interest rate derivatives definitions as well as all legacy non-cleared derivatives if the counterparties have bilaterally agreed to include them or both have adhered to the IBOR Fallbacks Protocol. According to the ARRC, as of March 12, 2021, there were 13,540 adhering parties to the IBOR Fallbacks Protocol. The FCA estimates that just over 85% of uncleared sterling LIBOR-linked swaps now have effective fallbacks in place because both parties have adhere to the protocol, while 99.7% have at least a one-sided adherence.[11]
Adjustable rate mortgages	ARRC's recommended fallback language for ARMs can be applied to any residential ARM, including those that do not refer to LIBOR. The adoption of the fallback language is voluntary for market participants. Fannie Mae and Freddie Mac have indicated that they intend to use this fallback language for newly originated ARMs and anticipate publishing updates in the first quarter of 2020 to their uniform ARM notes to incorporate the recommended language.
Floating rate notes (FRN)	The recommended FRN fallback language from ARRC provides for a specific "waterfall" for conversion to SOFR-based rates than previous waterfall provisions included in FRN documentation. The ARRC's language focuses on key elements (discussed below) to eliminate ambiguity and enforce consistent application of the language. • Benchmark Transition Events: the events that would trigger the move away from LIBOR under a contract; • Benchmark Replacement Process/ Waterfall: Adjusted rate that would replace LIBOR and the process to determine that; and • Benchmark Replacement Adjustment: The spread adjustment applied to the successor rate to keep it comparable to LIBOR since SOFR (the likely replacement rate in US) is expected to be lower than LIBOR.[12]
Securitisations	The recommended fallback language for LIBOR securitisations similarly includes a definition from ARRC of what would constitute a permanent cessation of LIBOR and provides a waterfall of replacement rates at such time. The finalised the order

[10] These provisions go into effect in the event LIBOR and other IBORs are discontinued. This information is taken from ARRC's analysis of fallback provisions, as presented at the November 2, 2017 ARRC roundtable. Materials are available at: https://www.newyorkfed.org/arrc/meetings-events.
[11] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/20210322-arrc-press-release-USD-LIBOR-Transition-Progress-Report.pdf
[12] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-Apr-25-2019-announcement.pdf

	of replacement rates for LIBOR securitisations in a "Benchmark Replacement Waterfall" is as follows: • Step 1: Term SOFR + Adjustment • Step 2: Compounded SOFR + Adjustment • Step 3: Relevant Governmental Body Selected Rate + Adjustment • Step 4: ISDA Fallback Rate + Adjustment • Step 5: Designated Transaction Representative Selected Rate + Adjustment The language is meant to provide a process that would allow securitisations to replace LIBOR with an economically comparable replacement rate and spread adjustment. The fallback envisages specific triggers and fallback rates with spread adjustments to avoid circumstances where one party may be permitted to make future determinations that could result in conflicting and potentially unintended outcomes, depending on how the provisions are drafted and the market conditions existing at the time. The ARRC has tried to be consistent with LIBOR replacement provisions in other products such as derivatives, loans and floating rate notes. The ARRC Recommendations note that while ISDA has proposed the same permanent cessation triggers, it is considering adding a precessation trigger, which may be the same as the ARRC's pre-cessation trigger regarding LIBOR no longer being representative. However, the ARRC Recommendations warn that if ISDA's cessation triggers do not match those used for securitisations and a benchmark replacement occurs based on one of the ARRC's pre-cessation trigger, the related hedges may not match the terms of the securitisation.
Corporate loans (syndicated and bilateral loans)	Unlike the FRN Recommendations, the recommended fallback for Syndicated loans set forth two alternative approaches for benchmark replacement; a 'Hardwired Approach,' which provides clear trigger events and a predetermined waterfall for selecting a replacement benchmark rate, and an 'Amendment Approach,' which identifies the trigger events but offers flexibility to market participants for selection of the successor rate and spread adjustment subject to negotiations. The ARRC recommendations include an additional fallback approach for bilateral loans called the 'Hedged Loan Approach' that was not included for syndicated loans. The approach is intended to be used as an alternative by borrowers looking to ensure that the fallback language in their loan agreement is consistent with the fallback language in any corresponding interest rate swap contract that they enter into with respect to their credit facilities. This approach provides that if the benchmark rate has been replaced in derivatives transactions referencing the ISDA definitions, then the benchmark rate for the underlying loan will be similarly replaced and the lender will make all necessary conforming changes to the loan documents to reflect such replacement.

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