Early trends for LIBOR replacement in the U.S. market

From the moment the UK Financial Conduct Authority (**FCA**) announced in July 2017 that it would no longer compel banks to submit rates for the calculation of LIBOR after the end of 2021, market participants have been asking themselves what reference rate would take its place. The FCA is concerned that *"it is not only potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them"* and is keen that market participants plan for a smooth transition away from LIBOR to alternative reference rates that are firmly rooted in data obtained from transactions.

Of course, the reform of interest rate benchmarks has been on the global agenda for the last few years in the wake of the benchmark manipulation scandals. In particular in 2014 the Financial Stability Board (**FSB**) laid out a reform agenda and alongside the reform of existing benchmarks, including LIBOR, the FSB recommended the development and adoption of alternative near risk-free benchmarks.

The risk-free rate of return is the theoretical rate of return an investor would expect from an absolutely risk-free investment over a specified period of time (it is often based on the yield on high-quality government bonds). Given the tendency in capital markets deals to follow "customary" provisions, "market" practice or "precedent" transactions, 2019 seems poised to be the year when the industry will settle on a clearer path that will create the basis for the transition to this new reality post 2021 with respect to loan, securities and derivatives products.

This article analyzes early trends in the following three distinct areas relevant to the U.S. market:

1. what alternative rate is likely to replace LIBOR?
2. for certain LIBOR referenced floating rate notes (**FRNs**), what approach is being proposed for determining an alternative reference rate?; and
3. what mechanism is being suggested for calculating any adjustments to margins when such alternative rate becomes effective?

Alternative reference rates – a clear frontrunner

It has been reported that in the U.S., the first Secured Overnight Financing Rate (**SOFR**) linked notes were issued over last summer, most notably by Fannie Mae, Credit Suisse, Barclays, Metlife and the World Bank.[1] According to the Director of Markets and Wholesale Policy at the FCA in a speech delivered on 28 January, 2019, about US$46.3 billion in SOFR-referencing US$ FRNs have been issued since mid-2018.[2]

In light of the fact that no forward looking term instrument based on SOFR currently exists, newly issued SOFR-indexed notes have taken a "backward looking" or "in arrears" compounded approach (i.e. using a calculation date closer to the interest payment date rather than at the beginning) to the calculation of the rate relevant to any interest period, which constitutes a deviation from "forward-looking" or "in advance" customary mechanics for instruments based on "IBOR" rates.[3] This "compounded-in arrears" approach seems like a more natural result for this calculation given the "overnight" nature of SOFR. While market participants may need to get used to not knowing the applicable rate in advance, there is general agreement that SOFR rates may provide more transparency and less volatility due to the fact that its computation is based on actually-traded secured transactions.[4]

While SOFR is gaining traction in the U.S., following, the Bank of England Working Group on Sterling Risk-Free Reference Rates' selection of reformed Sterling Overnight Index Average (**SONIA**) as its proposed benchmark for use in sterling derivatives and relevant financial contracts in April 2017, there has been a significant increase in SONIA referenced

1 LIBOR Transition Series: Perspectives on SOFR and SONIA Indexed Debt Issuances, https://www.pwc.com/gx/en/industries/financial-services/assets/pwc-libor-transition-series.pdf

2 LIBOR transition and contractual fallbacks; Speech by Edwin Schooling Latter, Director of Markets and Wholesale Policy at the FCA, delivered at the International Swaps and Derivatives Association (ISDA) Annual Legal Forum https://www.fca.org.uk/news/speeches/libor-transition-and-contractual-fallbacks.

3 Perspectives on SOFR and SONIA Indexed Debt Issuances, page. 3.

4 Alternative Reference Rate Committee's Fallback Consultation Webinar: Securitizations, FEDERAL RESERVE BANK OF NEW YORK, PAGE 10. https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC_Securitizations_Consultation_Webinar.pdf.

transactions not just in the derivatives markets but also bonds markets to the extent that most new sterling FRN issuance is SONIA based now.

Approaches for determining an alternative rate – finding a "one size fits all" solution

Both the Alternative Reference Rates Committee (**ARRC**), a committee composed of representatives of financial institutions and U.S. government authorities convened by the Federal Reserve Bank of New York, and the International Swaps and the Derivatives Association, Inc. (**ISDA**) have taken the lead in searching for an answer to the issue presented by LIBOR's discontinuance that reflects the general views of the different participants in the cash and derivatives markets. The consensus among the participants in each space is that, regardless of the rate or mechanics being used moving forward, consistency across products and jurisdictions must be ensured.

The ARRC "Consultation Regarding More Robust LIBOR Fallback Contract Language for New Issuances of LIBOR Floating Rate Notes" released in September of 2018 proposed a "waterfall" approach to determine the reference rate that would replace LIBOR upon the occurrence of specified trigger events signaling the incipient or permanent unavailability of LIBOR as an interest rate benchmark (the definition of such trigger events remains under further review and discussion).[5] It is worth noting that this "waterfall" approach contrasts with the "amendment" approach presented by the ARRC in its guidelines for the bilateral and syndicated loan markets where a more direct involvement of lenders and administrative agents would be

5 FEDERAL RESERVE BANK OF NEW YORK, https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-FRN-Consultation.pdf

expected; however, the guidelines described as the "hardwired" approach for the lending markets follow a more streamlined mechanic following waterfall-type steps.

The replacement benchmark waterfall suggested by the ARRC for FRNs generally follows the following order: (i) Term SOFR (forward-looking; if not available, interpolated), (ii) Compounded SOFR, (iii) SOFR Spot Rate, (iv) ARRC Replacement Rate, (v) ISDA Fallback; and (vi) Issuer Determined Rate. Likewise, the Structured Finance Industry Group (**SFIG**), in its LIBOR Task Force Green Paper dated 14 December, 2018,[6] produced a similar waterfall although, with respect to its last stop, including alternatives for consent of noteholders, holder objection rights and no consent/objection rights. In parallel, the responses of the majority of the participants in the ISDA "Consultation on Term Fixings and Spread Adjustment Methodologies"[7] expressed a clear view that a "compounded setting in arrears rate" would be a preferred choice for risk free rates.

With respect to the U.S. securitization market, on 7 December, 2018, the ARRC released its consultation for "New Issuances of LIBOR Securitizations". The replacement benchmark waterfall proposed in the consultation for securitizations modifies the version previously proposed for FRNs in that it does not propose Spot SOFR as the third level of the waterfall to address certain concerns raised by market participants in respect of using an unmodified overnight rate as a benchmark in comments to the Floating Rate Note consultation.[8] The ARRC also noted the additional concern relevant for securitization markets that the mechanics for interest rate calculation of the securities should not deviate substantially from the mechanics controlling the calculation of the interest rate applicable to any collateralized obligations serving as the securitized assets.

Have U.S. market participants taken these suggestions? The answer is: "too early to tell". Our research into publicly available registered USD LIBOR-referenced bond issuances since the publication of the ARRC's first consultation yielded no results that would indicate that the ARRC's proposed fallback provisions have already been implemented.[9] Two influential investment grade U.S. corporate issuers, in December 2018 and January 2019 medium-term US$ debt issuances which, provided that a calculation agent will use "the alternative reference rate selected by a central bank, reserve bank, monetary authority or any similar institution (including any committee or working group thereof) that is consistent with accepted market practice".[10] While this formulation seems to acknowledge that the ARRC is a worthy authority to guide the market through LIBOR's cessation, the detailed waterfall framework was not expressly adopted. In a January 2019 filing of a preliminary pricing supplement, a Canadian financial institution opted to grant the calculation agent the discretion to judge that LIBOR has been discontinued and to judge a comparable successor to LIBOR taking into account the relevant market trends.[11] It is likely that new issuers will continue to monitor the market until there is more certainty with respect to clear guidelines for the implementation of fallback rates during a transition period.

Adjustment mechanisms – some clarity down the road

Based on the responses of the majority of the participants to its market wide consultation on IBOR fallbacks, ISDA has announced that it will proceed with developing fallbacks for inclusion in its standard definitions based on the compounded setting in arrears rate and the "historical/median approach to the spread adjustment." ISDA and its independent advisors will consider "for example, whether to use a mean or median calculation and the length of the historical lookback period." The FSB's Official Sector Steering Group (**OSSG**) has welcomed this outcome.[12] Not surprisingly, ARRC consultation participants have expressed a strong preference for a mechanism that ensures consistency between the cash and derivatives markets, hence any efforts to creating these guidelines will likely be coordinated.

Final thoughts

There is still much to be done to ensure an orderly transition away from LIBOR in good time before the end of 2021 when panel banks will no longer be compelled to submit LIBOR quotes. There is an express recognition that there needs to be direct

6 LIBOR Task Force Green Paper, A Set of Recommended Best Practices for LIBOR Benchmark Transition, First Edition, http://www.sfindustry.org/images/uploads/pdfs/SFIG_LIBOR_Green_Paper_Combined_12.17.18.pdf

7 ISDA, https://service.betterregulation.com/sites/default/files/2018.12.20%20-%20ISDA%20Consultation%20Report%20by%20The%20Brattle%20Group.pdf.

8 FEDERAL RESERVE BANK OF NEW YORK, ARRC Consultation New Issuances of LIBOR Securitizations, page 10 available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Securitizations-Consultation.pdf.

9 According to market reports, Q4 2018 was a particularly bearish quarter for corporate bond issuances: https://www.cnbc.com/2018/12/21/reuters-america-update-1-corporate-bond-issuance-shrinks-to-7-year-low-as-selloff-deepens.html.

10 See https://www.sec.gov/Archives/edgar/data/764764/000076476418000221/pricingsupp2yearfloating-d.htm; https://www.sec.gov/Archives/edgar/data/38009/000104746919000025/a2237476z424b2.htm.

11 https://www.sec.gov/Archives/edgar/data/927971/000119312519015812/d697447d424b2.htm.

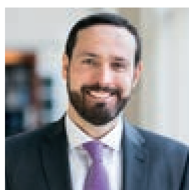
12 Speech by Edwin Schooling Latter, Director of Markets

co-operation across jurisdictions and products to avoid mismatches and inconsistencies. It remains to be seen whether differences in approach in the five main jurisdictions – UK, U.S., Euro area, Switzerland and Japan – as regards the nature of the reference rates (secured or unsecured), timing of the transition to reference rates and the approach to transition – will result in irreconcilable differences that will create five (or more) distinctive markets going forward, each with its unique set of customs.

For example, the International Capital Markets Association (**ICMA**) has suggested in its response to the ARRC's consultation,[13] that ARRC's approach (i.e., a direct reference to SOFR or term SOFR) differs from alternative fallbacks seen in recent European and Asian issues of FRNs and multi-currency debt issuance programs, whereby an "independent adviser" appointed by the issuer selects or advises on the selection of an alternative or successor rate and adjustment spread to be applied to such rate on the basis of (a) any recommendations made by relevant official bodies or (b) if no such recommendations have been made, customary market practice.[14] Similarly, ICMA has pointed out (among others) that the ARRC consultation does not expressly address multicurrency debt issuances, that market participants would need to be comfortable with a fallback provision that has not yet been developed, and investors will need to accept the risks associated with the spot SOFR rate suggested as the third step in the waterfall.

Whatever the outcome of several consultations, uncertainty will open and fuel a market for independent consultants and even arbitrators. Until the dust settles, market participants are advised to keep track of developments, trends, and updates, and pay special attention to those "often ignored" clauses in legal documentation that may be impacted by these issues.

Contacts



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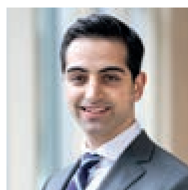

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13 Letter dated 16 November 2018 by ICMA, Re ARRC Consultation regarding more robust LIBOR fallback contract language for new issuances of USD-LIBOR floating rate notes.

14 For an example of this provision included in a prospectus supplement Barclays' filed with the SEC on 7 November, 2018 see: https://www.sec.gov/Archives/edgar/data/312069/000119312518322374/d641515d424b2.htm.
For an example instituted by HSBC, see file:///C:/Users/1084717/Downloads/holdings-us-shelf-prospectus-supplement%20(1).pdf.
For an example by ING, see https://www.jpx.co.jp/equities/products/tpbm/announcement/detail/nlsgeu000002bjts-att/nlsgeu000003p6qn.pdf.
For an example by UBS, see https://www.sec.gov/Archives/edgar/data/1114446/000091412118002087/ub46174838-424b2.htm.