What you need to know before LIBOR disappears

Impact on Swaps and Variable Rate Debt

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The History

The LIBOR scandal that emerged in 2008 highlighted a crucial flaw in the setting of LIBOR rates. Without enough direct trades from which to draw, some traders responsible for setting the rates via daily submissions were actually manipulating the rates for their own benefit. Reforms that followed the scandal sought to establish a reliable and credible LIBOR rate-setting process. However, as direct bank to bank trading has not recovered to pre-2008 levels, ***the UK Financial Conduct Authority (FCA) recently announced its intention to phase out LIBOR by 2021***. The move to replace LIBOR is not driven by suspicions of wrongdoing, but by ongoing concerns that it is no longer reflective of an actual market level.

The Problem

LIBOR is regulated by the FCA and is administered by the Intercontinental Exchange (ICE), an electronic trading platform. In calculating LIBOR, ICE relies on daily submissions from 15 to 20 banks that estimate the rate at which they could borrow unsecured funds from each other. "Estimate" is key since there are very few actual transactions in which banks borrow from one another. As regulator, the FCA spends considerable time persuading banks to continue submitting LIBOR estimates. The lack of an active interbank market in unsecured loans on which to calculate LIBOR led the FCA to conclude that LIBOR may not be sustainable as it no longer reflects market levels.

Over the past three plus decades, LIBOR has been used as a benchmark rate for bank loans, floating rate notes and the most traded interest rate hedging market. Indeed, in order for banks to enter into long term contracts such as swaps and loans, there must be a reliable market for hedging that long term risk.

The Solution

In 2014 the Federal Reserve Board, in cooperation with global regulators, created the Alternative Reference Rates Committee (ARRC). The purpose of the committee is to identify alternative rates that could take the place of US dollar LIBOR. Criteria for the new benchmark ensures that the replacement be transaction-based, liquid and resilient. ***In June 2017, the ARRC announced that it had selected a "Broad Treasuries Financing Rate" as the new benchmark for US dollar derivatives***. The BTFR is effectively a Repurchase Rate or 'repo rate' that lenders and borrowers use to transact in a robust short term funding market. Loans based on repo are for terms of overnight to one month. The loans are generally secured by US Treasury securities in standardized transactions that are critical to short term funding in the money markets. While the market has not yet adopted BTFR as the LIBOR replacement, Ponder expects that by 2021, a consensus rate will emerge with the BTFR rate the current leading candidate.

The Details

Existing Bonds and Loans

Existing bank and floating rate note documents likely each provide a different mechanism for determining an interest rate should LIBOR not be available. For all bonds with a maturity after 2021 (and even for some bonds with shorter maturities should the LIBOR market disappear sooner), ***it is imperative that clients understand their documents and the effect that LIBOR going away might have on their interest rates***. In addition and if the loss of LIBOR would trigger a penalty rate (i.e. PRIME, FED Funds plus a spread, etc.), clients should be proactive in talking with their advisors and bankers to determine if a reasonable solution could exist. Changes to the calculation index will likely require mutual consent.

New Bond and Loan Transactions

For new bank loans or floating rate notes, clients should insist that documents incorporate language that anticipates a future, as yet undefined, replacement index. Language should provide that 1) any change is mutually agreed upon by both parties, and 2) no change shall adversely affect either the market value or the expected cash flow of the transaction.

Existing Swaps

For swaps, current ISDA protocol provides that if a rate is unavailable, Reference Banks are polled to determine a rate for the contract. This is not meant to be a long term solution, but a temporary fix if a rate such as LIBOR is not published on a reset date. Since there is a risk that LIBOR is discontinued after 2021, the International Swap Dealers Association (ISDA) is developing a protocol that will define a process for altering existing swaps to incorporate "fallback" provisions. ISDA is expected to designate the BTFR as the fallback rate in case LIBOR is permanently discontinued. Adherence to protocols is voluntary, but there could be regulatory action requiring that all parties accept the change.

This is where a transition can be complicated. ***LIBOR is an unsecured interbank lending rate but BTFR is a collateralized and therefore secure lending rate***. The pairing of two different benchmarks is by definition basis risk. As a secured rate, BTFR will trade at lower absolute levels than LIBOR. Therefore, with a synthetic fixed structure, the borrower will receive less under BTFR than under LIBOR. Recently, the 1m BTFR rate was 1.14% and 1m LIBOR was 1.23%. How would this difference be accounted for in substitution? Early discussions are for a spread to apply to the new BTFR rate. Ponder is focused on this transition as it can materially impact our clients. Since interest rate swaps can have terms of 20 years or longer, the financial impact of a new index can be significant.

Clients could avoid the uncertain transition by terminating the swap(s). Obviously, this solution is sub-optimal given the valuations on most fixed payers and the difficulty and cost of replacing structures. Alternatively, clients can amend existing documents to proactively establish a fallback rate. But what would this fallback approach look like? What fallback rate is appropriate or optimal? Rather than select a fallback rate, our guidance for clients with swaps is thus similar to bonds - changes should be mutually acceptable with no adverse impact. Ponder notes that amending existing documents to incorporate this protection may be met with opposition by swap counterparties.

New Swaps

Interest rate swaps will continue to evolve with markets as they have in the past. For example: Over the last decade, many hospitals adapted to the change from LIBOR- to OIS–based discounting for swaps. This relatively benign change resulted in some valuations fluctuating by over $1 million. Since markets are dynamic, Ponder suggests built-in flexibility that allows for change, but protects our clients. To that end, our initial advice is to incorporate language within the swap documents that anticipates a future, as yet undefined, replacement index. ***As in new loan transactions, language should provide that 1) any change is mutually agreed upon by both parties, and 2) no change shall adversely affect either the market value or the expected cash flow of the transaction***.

AND STAY TUNED!

Ponder will continually gather information and analyze the impact of the BTFR rollout as well as continuing to monitor the LIBOR market. Our daily involvement in the bond and swap markets ensures that our advisors will be cognizant of any new initiatives. The possible discontinuation of a prevalent market component in LIBOR is a stark reminder that our clients have more leverage before closing than after the transaction is in place. Thus, today, it is more important than ever to set certain conditions in the negotiation process for all transactions. ***Please contact your Ponder advisor if you have any additional questions.***

Sources: www.theice.com ; www.fca.org.uk ; www.isda.org ; www.newyorkfed.org ; Bloomberg