Libor: Breaking up is hard to do

Libor is coming to end. Or is it? Practically it is. Most legacy product will be transitioned to risk free rates at their root, and new ones will increasingly not reference Libor. But the big discussion point in the past week has been on defacto Libor "survival" for some cases that just can't let go. And potentially, on a wider safety net for US legacy product

Tough legacy and the problems that need to be solved

The past week has been a pivotal one on the Libor front. Libor is supposed to be phased out by end 2021. In fact, the idea was to have a hard stop on 31 December 2021. While that central tenet remains, the concept has been muddied by some additional nuances when it comes to legacy product that mature beyond the final date for Libor. Musings from the official sector centre on the notion of having a continuation policy, the idea being that some product or parties may not be in a position to transition, so they will need a backstop plan.

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This is primarily aimed at so called "tough legacy" contracts, but also at protecting consumers and preserving market integrity. The latter point is important, as there is clearly a desire on the part of central bankers and regulators that the market remains functioning and stable as the transition occurs. Having a rump of players unable to transition, for whatever reason, can threaten the success of the project, and can create unwanted and inconvenient stresses. There is little doubt that this is part of the conversation in the US in particular.

> The UK based Financial Conduct Authority (FCA) has a central role in winding down the use of Libor. And the IBE Benchmark Administration (IBA) as the entity that calculates and publishes Libor, has a clear link to the Libor story, too. Both have made some key statements in the past week on the demise of Libor, but also on temporary continuation strategies where applicable. In addition, while specific reference has been made to GBP, EUR, CHF and JPY, the USD angle on this is on pause. That vacuum has been filled by comments from the Federal Reserve which have focused on the likely need for some form of USD Libor continuation as a protective strategy for the system and legacy Libor contracts.

Latest musings from various regulatory bodies act to both clarify and confuse

We identify three key elements in play here:

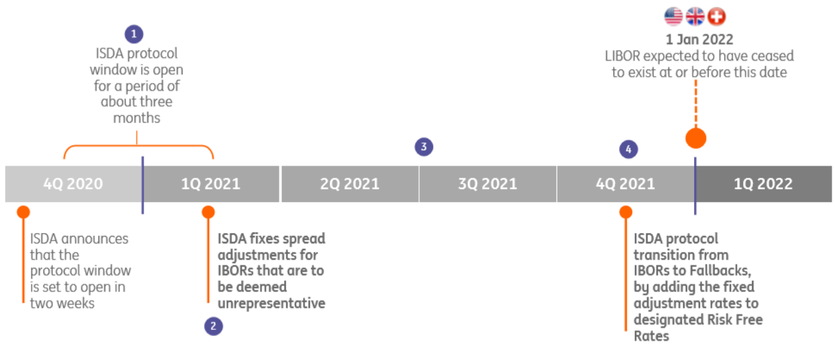
1. The FCA/IBA communications reiterate that 31 December 2021 is the conclusion date for GBP, EUR, CHF and JPY Libor. Not a pre-cessation announcement, but more of the confirmation. Nothing new here. Note that EUR refers to EUR Libor and not Euribor.

2. At the same time, there is consideration for a continuation process beyond 31 December 2021 for product that, for whatever reason, could not be transitioned. This is not new news, however high level comments open up all kinds of interpretation.

3. Meanwhile, USD Libor is not explicitly included in the above. And the Federal Reserve has been making noises about a safety net for legacy product, allowing some product referencing Libor to run to maturity.

Note that the fact that USD is not yet included should not yet be seen as being postponed, but that a few things still need to be ironed out. It is generally expected that IBA will also consult before the end of USD libor soon.

ISDA protocol timeline - Transition from Libor to Fallbacks for legacy derivatives



Crossed wires between moves to fallbacks for most, versus continuation for some others

Remember that the ISDA protocol window has been open since end October, facilitating sign-ups for players that wish to transition from Libor-linked derivatives to Fallback rates constructed as Risk Free Rates plus adjustment spreads (calculated as the 5yr median between the respective risk free and Libor rates). This provides a continuation strategy for legacy Libor linked product, so that they can continue in the case where any Libor, including USD Libor, comes to an end.

But this just caters for derivatives. For loans and other product there need to be bi-lateral agreements between counterparties on how to transition legacy Libor product in a world where there is no Libor. The thinking here is that loan counterparties could use a similar methodology as used in derivatives, and in that way there should be minimum friction, and especially for derivatives that are an overlay or hedge to underlying loans. But that in itself is complicated, as some sectors of the loans market are holding out for term rates, rather than use of the “in-arrears” structures.

Note that the continuation methodology, as stipulated in the UK legislative proposal, have focused on a continuation strategy where the FCA has the power to direct IBA to change the methodology of GBP LIBOR such that contracts would continue to reference LIBOR post end-2021 (but now on a synthetic basis so no longer involvement from panel banks). In that case, legally no changes are needed to be made, which largely eliminates the current work by the industry to incorporate fallbacks and/or pro-active transition contracts. Such an approach may be open to legal challenge though. Also, it may well be that the US Federal Reserve is going in this direction as well but alignment is needed between the FCA, IBA and US Fed and other regulators since USD LIBOR is more globally used than GBP LIBOR.

While the use of simple averages of risk-free rates for loans is a practical complement to compounded rates in arrears, as used by derivatives, there is still a considerable degree of unease in this space. Hence the conversation being had on how to push on with the end of Libor, while in effect ensuring that product that cannot be transitioned comfortably has something to latch on to as a safety net.

How there can there be a defacto continuation of Libor for some legacy product?

In theory, synthetic Libor rates derived from forward looking risk free rates plus a spread could be used to replicate Libor. Similar to the ISDA methodology, but using the term risk free rate, and adding the spread adjustment to that. The spread could be a subject for discussion; but it could even still use the ISDA methodology. Whether this avoids accounting/legal hurdles is an open question, but in the end the derivation used would likely be guided to reducing such frictions to zero (as practicable). A key issue is whether this is achievable.

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Alternatively, continuation of a panel bank derived Libor rate is the only way to really ensure that there are no frictions. This in fact could be a scenario where the FCA uses its powers under the Financial Services Bill to request panel banks to continue supporting LIBOR for the foreseeable future. Very unlikely for GBP, EUR, CHF, CHF, JPY. Possible for USD LIBOR but would need agreement between the FCA and NY Fed.

But then again, a panel bank derived Libor could be seen as a mistake as that would actually then mean defacto continuation with Libor beyond end 2021. It could be quite frustrating for players that bit the bullet and moved to alternative rates and/or agreed alternative fallback rates. It would also mean a continuation of Libor, which defeats the whole purpose of transition in the first place.

> It could also result in a two-pronged market, where liquidity successfully builds in SOFR and the like, but Libor-linked product never really goes away. While many might cheer at this prospect, it would in the end not get to where the official sector wanted to get us to - an end to Libor and take-up of risk-free rates. Expect the official sector to double down on pressure to transition in an effort to ensure that the future is still firmly in the direction of risk-free rates.

The period ahead will be key, as the Federal Reserve has intimated that it will come back with some further guidance on this. The GBP story is a step ahead, but at the same time could well have a synthetic Libor in play for tough legacy product, but we expect that to be very narrowly defined. Meanwhile, there is less of an issue for the eurozone as Euribor continues; no change there. EUR Libor ends, but the more important and reformed Euribor benchmark remains as is into the future.

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