Goodbye Libor

This is it! The final year for USD Libor is 2021. No looking back, and many decisions to be made ahead. Complications galore feature. Many loans will have a different convention to derivatives from 2022, and in 2021 there is a huge legacy transition exercise to be done. Players must estimate suitable spreads to be applied to SOFR for continuation. Lots to do!

We enter a regime of dominant risk free rates - far from a risk free process

Actually, there is no such thing as a risk-free rate. All rates have risk. The transition here is from Libor, which contains a bank credit risk, to overnight rates that minimise both credit and counterparty risk. Transition must happen in 2021, as there (likely) will be no e.g. USD Libor in 2022. Initial resistance to change has morphed to inertia, as players await first movers. And there has not been a huge movement so far, to say the least. One Federal Reserve spokesperson likened the process to herding cats; very apt.

A buildup in volumes would allow for derivatives referencing risk-free rates to begin to dominate Libor

Still today the vast majority of derivatives trades are set with reference to Libor, and not to, for example in the US, the Secured Overnight Financing Rate (SOFR). Many are awaiting a build in volumes before switching. We expect to see a material build in such volumes through Q2 2021, and we view it as being a simultaneous process, as volume in all product builds at the same time. This is vital. Such a buildup in volumes would allow for derivatives referencing risk-free rates to begin to dominate Libor. While not a flick of a switch, we do feel that transition to the use of the new rates can be swift; happening over a matter of weeks.

That, in turn, would facilitate the mapping out of term rates in SOFR in particular, for example, a 3mth rate in advance (and not in arrears). A decent rump of players in the loans market globally is calling for this as a must-have. We expect SOFR term rates to be in place by early Q3, and this is a critical call for a smooth transition. The official sector had an early preference for risk-free rates to be purely set in arrears, but pressure from the loan market, in particular, has ultimately called for term rates. Now they need to be delivered in the US, as they (virtually) have been in the UK.

A world of different conventions makes for complications at the margin - in arrears versus in advance for starters

As it is, the bulk of derivatives will be based off SOFR in arrears. As for loans, SOFR daily simply appears to be the preference, effectively using rolling daily rates for the period in question. Mathematically the difference between the two is quite mild, especially to the extent that rates are broadly unchanged, both in the rearview mirror and as mapped out by futures. But still, it's not the same.

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Here are the complications

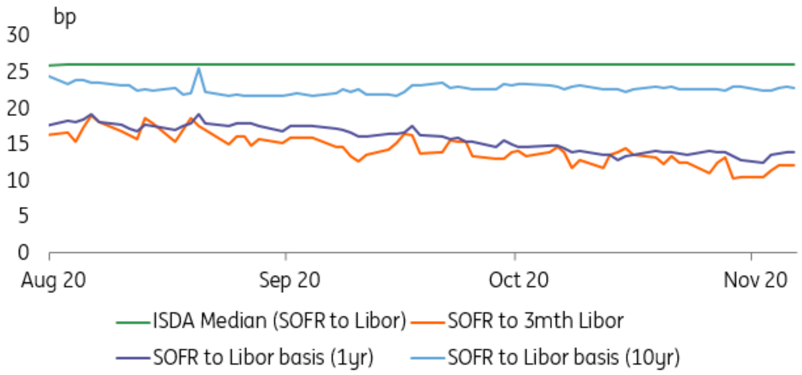
Complications will arise to the extent that (some) loans in the future will be set with reference to term rates while derivative overlays will be set in arrears. Over the counter solutions will be available to solve this, but this is still an extra step, a complication.

The other issue is how to deal with legacy Libor products, and especially loans. Here, bi-lateral conversations will have to be had, effectively on suitable spreads that translate from Libor to risk-free rates (plus an adjustment spread). There are traded market spreads that can help as a reference, but they move. Not easy. Also not easy as Libor is so low now that the market spread is below average, which makes the discussion that bit more complicated.

The ISDA protocol is convenient, but higher Libor rates would make it more appealing

And this is why there is some scrutiny on the ISDA protocol terms, as the calculated median spread adjustment is well above the current spread between SOFR and Libor, implying a fallback rate that is over 10bp above the legacy Libor rate. The basis between SOFR and Libor is traded in the market. The 10yr spread (22bp) is only a few basis points below the ISDA median (26bp), so the long term story is not too deviant from the ISDA spread. However, the 1yr spread (15bp) is much closer to the cash difference between SOFR and Libor (12bp). You can see the dilemma here – go for a convenient long-term solution, or pay closer attention to short term valuation differences.

Note the difference between the ISDA spread, the 10yr spread and the 1yr spread.



The ISDA protocol is undoubtedly convenient and a decent long term solution. But at the same time, players are within their rights not to use it, but instead to derive some other measure of the adjustment spread. That takes time and effort and can get quite complicated. Wide application of the protocol would be the best case solution and especially if applied to the transition of legacy loans. Our gut tells us that we will get all of the above. It can get really very messy; get ready for it as best you can.

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