Reappearing Libor: And for my next trick ...

The end of 2021 we were told. No going back, Libor was finished. Well, yes, no, and it depends. In the case of GBP, JPY, EUR and CHF Libor, there is indeed the intention for there to be a hard stop. However, the latest out of the US flips that, with an explicit plan to continue with USD Libor through to mid-2023. And then it really ends, we're told

Extension to mid-2023 for USD Libor legacy product, but new business in Libor ends in 2021. That's the plan.

The announcement that USD Libor would have an effective 18-month extension is quite a development. It has certainly made those in varying degrees of preparation mode sit up and listen to the mood music just that bit closer.

As there are important nuances here. Any continuation of references to Libor beyond end-2021 should be purely for legacy product. So accelerated progress should be made through 2021 to get to the point where all discussions on new product are with reference to the new risk-free rates (and not referencing Libor). At the very minimum, all new loans, bonds and derivatives should not reference Libor from 2022 onwards.

In that sense, the end-2021 date still holds for new product. By that time there should be a term rate for SOFR, which could mean that product or players that prefer to employ the term rate could do so. We are of the opinion that an IOSCO-compliant forward-looking term SOFR rate is still probable by mid-2021, on the assumption that sufficient volumes have built in SOFR futures, and wider SOFR derivatives through the first half of 2021.

Transitioning legacy product smoothly has been a real headache

Tough legacy product is where some room for manoeuvre is needed, and indeed there had always been an explicit possibility that a Libor replica of some description could be posted after the end of 2021 to help tackle product that could not transition. For USD Libor, that would only now be needed post-mid-2023. A central objective here, however, had always been to make this the exception rather than the rule, and this was never intended as a final solution for all such product. But it would help.

> *Large chunks of the legacy marketplace were falling into what could be termed 'outcome un-determinative'*

Tough legacy had been perceived to be a small resistant element of the marketplace that could be dealt with as a side issue. But it had become increasingly apparent that large chunks of the legacy marketplace were falling into what could be termed "outcome un-determinative". There were clearly many conversations ongoing, but real action towards transition was seen as next year's action point. How things would actually pan out through 2021 was tough to call.

The lack of a term SOFR rate was seen in many quarters as a constraint towards real progress, and it would be well into the middle of 2021 before such a term rate became available. Many participants were asking questions like: *'what will we do if there is no term rate in time?', 'how will we transition then?', 'do we need a waterfall methodology or a backstop?'*, and if so, '*how to transition from that to future term rates?*'

Clearly far more questions than answers.

While this was a backdrop that required some push from the official sector, it was also a backdrop that provided some unease for the Federal Reserve and the wider regulatory environment. The protection of the system is key, and a rump of un-transitioned loans and bond product is not a desirable outcome. Add to that the requirement to protect the consumer, and the rationale for some timing leeway was there to be pushed on.

> What we have now overall is a three-pronged approach to Ibor reform. In the eurozone, Euribor continues, so no transition to be concerned with there. The key Ibors to be transitioned are GBP, JPY and CHF; with a target transition by end-2021. Then, legacy USD Libor product transitions by mid-2023.

So what happens for those that signed up to the ISDA protocol?

For derivative players that have signed up for the ISDA protocol, there will be the obvious question as to how this affects them. The fixing of the adjustment spread happens at a point where the respective ibors are deemed unrepresentative at some point in the future. The wording here is vague, so it is not impossible for all adjustment spreads to be fixed at the same time

However, in our opinion, it is unlikely that the SOFR-Libor adjustment spread will be fixed in Q1 2021, as USD Libor does not need to transition at the end of next year. The other Ibors that will transition by end-2021 will have their adjustment spreads fixed as planned. For USD Libor, there could be a separate fixing at some point around the turn of 2022 into 2023, ahead of the transition to coincide with the end of USD Libor by mid-2023.

> *There is absolutely no obligation for players to use the new risk-free rates*

If the SOFR to Libor spread adjustment is delayed, it could allow the spread adjustment to drift lower towards 20bp, compared with a current spread of 26bp. That would not happen should USD Libor drift higher in the coming quarters. Not huge variability, as it is still within a margin of error of a few basis points, but if the USD adjustment spread is not fixed with the others in Q1 2021, the USD adjustment spread itself becomes that bit less certain.

Will Libor really go away in the end?

While there will be an extension of sorts for legacy USD Libor product, the plan is for new USD Libor product to be no more from 2022 onwards. New product should reference the new risk-free rates. Note however that this is advisory. There is absolutely no obligation for players to use the new risk-free rates. Should they become the market standard, then players will want to use them, and our central view is that is precisely what happens. We expect dominant market flows to be in SOFR.

> At the same time, for as long as a replica Libor persists the notion of continuing with Libor or a proxy Libor beyond these deadlines persists. The challenge for Libor detractors is to make that go away. The extension for USD Libor provides a sensible safety net, but it also gives Libor one more lifeline to cling to, one that could yet morph into something more permanent.

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