BB&T Corporate & Institutional Services

Replacing Libor

The transition to 'risk-free' reference rates is underway

The London Interbank Offered Rate (Libor), the reference rate for $20 trillion in financial products – including commercial and mortgage loans – is winding down.

Major global banks that provide the interbank lending rates used to calculate the floating-rate benchmark will no longer be required to do so after 2021. Even now, the average daily volume of Libor-based loans is only $500 million – not much on which to base such a widely used reference rate. Consequently, regulators have begun initiatives to develop so-called "risk-free rates" (RFRs) to replace the various versions of Libor worldwide, a process still in its early stages but progressing quickly, and one that is becoming increasingly important to corporate borrowers.

The RFRs furthest ahead in this process are those replacing the U.K.'s Sterling and the U.S. dollar (USD) versions of Libor, respectively the Sterling Overnight Index Average (SONIA) and the Secured Overnight Financing Rate (SOFR). Similar efforts for the euro, Japanese yen and Swiss franc are at various stages of development.

The New York Federal Reserve Bank began publishing SOFR in April 2018, after its Alternative Reference Rate Committee (ARRC) in June 2017 settled on SOFR to become the USD's RFR. A major factor in its decision: SOFR is generated from more than $800 billion in overnight repurchase agreement-related transactions, which – unlike Libor – provides a highly robust and transparent benchmark.

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Setting the Groundwork

Starting in May 2018, major exchange companies including the CME Group and the Intercontinental Exchange (ICE) launched futures contracts based on the SOFR and SONIA benchmarks. Those have steadily gained volume, and in October 2018 the CME cleared the first SOFR-based swap transactions. Establishing those derivative markets will facilitate the pricing of more complicated derivative markets, such as the over-the-counter (OTC) swaps used by corporates to hedge interest rate risk, as well as cash products such as commercial loans.

So far, several government institutions have issued SOFR-based bonds, including Fannie Mae, the World Bank and New York City's Metropolitan Transit Authority (MTA). Toyota Motor Credit Corp. (TMCC) was the first corporate to sell SOFR-based debt, issuing $500 million in three-month commercial paper priced off the new benchmark in late October 2018.

The financial community has moved quickly to build the market infrastructure for SOFR-based products, ahead of transitioning the $20 trillion worth of exposures. Much of that exposure is relatively short-term and should be refinanced or replaced by SOFR-based products by the end of 2021. However, there will be a significant portion of financial instruments, much of it currently in existence, that mature well past that date. As a result, the ICE Benchmark Administration (IBA) has pushed to continue publishing Libor until at least 2025. In addition, IBA has taken significant measures to develop a more structured, "waterfall" approach to calculating Libor, should interbank transactions be in short supply.

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Constructing Escape Hatches Should Libor Disappear

In addition, the ARRC is working on "fallback" language to insert in financial contracts that enables a smooth transition to SOFR or an intermediary rate, if need be. In the fall, it sought comments on fallback language for syndicated business loans and floating-rate notes. In late 2018, the ARRC outlined draft language for new contracts that reference Libor so as to ensure these contracts will continue to be effective in the event that Libor is no longer usable. While the final language may change somewhat, banks and their clients imminently pursuing transactions and drawing up contracts should consider it.

The ARRC was also seeking comments by Feb. 5, 2019, on fallback language for bilateral business loans and securitizations, and the committee is expected to produce in 2019 final recommendations for safer contract language in those cash products.

Satisfying Borrowers' Need for a Term Rate

A major difference between Libor and the RFRs is that the former is a forward-looking term rate, while the RFRs such as SOFR and SONIA are backward-looking, overnight rates. Corporate borrowers pricing their commercial loans on three-month Libor – the most common benchmark for large syndicated loans – know exactly what their interest payments will be every three months until the loan matures. That's critical for companies managing their cash.

Generating SOFR from $800 billion in repo transactions will provide a highly stable and transparent benchmark that will be much harder to tamper with than Libor, which major banks manipulated to their benefit for years until the scandal came to light in 2012. However, end users of financial products based on SOFR won't know their total payments until the end of the transaction period, after compounding each day's rate.

The ARRC has noted that corporate borrowers and other users of Libor products have expressed concern about the overnight, backward-looking nature of SOFR. The New York Fed committee plans to produce an indicative SOFR-based term reference rate based on futures data in early 2019 to help promote familiarity with the term rate, and a forward-looking term SOFR reference rate by the end of 2019.

What shape the ARRC's indicative rate may take is unclear at this point, given it has expressed concerns that "term fixings" could face challenges similar to Libor, such as a lack of liquidity. Back in 2017, the committee nixed two term SOFR proposals it was considering.

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Businesses Value Certainty

In the meantime, the IBA published a paper at the end of 2018 that describes a preliminary methodology it has developed, based on data from futures contracts, to derive a forward-looking term rate for SONIA (https://www.theice.com/publicdocs/IBA_ICE_Term_Risk_Free_Rates_October_2018.pdf). The IBA notes in the paper that many market participants value having forward-looking term rates in their financial contracts for budgeting, cash flow and risk management purposes, and businesses generally value certainty in calculating their interest rate expense.

"In addition, many financial planning and operating systems are designed for contracts that reference forward-looking term rates and may not be equipped to compound interest accruals on a daily basis," the paper says, adding that "redesigning these systems could prove to be an expensive and time-consuming procedure for many businesses."

For market participants wanting to monitor how these early steps in the transition to RFRs are advancing, the IBA maintains a portal that provides current RFR rates based on transactions compounded in arrears, and will provide the forward-looking term rates when they become available. It can be found at https://www.theice.com/marketdata/reports/244.

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