“Racing” to the IBOR transition finish line

J. Paul Forrester and Mary Jo N. Miller

Abstract

Purpose – *Summarize and review the key developments during 2021 relating to transition of the London InterBank Offered Rate (LIBOR) to alternative risk-free rates, in accordance with the guidance of global regulators and market participants.*

Design/methodology/approach – *Outlines and explains four key events to date during 2021 that are instrumental to the success of LIBOR transition, including the ISDA 2020 IBOR Protocol and Supplement, the 5 March 2021 announcements by ICE Benchmark Administration and the Financial Conduct Authority, the transition of interdealer swap conventions from LIBOR to SOFR, and the ARRC endorsement of the CME Group SOFR term rate.*

Findings – *The global adherence to the ISDA Protocol and Supplement, the successful launch of ''SOFR First'' and other ''RFR First'' swaps convention transitions, and the ARRC's endorsement of CME's SOFR term rate have given the market the clarity and tools that it needs to complete the transition away from LIBOR by the deadlines fixed by the 5 March 2021 benchmark transition event.*

Practical implications – *It now is clear that market participants globally have the resources to, and must, move to adopt alternative reference rates and related operational systems and other infrastructure to cease origination of new LIBOR-linked contracts after 31 December 2021. The ARRC's endorsement of the SOFR term rate for business loans and related derivatives and securitizations is a critical positive development for the structured finance market.*

Originality/value – *Expert analysis and guidance from experienced finance lawyers.*

Keywords *IBOR transition, Benchmark replacement, Alternative Reference Rates Committee (ARRC), Alternative risk-free rates, ISDA protocol*

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In our Winter 2020 Structured Finance Bulletin article [1] we discussed a number of key developments with respect to the global transition from the London Interbank Offered Rate (“LIBOR”) and similar interbank offered rates (“IBORs”) to replacement benchmark interest rates, and how those developments affect structured finance products.

Since publication of that article in November 2020, transition activity has accelerated significantly, in large part due to (a) the effectiveness on 25 January 2021 of the ISDA 2020 IBOR Fallbacks Protocol [2] and the related Supplement No. 70 to the 2006 ISDA Definitions [3]; (b) the announcements on 5 March 2021 by ICE Benchmark Administration, LIBOR's administrator (“IBA”) [4], and the UK Financial Conduct Authority, IBA's regulator (“FCA”) [5], that IBA will cease publication of the majority of LIBOR settings after publication on 31 December 2021, and of all remaining settings after publication on 30 June 2023; (c) the change in trading conventions for interdealer linear swaps from LIBOR to the Secured Overnight Financing Rate (“SOFR”) on 26 July 2021 pursuant to the Commodity Futures Trading Commission's “SOFR First” Transition Initiative [6]; and (d) the formal recommendation on 29 July 2021 [7] by the Alternative Reference Rates Committee (“ARRC”) of a SOFR term rate.

ISDA IBOR Fallbacks Protocol and Supplement

As described in detail in the Winter IBOR Article, the IBOR Protocol and IBOR Supplement apply to legacy and new-origination LIBOR-linked contracts, respectively. By agreeing to adhere to the ISDA IBOR Documents, adhering market participants incorporate ISDA's benchmark rate fallback language into all of their derivatives contracts with other adhering parties, with no further action. The ISDA IBOR Documents offer a robust multi-tiered waterfall of fallback rates for LIBOR, starting with SOFR and, if SOFR is unavailable, falling to (a) the Fed Recommended Rate (the Fed-recommended replacement for SOFR), (b) the Fed's Overnight Bank Funding Rate, and finally (c) the Fed's Federal Open Market Committee Target Rate [8]. Based on consultations conducted by ISDA during 2018 and 2019 [9], SOFR, as implemented in the ISDA IBOR Documents, is SOFR compounded in arrears [10], consistent with the calculation methodology used for Overnight Index Swaps.

At the time of publication of this article, ISDA reports over 14,440 adhering parties to the IBOR Protocol [11]. The combination of IBOR Protocol adherence and the October 2020 transition by central counterparties of their discounting rate and price alignment interest from IBORs to RFRs [12] has led to a significantly increasing, albeit still small, growth in the volume of SOFR futures [13]. The ARRC has noted that the transitioning of derivatives markets to the "more robust" chosen rate of SOFR compounded in arrears is "essential to ensure financial stability" and to the construction of a SOFR term rate over time [14].

Benchmark Transition Event

On 5 March 2021, IBA released [15] a feedback statement ("Cessation Statement") [16] reporting the results of its 4 December 2020 Consultation on Potential Cessation [17]. Pursuant to the Cessation Statement, IBA intends to cease publication of (i) all GBP, EUR, CHF and JPY LIBOR settings, and the 1-Week and 2-Month USD LIBOR settings immediately following the LIBOR publication on 31 December 2021, and (ii) the Overnight and 1-, 3-, 6- and 12-Month USD LIBOR settings immediately following the LIBOR publication on 30 June 2023, subject to any rights of the FCA to compel IBA to continue publication using a changed methodology. The announcement was supported by a number of global regulators, and also constituted a "Benchmark Transition Event," but did not trigger a "Benchmark Replacement Date," under the ARRC's June 2020 refreshed [18] fallback language recommendations [19].

With definitive dates for the cessation of LIBOR publication now established, and only a few months remaining until the cessation of the majority of LIBOR settings, most markets are starting to accelerate preparation for the transition, although progress has been greater in the derivatives, floating rate notes and securitizations market segments [20], which are more accustomed to using overnight rates than the business loans and trade finance segments because of their structural characteristics and customary payment calculations [21].

SOFR and RFR First

In April 2021, the ARRC published the principles that would need to be satisfied for it to recommend a SOFR term rate [22]. The second of these is that the rate "be rooted in a robust and sustainable base of derivatives transactions over time." The business loans market in particular has been delaying adoption of SOFR in new issuances and has been looking and waiting for an alternative that looks more like LIBOR, including a term SOFR option.

With a clear known cessation date, and to encourage the acceleration of the SOFR derivatives market and development of forward curves (which would facilitate the construction of a SOFR term rate), on 8 June 2021 the Market Risk Advisory Committee of the Commodity Futures Trading Commission recommended a series of best practices for switching interdealer trading conventions from LIBOR to SOFR [23]. These best practices, referred to as "SOFR First" [24], provide a phased approach to prioritizing trading in SOFR over LIBOR for identified market segments in order to "decrease reliance on USD LIBOR in light of supervisory guidance that such activity should cease ... by December 31, 2021."

Pursuant to the initiative, the transition to SOFR for linear swaps was completed successfully on 26 July 2021 [25]. The second phase, relating to the transition of cross-currency swaps from LIBORs to alternative risk-free rates ("RFRs") and referred to as "RFR First," is expected to occur on 21 September, to be followed later in 2021 by the transition from LIBOR to SOFR for non-linear derivatives and exchange-traded and other derivatives. The ARRC had stated previously that the successful implementation of "SOFR First" likely would satisfy its key principle regarding a deep and liquid base of derivatives transactions, and facilitate a formal SOFR term rate recommendation by the ARRC [26].

The "SOFR First" initiative was built on a similar initiative in the United Kingdom relating to the Sterling Overnight Indexed Average ("SONIA"). The "SONIA First" initiative [27] was proposed in September 2020 and updated in May 2021, and calls for all interdealer derivatives conventions to switch from LIBOR to SONIA by the end of 3Q2021 [28].

Phase 2 of "SOFR First" – the "RFR First" recommendation for cross-currency swaps – has been formally endorsed by FCA [29] and adopted by other working groups addressing transition in the key LIBOR currencies (USD, GBP, EUR, CHF, and JPY). In view of both "SOFR First" and "SONIA First," as well as guidance from the Swiss Financial Markets Supervisory Authority [30], the Swiss National Working Group similarly has recommended a "SARON First" initiative for the use of the Swiss Average Rate Overnight ("SARON") swap curve and SARON-based derivatives, and stated support for the "RFR First" cross-currency swap initiative [31]. Meanwhile, the Working Group on Euro Risk-Free Rates has recommended an "€STR First" initiative: an interdealer trading switch from Euro Overnight Index Average ("EONIA") to Euro Short Term Rate ("€STR") pricing and trading conventions in line with the 15 October 2021 central counterparty switch [32]. The Japanese Working Group – the fifth of the five key currency LIBORs – also recommended switching swaps price quoting conventions from LIBOR to the Tokyo Overnight Average Rate ("TONAR") starting from 30 July 2021 [33].

Term SOFR Recommendation

As noted above, the business loans market has been relatively slow to adopt SOFR for new loan originations. Syndicated loans, in particular, present a number of complicating features that typically are not present in floating rate notes and other structured products, including an actual/360-365-366 day count convention versus 30/360 fixed, the borrower's ability to prepay a loan at any time (including during an interest period), and the relatively common trading or assigning by lenders of loans among themselves [34]. As a result, the FRN market in particular has had greater success adopting and operationalizing compounded and SOFR averages, while the business loans market has pressed for a SOFR term rate.

With "SOFR First" successfully launched and creating the required "robust" forward-looking SOFR derivatives market, the ARRC stated that its key principles for recommending a SOFR term rate had been satisfied and, on 29 July 2021, the ARRC published a formal recommendation for the use of term SOFR [35], as produced by CME Group [36], in specified financial products, specifically business loans, the derivatives used to hedge them, and the securitizations holding them. The ARRC also published a factsheet summarizing key transition steps to date, upcoming milestones, and the strengths of SOFR [37]. Previously the ARRC had published tools to facilitate the use of the newly recommended rate, including applied-in-advance conventions [38] and best practices related to scope of use [39]. The ARRC emphasized in its announcement that the formal recommendation of Term SOFR concluded the ARRC's Paced Transition Plan [40], and stressed that market participants now have "every tool they need to transition from LIBOR."

The ARRC's recommended use of term SOFR is a timely addition to the universe of alternative reference rates that have emerged in the USD LIBOR market to address the market preference in some segments for a forward-looking rate, and particularly one that is credit sensitive. U.S. regulators have been critical of these credit sensitive rates [41], voicing concern that these rates reflect the same flaws as LIBOR and are not supported by a robust underlying market [42].

With term SOFR now a reality (with a limited scope of use that includes incorporating securitizations and hedging derivatives), market participants – notably those generating loans destined for inclusion in Collateralized Loan Obligations – can be expected to increase new originations of SOFR-linked loans. This development will help the market comply with the ARRC's best practice recommendations for cessation of new use of USD LIBOR [43]. In addition, there now is certainty that legacy contracts that have adopted the ARRC's fallback language recommendation will fall back to SOFR, as will those benefitting from the legislative solutions described below [44].

Legacy Contracts Still an Issue

Although some legislative activity has occurred, so-called legacy contracts – that is, active contracts due to mature after 2021, that were entered into before fallback rates for a permanent discontinuance of LIBOR were contemplated, that are widely held by holders that are difficult or impossible to identify, and that require unanimous holder consent to amend essential provisions, such as the interest rate – continue to pose a challenge to completing the transition of all financial instruments from LIBOR to alternative RFRs.

There has been some progress at the state level in implementing legislative solutions that allow contracts with no or inadequate fallback provisions to transition from LIBOR to SOFR as a matter of law, with notably the State of New York [45] and the State of Alabama [46] having enacted such legislation. At the federal level, legislation still is pending before the U.S. Congress [47]. If and when enacted, federal legislation would preempt these (and other intervening) state laws and provide a solution for all U.S. law-governed documents that fail to address a permanent cessation of LIBOR. The current draft of such federal legislation, most recently revised on 29 July 2021, (a) replaces LIBOR with a form of SOFR in LIBOR-linked contracts that have no or inadequate fallback provisions; (b) provides a safe harbor from liability in the implementation of the replacement rate and confirms continuity of contract; and (c) clarifies that benchmark replacement does not constitute impairment of an indenture security holder's right to receive payment of principal and interest under the Trust Indenture Act of 1939.

Legislative solutions are not unique to the United States. The FCA recently closed a consultation [48] on how it proposes to use its powers, granted pursuant to the UK Benchmarks Regulation, as amended by the Financial Services Act 2021 [49], over the use of critical benchmarks. The FCA notes that, unlike many jurisdictions (including the United States), the UK has an existing regulatory framework applicable to critical benchmarks, which will allow it to manage an orderly wind down of LIBOR [50].

The UK also currently is consulting on a proposed decision to use its powers under the Financial Services Act 2021 to require IBA to change the way 1-, 3-, and 6-month GBP and JPY LIBOR settings are determined for a period of 12 months after cessation on 31 December 2021, in essence creating a "synthetic" GBP and JPY LIBOR [51]. The proposed synthetic rates will allow "the pool of outstanding legacy contracts that have no realistic prospect of being amended" to terminate in an orderly way that protects consumers and maintains the integrity of the financial system.

A legislative solution to aid legacy contracts also is being proposed in the European Union. The Euro Risk-Free Rates Working Group sent a letter to the European Commission on 15 July 2021 [52] identifying a number of factors that have contributed to the slow pace of transition of EONIA contracts, and urging support for a statutory solution. Like the UK, the European Union is empowered under the Benchmarks Regulation to ensure that benchmark transition is transparent to market participants and does not create undue economic disruption.

Edging Toward the Finish Line

With 31 December 2021 quickly approaching, the pieces are falling into place globally for the transition from IBORs to RFRs to occur timely and efficiently if market participants stay the course. The recent events discussed in this article are critical components of a successful transition. In the United States, the recent recommendation of a SOFR term rate for business loans, with a scope of use that includes hedges and securitizations that support and hold those loans, is a linchpin for the structured finance market.

Notes

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3. Amendments to the 2006 ISDA Definitions to include new IBOR fallbacks – Supplement number 70 to the 2006 ISDA Definitions, International Swaps and Derivatives Association, published on 23 October 2020 and effective 25 January 2021 (the "IBOR Supplement," and together with the IBOR Protocol, the "ISDA IBOR Documents") (http://assets.isda.org/media/3062e7b4/23aa1658-pdf/).
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6. SOFR First | MRAC Subcommittee Recommendation, Commodity Futures Trading Commission, 13 July 2021 (www.cftc.gov/media/6176/MRAC_SOFRFirstSubcommitteeRecommendation071321/download). The SOFR First initiative is modeled after the UK SONIA First initiative (www.bankofengland.co.uk/news/2020/september/fca-and-boe-joint-statement-on-sonia-interest-rate-swap), and calls for four phases of product pricing transition that are schedule to occur prior to the end of 2021: linear swaps on 26 July 2021 (www.cftc.gov/PressRoom/PressReleases/8394-21) and cross-currency swaps (referred to as the "RFR First" initiative – www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Press_Release_Endorsement_of_MRAC.pdf) on 21 September 2021, followed by the transition of non-linear derivatives and exchanged-traded and other derivatives. Similar initiatives are in process in Switzerland (www.snb.ch/n/mmr/reference/minutes_20210701/source/minutes_20210701.n.pdf), the European Union (www.esma.europa.eu/sites/default/files/library/esma81-391-73_eur_rfr_wg_statements_on_estr_first_and_ccs.pdf), and Japan (www.boj.or.jp/en/paym/market/jpy_cmte/data/cmt210726b.pdf).
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8. See definition of "Applicable Fallback Rate" in IBOR Protocol and IBOR Supplement §§7.1(ab)(xxii) and (xxiii).
9. In the Summary of Responses to the ISDA Consultation on Final Parameters for the Spread and Term Adjustments (http://assets.isda.org/media/3e16cdd2/d1b3283f-pdf/), published for ISDA by The Brattle Group on 15 November 2019, The Brattle Group states, "The 2018 Consultation and the Supplemental Consultation established that the overwhelming majority of respondents preferred the compounded setting in arrears rate to address the differences in tenors between IBORs and overnight risk free rates ("RFRs"), and the historical mean/median approach for the spread adjustment to address credit risk and other premia between IBORs and corresponding RFRs across benchmarks." See page 4.
10. IBOR Fallback Rate Adjustments Rule Book, ISDA and Bloomberg Index Services Limited, see page 2 (http://assets.isda.org/media/34b2ba47/c5347611-pdf/?_zs=Mdvp81&_zl=82Bj5).
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17. Consultation on Potential Cessation, IBA, 4 December 2021 (www.theice.com/publicdocs/ICE_LIBOR_Consultation_on_Potential_Cessation.pdf).

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44. See Scope of Use, page 2.
45. New York State Senate Bill S297B – An act to amend the general obligation law, in relation to the discontinuance of the London interbank offered rate, passed by the New York State Legislature on 24 March 2021 (www.nysenate.gov/legislation/bills/2021/s297/amendment/b).
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