IBOR Update
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Following the ISDA launch of the IBOR Fallbacks Supplement and Fallbacks Protocol on October 23rd, 2020 a further series of announcements in November 2020 have added additional momentum to the IBOR transition process.

In two separate statements made in mid-November Fed Governor Quarles seemed to indicate a change in regulatory thinking. He commented on the need to find a mechanism that allowed the bulk of legacy contracts to mature on their existing terms without transition to a new rate. His second comment on the need for legislation for a hard tail when, “we’ve had time to think about it”, added to the market belief that there would be an extension to the end 2021 deadline for LIBOR cessation.

However, any thoughts of a complete extension of the LIBOR deadline were ended with the November 18 announcement by the IBA of a consultation on plans to terminate publication of all LIBOR tenors denominated in Sterling, EURO, Swiss Franc and Yen after December 31, 2021.

The fact that USD LIBOR was conspicuously omitted from the consultation led the market to believe that the cessation of USD LIBOR would not be concurrent with the other LIBOR fixings. Although the IBA reiterated its warning that market participants could not rely on publication beyond end 2021, the USD LIBOR forward basis immediately repriced to reflect the impact an extension would have on the historical spread used as the credit replacement add-on in USD fallback rates.

LIBOR transition to SOFR for the US market is proving more problematic than in other currencies. Firstly, the size of the transition - the NY Fed estimates that $200tn of derivatives, loans and bond contracts rely on USD LIBOR. Secondly USD LIBOR is also embedded in retail transactions such as mortgages, car loans, credit cards and student debt to a greater extent than any of the other comparable LIBORs. Transition therefore has a more widespread impact with an increased scrutiny on treating customers fairly.

US transition is also hampered by the fact that SOFR is an entirely new rate whereas other currency RFRs are remediated versions of existing rates. Introduction of a new rate requires time for its acceptance and to build liquidity.

The lack of a dynamic credit spread in SOFR lending poses problems for some lenders particularly in times of funding stress. Efforts to advance the use of SOFR alternatives such as Ameribor or the creation of a dynamic credit spread add-on such as the ICE Bank Yield Index or Bloomberg’s Short-term Bank Yield Index have diverted attention and resources away from establishing SOFR as the market standard.

The switch to SOFR discounting at the CCPs in October has resulted in improved liquidity but SOFR derivatives still only account for approximately 5% of the market. Delays in creating a liquid SOFR derivatives market also risks the creation of a SOFR term rate which we see as an essential part of the tough legacy solution.

Since the November 18 IBA announcement, market debate had centred on the length of the delay rather than the possibility of a delay for USD LIBOR and it did not have to wait long for an answer in a series of highly co-ordinated announcements made on November 30.

The IBA announced that based on feedback from the panel banks and discussions with the FCA and other official sector bodies it would also consult on the intention to cease the publication of the one-week and two-month USD LIBOR immediately following the LIBOR publication on December 31, 2021, and the remaining USD LIBOR settings immediately following the LIBOR publication on June 30, 2023.

The consultation started in December and runs concurrently with the consultation announced on November 18, closing for feedback by the end of January 2021. Subject to the results of the consultation, the IBA also noted that any continued publication of USD LIBOR settings based on panel bank submissions beyond December 31, 2021 would need to comply with applicable regulations.

In its response the US Banking regulators noted that extending the publication of USD LIBORs until June 30, 2023 would allow an increased amount of legacy USD LIBOR contracts to mature. However, the statement also reiterated encouragement to transition away from USD LIBOR as soon as practicable. The US Banking Regulators expressed their view that "failure to prepare for disruptions to USD LIBOR, including operating with insufficiently robust fallback language, could undermine financial stability and banks' safety and soundness."

In a strongly worded comment, the agencies also pointed to the consumer protection, litigation, and reputational risks, that arise from new contracts referencing USD LIBOR after December 31, 2021 and that bank practices would be examined accordingly. The agencies encouraged banks to cease entering into new USD LIBOR referencing contracts as soon as practicable and in any event by December 31, 2021.

The Federal Reserve Board welcomed and supported the proposal that introduced a clear end date and an orderly wind-down for USD LIBOR with a clear directive for banks to stop writing new USD LIBOR contracts by the end of 2021.

The FCA response also welcomed and supported the extension by the panel banks together with a clear end date for the USD LIBOR panel. The FCA pointed to the supervisory guidance from the US Banking Regulators limiting the new use of USD LIBOR after end of 2021 adding it would consider how most appropriately to use its own powers to limit the use of USD LIBOR in new contracts. The FCA also encouraged market participants which are parties to legacy LIBOR contracts to continue work to convert these contracts or to adopt robust fallbacks.

The ARRC commented that the supervisory guidance to cease new USD LIBOR issuances by the end of 2021 would support a smooth transition for legacy contracts by allowing time for most to mature before USD LIBOR ceases, subject to consultation outcomes.

Subject to parliamentary approval the FCA will have the power to require the continued publication of LIBOR using a modified non panel-based methodology. The FCA had previously indicated that it may exercise this power to allow the continued publication of a modified LIBOR for use in tough legacy contracts that cannot practicably be transitioned by the counterparties themselves.

Although this does invite the observation that the FCA could impose the publication of a modified USD LIBOR on IBA rather than allow continued panel bank submission. It is generally accepted by the market that the USD panel banks will continue until June 2023.

In a further acknowledgement of the role of the FCA as LIBOR supervisor, a note from ISDA also highlighted that any continued publication of USD LIBOR based on panel bank submissions beyond December 31, 2021 will need to comply with applicable regulations, including as to representativeness.

An announcement of non-representativeness had been expected from the FCA in the coming weeks which would mark the end of the five-year look back period used to calculate the fallback adjustment spreads. In previous communications ISDA had confirmed that the spread adjustment would become static at the time of an FCA announcement. So, even if a LIBOR continues to be published after an FCA declaration of non-representativeness the spread adjustment for switching a contract from a LIBOR setting to the relevant RFR at any future time will be known.

It remains to be seen if the expected non-representativeness declaration from the FCA will include USD LIBOR. The FCA had publicly stated their intention to provide the market with 12-months advance notice of the effective date of a non-representativeness decision which is important because it triggers the calculation of the spread adjustment.

The market repricing we saw of the forward USD LIBOR basis only makes sense if the FCA were to delay a USD non-representativeness decision. However, at a December 8 forum the FCAs' Edwin Schooling Latter stated that although the end date for USD LIBOR is different, what is common is the clear proposal for all currency LIBORs to end and that all 5 announcements could be made simultaneously.

The ISDA supplement and the amendments made by the protocol will take effect on January 25, 2021. The results of the IBA consultation will be shared with the FCA shortly after the end of January before being made public. We expect the publication of the consultation results to be accompanied by an FCA declaration of non-representativeness although it is a finely balanced decision as to if this will include USD LIBOR.

Including USD LIBOR in an end of 2021 declaration of non-representativeness represents the most aggressive option for the FCA but it would aid the regulatory objective of ending new USD LIBOR activity as it would reduce its use in new derivatives, however, it would cause problems in the non-derivative markets where the pre-cessation trigger does not exist.

Taken together with the current lack of a term SOFR rate plus the FCA acceptance of a delay to the cessation of USD LIBOR, on balance we expect the date of non-representativeness to be announced at a later date than the FCA announcement for the other 4 LIBORs. The calculation of the ISDA fallback spreads would then not all occur at the same time.

The role of the CCPs in the mechanics of the market transition cannot be underestimated. As we have previously commented, the CCP rulebook allows the migration of cleared trades to the RFRs prior to a permanent LIBOR cessation. We already know that the clearing houses will implement the ISDA fallbacks in all legacy cleared derivatives contracts as of the effective date. For non-USD trades the actual CCP transition of legacy cleared trades is therefore expected to be concurrent with the bilateral market at end of 2021.

Given the delay to USD LIBOR cessation, CCPs would be expected to transition USD cleared trades on June 30, 2023. We have previously commented that a material change in USD LIBOR liquidity would impact the CCPs ability to manage risk in the event of a default. The extended timeline for USD cessation increases the chances that the CCPs migrate cleared USD trades to SOFR before USD LIBOR cessation.

The risk introduced by a bifurcation of cleared and non-cleared derivative markets together with the knock-on effects for the cash markets would be problematic. Ongoing consultations between the CCPs and its members had been aimed at ensuring that any CCP pre-cessation transition coincided with the transition in the bilateral market. For non-USD trades this issue now appears to be resolved however for USD trades the extended timeline increases the risk that cleared and non-cleared trades will not transition concurrently.

The publication of the ISDA supplement and the protocol has provided the derivatives market with the safety net of a robust fallback. If the IBA consultation has the expected results, there will be further clarity to the timeline of LIBOR cessation. An FCA announcement of non-representativeness will set the static fallback spreads and remove market volatility from the transition value transfer costs.

Successful transition still has hurdles, notably how to manage the apt named “tough legacy” contracts and to what extent derivatives solutions can be replicated in cash markets. However, these 2020 developments should decisively shift the focus from the regulatory delivery phase to an accelerated active transition by market participants in 2021.