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The Last Days of LIBOR

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On December 16, 2022 the Board of Governors of the Federal Reserve adopted a final rule identifying the benchmarks that will replace LIBOR in various types of financial instruments when LIBOR (at least in its current form) ceases to exist on June 30, 2023. This marked a significant milestone in the U.S. financial system's transition away from LIBOR.

LIBOR and Its Demise

The London Interbank Offered Rate (LIBOR) was created in the 1980s as a proxy for the rate at which banks could borrow from one another on an unsecured basis. Over the next four decades it morphed into the world's most important benchmark, used as the base interest rate in an ever-increasing variety of financial instruments. At its peak, more than $200 trillion of financial contracts were tied to LIBOR, and it was published in five different currencies and seven different maturities each business day.

Over the years, however, the interbank unsecured lending market that it sought to reflect grew illiquid as it was replaced by other forms of financing. As a result, LIBOR panel banks often had to rely on trader judgment rather than actual transactions to submit the rate quotations used to calculate the benchmark. Collectively, these conditions made LIBOR very susceptible to manipulation. Over the past decade, the panel banks have faced a myriad of fraud-based claims from both regulators and private litigants and have paid out billions of dollars in settlements.

Efforts to reform or replace LIBOR began in earnest in 2012, when the regulator for the benchmark's administrator, the UK's Financial Conduct Authority (FCA), published a report recommending comprehensive reforms to LIBOR. In 2013, the International Organization of Securities Commissions (IOSCO) published principles for financial benchmarks to promote the quality and integrity of benchmarks by ensuring that they would be based on arm's-length transactions in robust markets. In 2014, the Financial Stability Board endorsed the IOSCO principles and recommended reforms to strengthen LIBOR and the development of risk-free rates that could provide alternatives to LIBOR. That same year, the Fed board and Federal Reserve Bank of New York (FRBNY) convened a group of private-sector financial institutions known as the Alternative Reference Rates Committee (ARRC) to spearhead those efforts in the United States. Finally, in 2017 the FCA announced that it would no longer compel or persuade banks to provide LIBOR submissions after 2021, effectively commencing the countdown to LIBOR's cessation. The process would be neither quick nor easy.

SOFR and Its Adoption

In 2017, the ARRC identified the Secured Overnight Financing Rate (SOFR) as the (nearly) risk-free rate best suited to eventually replace USD LIBOR. Unlike LIBOR, SOFR has the benefit of being based on a robust underlying market (the roughly $750 billion market for U.S. Treasuries repurchase agreements). But SOFR also bears other significant differences from LIBOR that have complicated the transition process. First, SOFR itself is an overnight rate and does not have a term structure like LIBOR. Second, SOFR is a secured financing rate, while LIBOR is based on unsecured financing; so SOFR rates do not reflect the bank credit risk embedded in the LIBOR rates they would replace.

Following the ARRC's identification of SOFR as the preferred LIBOR replacement benchmark in 2017, various industry groups sprang to action to assist their members in effecting the transition. The primary industry association for derivatives, the International Swaps and Derivatives Association (ISDA), was probably the most active and coordinated of these groups, conducting multiple market consultations to build industry-wide consensus on all aspects of the transition. One of ISDA's first accomplishments in this regard was coordinating the derivatives market's coalescence around Fallback Rate (SOFR) as its preferred replacement benchmark. Since January 2021, all standard LIBOR-based derivative transactions have provided this version of SOFR, which is compounded in arrears and published by Bloomberg Index Services Limited, as the primary fallback to USD LIBOR.

Coordination within the cash markets with LIBOR exposure has proved more challenging, and these markets have generally been less keen to adopt Fallback Rate (SOFR) as a fallback rate. Market participants have worried that a rate compounded in arrears would be problematic for borrowers that value the cash flow certainty of a forward-looking rate (like LIBOR) that can be calculated well before a payment became due.

In a series of consultations conducted by the ARRC, cash market participants generally expressed a preference for term rates based on SOFR. However, whether such rates could be developed before LIBOR ceased to be published remained an open question during the early years of the transition; both regulators and the ARRC expressed concerns that SOFR-based term rates might suffer from some of the very same issues (e.g., a thin underlying market) that plagued LIBOR.

This uncertainty led some market participants to adopt SOFR-based rates that are calculated in advance by averaging SOFR rates over an earlier observation period, such as the Average SOFR benchmark published by the FRBNY. Eventually, however, the initial concerns that regulators and the ARRC had with term SOFR rates were assuaged as a robust derivatives markets for trading SOFR on a term basis developed. In July 2021, the ARRC formally recommended the use of term SOFR rates (as published by CME Group, "Term SOFR") for most cash products.

Spread Adjustments

These SOFR-based rates and calculation methodologies helped address SOFR's lack of a term structure, but they did not solve for the value transfer that could arise from replacing an unsecured financing rate with a secured rate in existing contracts. ISDA took the lead on this subject. Following a series of market consultations, in March 2021 it published standardized spread adjustments that could be added to SOFR-based replacement benchmarks to account for this difference. These recommended spread adjustments were based on the five-year historical median difference between USD LIBOR and SOFR. In June 2021, these same spread adjustments were endorsed by the ARRC for use in cash products.

LIBOR tenor being replaced	Spread applied to SOFR-based rate (bps)
1-week USD LIBOR	3.839
1-month USD LIBOR	11.448
2-month USD LIBOR	18.456
3-month USD LIBOR	26.161
6-month USD LIBOR	42.826
1-year USD LIBOR	71.513

Documentation

Perhaps the most significant effort in the process of moving away from LIBOR has been establishing contractual language to effect the transition across product types. For some types of contracts, market participants have preferred a "hardwired" approach, calling for an automatic transition to a replacement benchmark upon LIBOR's cessation or the occurrence of certain other pre-cessation events. Other markets been more prone to delegating the responsibility of selecting a replacement benchmark (usually subject to certain predetermined limitations) to one or more deal parties.

Regardless of the product type or preferred approach, defining clearly delineated events that would trigger the automatic conversion to a replacement benchmark or the right to designate a replacement benchmark has been a critical component of the document remediation process. Over time, the language setting forth cessation-based triggers has become more and more standardized across products, but pre-cessation triggers have continued to vary across contract types. The one pre-cessation trigger that has become fairly standard across product types is a statement by LIBOR's administrator (the FCA) announcing that LIBOR is no longer representative of the underlying market it is meant to represent (the "representativeness trigger").

The market that has been most coordinated in its documentation approach is the market with (by far) the largest exposure to LIBOR, the derivatives market. In addition to standardizing the replacement benchmark provisions, ISDA has published standardized hardwired triggers that have made their way into the bulk of legacy LIBOR-based derivative transactions. All the major derivatives clearing houses have incorporated such language into their legacy transactions, and over 15,000 market participants have signed on to the ISDA 2020 IBOR Fallbacks Protocol to incorporate such fallback provisions into their legacy uncleared transactions.

Documentation within the cash markets is more varied across products, and even from deal to deal. For its part, the ARRC (in coordination with relevant industry groups) conducted several product-specific market consultations and published product-specific recommended benchmark replacement language, which has helped bring some consistency. Still, ARRC's suggested provisions have been frequently modified and negotiated, and many cash instruments include bespoke fallback provisions that predate the publication of the ARRC's recommended language.

The LIBOR Act and the Fed Rule

Industry transition efforts received a bit of relief in March 2021, when the FCA announced that LIBOR's administrator, the ICE Benchmark Administration (IBA), with the cooperation of the panel banks, had agreed to continue publishing certain tenors of LIBOR beyond the end of that year. The IBA committed to publishing overnight, 1-month, 3-month, 6-month, and 12-month USD LIBOR through June 30, 2023. Two other two USD LIBOR tenors (1-week and 2-month), as well as all EUR and CHF LIBOR tenors and most GBP and JPY LIBOR, would still cease to be published at the end of 2021.

Despite the continuing publication of these USD LIBOR tenors, in October 2021 the Fed board and its fellow U.S. prudential regulators issued a joint statement encouraging the institutions they oversee to cease entering into new LIBOR contracts by the end of that year.

Even with this mandate (and the massive transition efforts to date), many contracts that reference LIBOR and have no workable fallbacks remain outstanding. In March 2022, the U.S. government enacted legislation to provide a backstop aimed at ensuring a smooth transition for these transactions. The Adjustable Interest Rate (LIBOR) Act provides that LIBOR-based contracts that lack practicable replacement benchmarks (i.e., benchmarks that are untethered to LIBOR and do not involve a poll) will automatically transition (by operation of law) to the applicable reference rates recommended by the Fed board, each as adjusted by the relevant recommended spread adjustments, on June 30, 2023 (the "LIBOR replacement date").

The LIBOR Act also provides legal safe harbors insulating (1) any "determining party" with the contractual right to choose a replacement benchmark that selects the applicable benchmarks recommended by the Fed board; and (2) any "calculating party" that needs to make technical, administrative, or operational conforming changes to a contract in order to perform calculations using the applicable benchmark recommended by the Fed board. The LIBOR Act applies to all in-scope contracts governed by U.S. law and expressly preempts the earlier state laws (including New York's) purporting to address benchmark replacement.

On December 16, 2022, the Fed board published a final rule (the "Fed Rule") setting forth the replacement benchmarks that will replace LIBOR on the LIBOR replacement date pursuant to the LIBOR Act. Under the Fed Rule, SOFR (plus a 0.644 basis point spread adjustment) will replace overnight LIBOR in all in-scope contracts that reference that rate, but term LIBOR rates will be replaced by different replacement benchmarks in different types of products.

Unsurprisingly (given the consensus within that market), the Fed board recommended Fallback Rate SOFR as the replacement benchmark for derivatives transactions.

For cash transactions, the Fed board generally recommended the applicable tenor of Term SOFR to replace 1-month, 3-month, 6-month, and 12-month LIBOR, but it did flag certain types of transactions, including Federal Family Education Loan Program (FFELP) asset-backed securitizations (ABS), transactions involving entities regulated by the Federal Housing Finance Agency (FHFA), and consumer loans, that will transition in different ways.

Consistent with current practice in the FFELP ABS market, legacy transactions linked to 3-month LIBOR will transition to 90-day Average SOFR, and all other LIBOR tenors will transition to 30-day Average SOFR, each as modified by the related recommended spread adjustments.

The 30-day Average SOFR will also serve as the replacement benchmark for all tenors of LIBOR in all transactions involving FHFA-regulated entities except for Federal Home Loan Bank (FHLB) advances. Government-sponsored entities like the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) have been utilizing 30-day Average SOFR in newly issued multifamily loans and other structured products since 2020, and both Fannie Mae and Freddie Mac have recently identified it as the replacement benchmark for transactions in which they serve as determining parties. Unlike other transactions involving FHFA-regulated entities but consistent with the current practices of the FHLB, the Fed board has selected Fallback Rate (SOFR) as the replacement benchmark for FHLB advances.

Lastly, while in-scope consumer loans will transition to Term SOFR like most cash products, the Fed has elected to modify the implementation of spread adjustments for such products. Rather than having the full recommended spread adjustments apply immediately following the LIBOR replacement date, they will be phased in (linearly) over a one-year period.

Synthetic LIBOR

The LIBOR Act and Fed Rule should provide a solution for most U.S.-law-governed LIBOR-based transactions that do not contain clear and practicable fallback provisions, but many legacy cash instruments (including most U.S. syndicated loans) are expected to fall outside their scope. Most U.S. credit agreements (and various types of indentures) call for interest to be calculated based on the prime rate when LIBOR (or the applicable benchmark) is unavailable or otherwise unsuitable for use. Prime has traditionally yielded much higher rates than LIBOR, so borrowers will likely find its use to be highly objectionable. However, this benchmark is expected to remain viable beyond the LIBOR replacement date, and it is not linked to LIBOR or polling, so contracts that have (temporary or permanent) fallback provisions referencing prime will typically fall outside the scope of the LIBOR Act and the Fed Rule.

To potentially address this issue, the FCA commenced a consultation in November 2022 seeking industry consideration of whether the FCA should compel the IBA to publish synthetic LIBOR for a 15-month period from the LIBOR replacement date (through September 30, 2024). Under this approach, which is similar to the one employed for certain tenors of GBP LIBOR and JPY LIBOR, synthetic LIBOR would equal the applicable Term SOFR rate plus the recommended spread adjustment rather than being based on panel bank rate submissions.

Additionally, synthetic LIBOR would be declared permanently non-representative. As such, synthetic LIBOR would not affect any transactions documented with ARRC-recommended benchmark replacement provisions because the contractually prescribed replacement benchmarks would take effect when LIBOR is deemed unrepresentative on the LIBOR replacement date. However, any transactions calling for fallback to the prime rate that either lack permanent transition provisions or include bespoke provisions that do not include a representativeness trigger would instead revert to synthetic LIBOR on the LIBOR replacement date (if the FCA does indeed compel its publication).

In any case, reliance on either synthetic LIBOR or the LIBOR Act and Fed Rule is highly unlikely to be the preferred course of action for most major market participants. We should expect large financial institutions (and their regulators) to be pushing contractual remediation at a frenzied pace over these last six months of USD LIBOR's existence.

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