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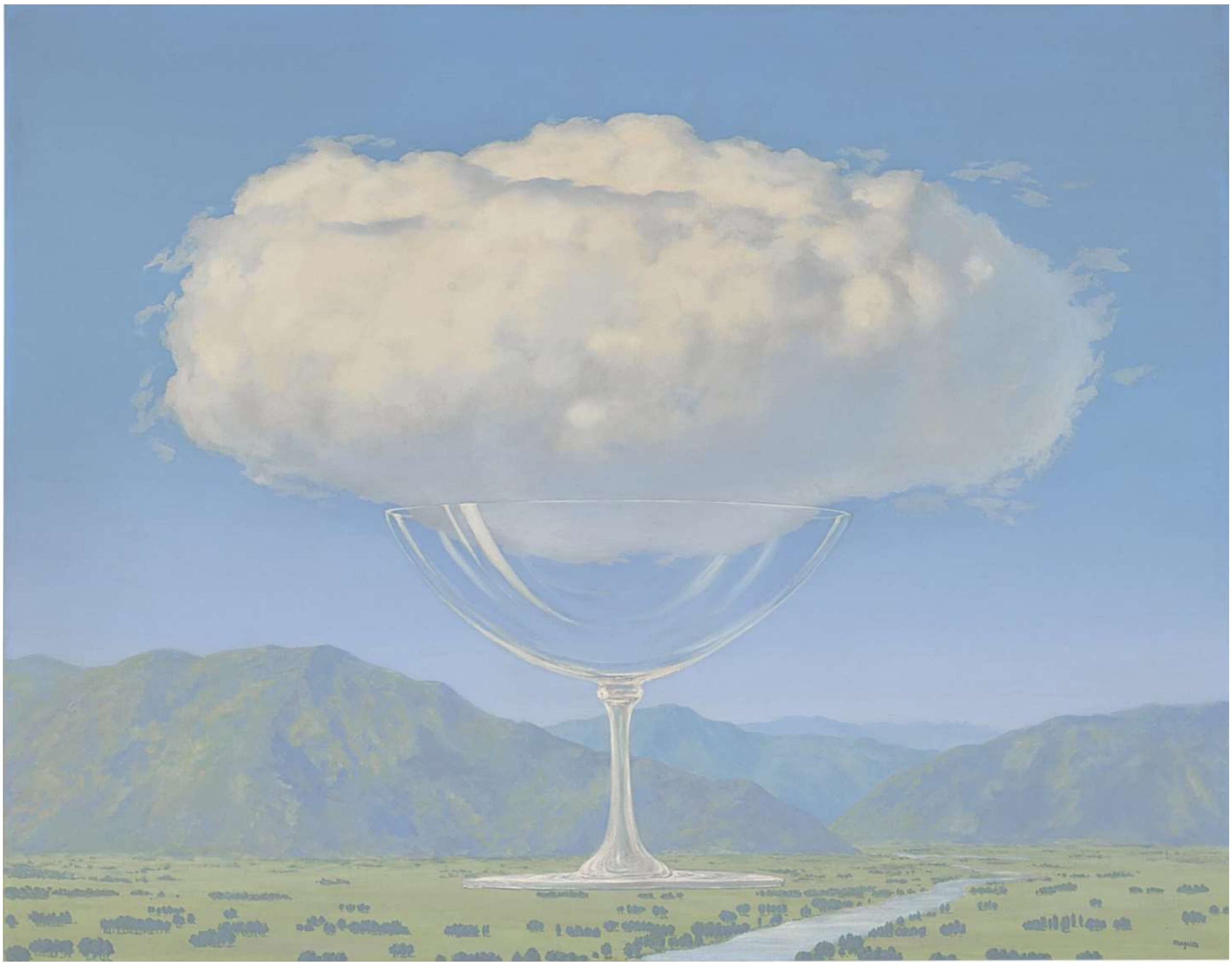
Derivatives Advisory



IBOR Update III
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LIBOR Cessation

On 5th March 2021, in a highly anticipated statement,[1] the FCA announced the future cessation and/or loss of representativeness of the 35 LIBOR fixings currently published by ICE Benchmark Administration (**IBA**). Following its recent market consultation,[2] IBA had notified the FCA that it intended to cease publishing all LIBOR fixings . The FCA confirmed that it would not compel any of the panel banks to continue LIBOR submissions beyond their notified date of departure from a panel, nor require IBA to continue publishing panel bank LIBOR.

In accordance with the terms of the consultation, this will result in all the panel-based Euro, Swiss Franc, Yen and Sterling fixings, plus two of the lesser used USD fixings ceasing publication immediately after 31st December 2021. Publication of the remaining USD LIBOR fixings will continue for a further 18 months and cease immediately after 30th June 2023.

In making the statement, the FCA noted that this would result in contractual triggers for the calculation and future application of fallbacks that are activated by pre-cessation or cessation announcements made by the FCA.

ISDA confirmed separately[3] that the FCA announcement constituted an index cessation event for all 35 LIBOR indices. As a result, the lookback period for the calculation of the spread adjustments to be used in the IBOR fallbacks has ended and the fallback spread adjustments published by Bloomberg are now fixed, as of the date of the announcement for all Euro, Sterling, Swiss Franc, USD and Yen LIBOR fixings indices.

Bloomberg also published[4] a list of the LIBOR currencies and tenors along with the relevant spread adjustments following the ISDA defined *Spread Adjustment Fixing Date*.

Table 1: Spread Adjustments: Source Bloomberg

Libor	Tenor (Months)	Spread Adjustment
CHF	1	- 0.0571
CHF	3	0.0031
CHF	6	0.0741
EUR	1	0.0456
EUR	3	0.0962
EUR	6	0.1537
GBP	1	0.0326
GBP	3	0.1193
GBP	6	0.2766
JPY	1	-0.02923
JPY	3	0.00835
JPY	6	0.05809
USD	1	0.11448
USD	3	0.26161
USD	6	0.42826

[1] https://tinyurl.com/4xy4w455
[2] https://tinyurl.com/fmnevbyr
[3] https://tinyurl.com/4htjhm8v
[4] https://tinyurl.com/4nevtkzv

As discussed in our previous whitepapers, the spread adjustments (designed to minimise value transfer between counterparties) represent the credit element inherent in LIBOR and will be added to the equivalent compounded in arrears RFR at the time of cessation for legacy LIBOR referencing transactions.

Following the 18-month extension to the cessation of USD LIBOR, the market had been split as to whether the USD spreads would be set at the same time as the other LIBOR spreads; that debate is now closed. Although some market participants were surprised that the observation period for USD LIBOR spreads had ended despite the later date of USD cessation, this had been flagged as a possibility. Edwin Schooling Latter, the Director of markets and wholesale policy at the FCA, had previously commented that the difference in the timing of cessation overstated the difference in the future path for USD LIBOR and the consultation had opened the way to making announcements on the future path for all five index currencies simultaneously.

As previously noted, all ISDA governed derivatives transactions executed since 25th January 2021 automatically include the fallback provisions. Adherence to the voluntary ISDA Fallbacks Protocol is required to incorporate the fallbacks into legacy non-cleared derivatives trades. ISDA has reiterated that the protocol remains open for adherence on the ISDA website[5] which also lists the 13,500+ counterparties (as of 9th March 2021) which have already adhered to the protocol.

The fixing of the spread adjustments is a pivotal moment for the transition away from LIBOR, as there is now clarity on the future terms of derivative contracts that incorporate the ISDA fallbacks. Now that the spread is static, the economic terms of an active conversion from a LIBOR referencing contract to an RFR referencing contract are known. Valuation impacts will no longer be driven by the forward basis markets which will converge to the published fixed spreads.

Many market participants have previously cited a lack of a firm deadline and variability in economic terms as the major reason for delaying transition from LIBOR to RFRs. Regulators will expect to see an increase in the levels of active transition now that the deadline is confirmed, and the valuation adjustment is no longer variable.

It remains to be seen if active transition will result in the spread being applied to the RFR or if it will lead to the spread being cash settled between counterparties, potentially driven by XVA considerations.

Highlighting the limited time to complete transition, a statement[6] issued by The Working Group on Sterling Risk-Free Reference Rates detailed the progress already made in moving away from GBP LIBOR to SONIA but reiterated that all businesses must remove their reliance on GBP LIBOR by the end of this year.

In accordance with the roadmap, the next major industry milestone is to cease the use of GBP LIBOR in new loans, bonds, securitisations and linear derivatives, intended by 31st March 2021 for products expiring after the end of 2021 and by the end of June 2021 for most remaining products.

[5] https://tinyurl.com/4x5nea84
[6] https://tinyurl.com/ry6pk3k

The Working Group also encouraged all businesses to complete the identification of existing exposures by 31st March 2021 and to progress with active conversion aiming for completion by 30th September 2021.

Synthetic LIBOR

Although this announcement will result in the end of panel-based LIBOR, it has been widely expected that a defined number of the fixings would survive, albeit using an amended methodology, which has been referred to as "synthetic" LIBOR. The FCA statement also confirmed that it would consult about using its prospective new powers, if the required legislation is passed, that would require IBA to publish a synthetic LIBOR.

In the case of Sterling, this would represent 1-month, 3-month and 6-month fixings for a further undefined period after the end of 2021. Presumably at the request of the Japanese regulator, the FCA consultation is also expected to result in the continued publication of 1-month, 3-month, and 6-month Japanese Yen fixings for a further year, ending publication on 30th December 2022.

The statement also indicated that the FCA was considering continued publication of synthetic 1-month, 3-month and 6-month USD LIBOR fixings after the end of June 2023 for which it continues to gather the views of market participants and the US regulators.

The FCA confirmed that the proposed methodology for synthetic LIBOR would be a forward-looking term rate version of the relevant RFR plus a fixed spread adjustment calculated using the same parameters as the spread adjustment implemented in the IBOR Fallbacks Supplement and the Fallbacks Protocol published by ISDA.

The FCA was also clear that publication of a synthetic LIBOR was solely intended to assist legacy contract holders and that its use by UK regulated firms in new transactions would be prohibited. Clarification of which legacy uses of synthetic LIBOR would be permitted will come following another consultation later in 2021.

A separate statement of policy[7] document was also published, providing further details of the rationale for the use of synthetic LIBOR and its methodology together with details of the consultations.

The statement made it clear that although the publication of a synthetic LIBOR provided a fair approximation of what the corresponding panel bank LIBOR would have been, it would no longer be representative of the underlying market or economic reality that it is intended to measure. As a consequence, all 35 LIBOR indices will either cease to be provided by any administrator or no longer be representative immediately after panel bank cessation.

The Next Steps

In our opinion, the last three months have delivered two of the three building blocks required for a successful transition away from LIBOR. In January, we saw the effective date of the ISDA fallbacks and now in March, we have had confirmation of the cessation dates together with

[7] https://tinyurl.com/2cphj4a3

the fixing of the associated spread adjustments. We believe the final building block is the development and use of a synthetic LIBOR for tough legacy contracts.

As noted above, the FCA statement confirmed that synthetic LIBOR would be used as a solution for part of the LIBOR transition. It also confirmed that synthetic LIBOR would be forward-looking and derived from RFRs. In many respects, synthetic LIBOR is a like for like replacement for the existing LIBOR fixings and could therefore be widely used with virtually no technology development or alteration to business practices.

However, the very existence of a forward-looking term rate is by definition reliant on deep and liquid derivatives markets in the RFRs. These markets would not exist with sufficient liquidity if the majority of derivative and cash products did not transition to the daily overnight compound in arrears versions. It is not surprising therefore to see the regulators push for the wholesale adoption of the daily in arrears version as the market standard in all but a restricted subset of yet to be defined tough legacy contracts.

As we have previously noted, the pre-existence of a liquid SONIA derivative market has allowed the development of a forward-looking term SONIA rate, versions of which are currently published by FTSE Russell, IBA and Refinitiv for the major tenors. The decision to adopt a completely new rate in the US has meant that liquidity in SOFR has been slow to build. The acceptance of SOFR as a replacement for LIBOR also faces resistance in some quarters given the lack of a dynamic credit spread. The ongoing attempts to develop a SOFR alternative that includes a market sensitive credit element also diverts focus away from building SOFR liquidity.

Now that the USD spreads have been fixed and the cessation date is known, it is possible that the shift to SOFR derivatives will accelerate. The fact that the Fed made it clear that banks and other regulated firms need to stop the origination of new USD LIBOR based contracts by the end of 2021, aside from legacy hedging requirements, will certainly help. However, a continuing lack of SOFR liquidity will negatively impact the efforts to build a forward-looking LIBOR equivalent term rate which is intended to be launched in Q3.

Although USD legacy contracts will continue to reference LIBOR after 31st December 2021, we expect there will be limited and diminishing liquidity in new LIBOR products even though the rate will be published until end June 2023. This could result in "stranded" LIBOR products where perfect hedging becomes either impossible or expensive.

The FCA will seek to constrain the use of synthetic LIBOR for the yet to be defined tough legacy contracts with global regulators policing their use in legacy contracts. We expect further clarity on how this will be managed from the FCA consultation due in Q2 2021.

What constitutes a tough legacy contract is open to interpretation however, one view is that the definition will capture all LIBOR referencing contracts that have not triggered a fallback at the time of representative LIBOR cessation. This would provide a similar safety net to the ISDA protocol as it would ensure clarity of outcome for all non-transitioned contracts.

All ISDA referencing contracts have now been triggered and will fall back to the compounded in arrears RFR plus adjustment spread. For those contracts that actively transition to an RFR or alternative rate, synthetic LIBOR is not relevant. For the remaining contracts replacing the

LIBOR fixing with a synthetic LIBOR would help protect market integrity and stability by ensuring contracts continue to function in the way intended.

By design, synthetic LIBOR is a forward-looking term rate that offers a fair approximation of what panel bank LIBOR might have been. It will certainly be used in contracts that genuinely cannot transition to an RFR but it could also be used as a safety net for a much wider set of transactions. For example, it could be used for securities where consent thresholds have not been met. The UK Working Group launched a consultation[8] seeking feedback on the successor rate to GBP LIBOR in legacy bonds and it is worth noting that they have proposed either daily compounded in arrears SONIA or the use of term SONIA.

Future risk management and market pricing of contracts that reference a synthetic LIBOR may be problematic given the nonstandard nature of the product and the likely illiquidity of these contracts and available hedges. It is also worth noting that LIBOR referencing securities are being increasingly haircut when used as collateral due to difficulties in determining their value.

There is also the additional problem of introducing a new basis risk into a hedged portfolio where fallbacks differ between a contract that uses synthetic LIBOR and a derivative hedge that falls back to the daily compounded RFR. It is likely that this basis risk will also cause a break in the accounting treatment.

A mitigant to this basis would be to allow a derivative hedge that references the term RFR rate itself, but these products do not yet exist and the regulators are currently keen not to bifurcate the derivatives market.

For certainty of outcome, the regulators continue to push active transition as the only mechanism where counterparties maintain control over the economics of their contracts.

Conclusion

We believe the ISDA announcement to fix the adjustment spreads establishes a market standard price for the transition of bilateral loans, which could mitigate the conduct risk concerns institutions may have felt they had when informing clients of changes in loan spreads. This will help to drive an increase in active transitions in the loan market which has lacked the progress seen in other products.

The FCA announcement removes any further debate around extension of the LIBOR cessation date. All market participants now have the choice of engaging in an active transition process, accepting the outcome of the fallbacks or hoping to rely on a synthetic LIBOR rate that is yet to exist. While we await the results of the FCA consultation in Q2, we believe all institutions should accelerate the transition of LIBOR referencing contracts ensuring certainty of the outcome when LIBOR ceases.

[8] https://tinyurl.com/4nskanks

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