

It's the end of LIBOR as we know it

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Across the global markets, the countdown to midnight on New Year's Eve started long before revelers gathered in Times Square. Regulators had announced that the end of 2021 would also be the end of nearly all tenors of LIBOR in the \$400 trillion global market.

This presented multiple challenges on two fronts: *new transactions* needed to find a replacement benchmark(s) as a reference for their borrowing costs and outstanding "*legacy*" transactions needed to function without disruption following the discontinuance of their embedded benchmark.

For several years, committees organized by central banks, such as the Alternative Reference Rates Committee (or "ARRC"),¹ had worked on identifying robust alternative reference rates for their respective currencies.

In the U.S., the ARRC settled on the Secured Overnight Financing Rate ("SOFR"), a "risk-free" rate that is derived from \$800+ billion of daily trading activity in the U.S. Treasury repo market. While considered to be safe from the manipulation problems that plagued the setting of LIBOR, SOFR is structurally different in two fundamental ways: it is an overnight and secured rate, whereas LIBOR was a forward-looking term rate with a bank credit component.

With a clearer view of the likely replacement for LIBOR, markets began in earnest to incorporate more robust language² into contracts to contemplate the transition to SOFR plus an adjustment that reflected the historical average difference between SOFR and the corresponding tenor of LIBOR. The date for fixing that historical spread was set on March 5, 2021, when LIBOR's regulator, the U.K. Financial Conduct Authority, announced³ the date by which most LIBOR currency-tenors could no longer be used in new transactions.

The FCA also announced that a "synthetic" version of LIBOR would be available for GBP and Yen LIBOR, but only on a temporary basis and only for use in administering "tough legacy" contracts. There were no plans for a synthetic version of USD LIBOR.

Rather, the settings for 1-week and 2-month USD tenors (the least common tenors) would cease as of December 31, 2021 while all other USD tenors would continue to be published on the basis of panel bank submissions until June 30, 2023, the only LIBOR currency-tenors to do so.

Regulators immediately began to turn up the pressure⁴ on regulated entities to stop using LIBOR in new transactions, subject

to a few exceptions, and to remediate legacy transactions. They generally expressed⁵ a preference for SOFR but were careful to acknowledge that other reference rates may be appropriate for a bank's funding model and customer needs.

While the derivatives market was generally able to adapt to the new overnight risk-free rates,⁶ some markets (particularly loans and securitizations) struggled with SOFR's lack of a forward-looking term rate. Some of these markets looked to alternatives to LIBOR that had a term feature, such as Bloomberg's Short-term Bank Yield Index (or "BSBY").⁷

These alternative term rates also included a credit sensitive component. As they gained increasing attention in some markets, supporters of SOFR raised concerns about whether this development would detract from the volume of trading activity in SOFR futures, a critical foundation for building a forward curve to ultimately support the production of a SOFR term rate.

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Faced with this challenge to increased SOFR activity, some U.S. regulators criticized⁸ BSBY and other credit sensitive replacement benchmarks, saying they suffered from "many of the same flaws as LIBOR." Beginning in April, the ARRC released a series of statements identifying the key principles⁹ and market indicators¹⁰ it would consider when recommending a forward-looking SOFR term rate, and then officially recommended¹¹ it (subject to certain "best practices"¹²) in July.

To help buttress liquidity in SOFR trading, the CFTC's Market Risk Advisory Committee ("MRAC") adopted the "SOFR First" recommendation¹³ for a four-phase transition from LIBOR to SOFR. The MRAC recommended that dealers replace LIBOR with SOFR for interdealer quotes on linear swaps in July and "turn off" interdealer LIBOR screens by October.

Other phases of the “SOFR First” recommendation applied to cross-currency swaps, non-linear derivatives (such as swaptions) and exchange traded derivatives, which took effect over the second half of 2021.

Regulators also helped pave the way for LIBOR transition by providing regulatory relief for legacy transactions that needed to be amended to incorporate the new alternative rates. For example, the FDIC provided guidance on regulatory capital relief,¹⁴ the CFPB gave its blessing to the ARRC-endorsed SOFR replacement for consumer transactions,¹⁵ the CFTC eased its swap reporting¹⁶ and clearing¹⁷ requirements, and the Treasury Department presented the markets with guidance on the tax treatment¹⁸ of LIBOR transition just hours before New Year’s Eve. The SEC also provided guidance¹⁹ for investment professionals to consider when recommending LIBOR-linked securities and to issuers of securities on disclosing risk factors related to LIBOR exposure.

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In the third quarter of 2021, regulators continued to press²⁰ market participants to stop using LIBOR in “new transactions,” while market participants (particularly in the loan markets) struggled to understand whether certain anticipated activity in 2022 (such as funding under committed and uncommitted facilities) would fall within the exceptions for new use of LIBOR.

In October, several federal and state regulators issued a joint statement²¹ providing guidance on what constitutes a “new LIBOR contract” and, in November, the Federal Reserve Board issued additional guidance²² in the form of FAQs.

Meanwhile, market participants continued to focus on legacy transactions that could not be remediated before year-end. In the U.K., a working group that included the Bank of England and the FCA had previously described²³ these as “tough legacy” contracts for which supervised entities would be permitted to use synthetic forms of LIBOR — but only for a limited population of contracts — in furtherance of the public policy of encouraging market participants to be proactive in their remediation efforts.

But, as the year-end deadline approached, the population of “tough legacy” contracts turned out to be much larger than anticipated and, on November 16, the FCA announced²⁴ that synthetic GBP and Yen LIBOR would be permitted for all legacy contracts except for cleared derivatives (which had accommodated LIBOR transition through rule changes).²⁵

On the other hand, USD LIBOR, which does not have a planned synthetic form, will continue to be published on the basis

of panel bank submissions. However, it may not be used for “new transactions” (with a few exceptions noted above) after December 31, 2021 and may not be used for legacy transactions when it ceases to be published (June 30, 2023 for most tenors and December 31, 2021 for 1-week and 2-month tenors).

After the relevant cessation dates, legacy contracts without adequate fallback provisions for the end of USD LIBOR present the potential for disputes about their proper interpretation. To address this risk, New York State enacted legislation²⁶ that would govern the interpretation of these legacy contracts and help transition them to the SOFR-based replacement rates recommended by the ARRC.²⁷ Similar legislation was enacted in Alabama and is currently working its way through the U.S. Congress as a federal law.²⁸

After many years of cooperation across the globe and across the public and private sectors, comprehensive plans for a smooth transition from LIBOR are now in place, in the case of *new transactions* through the use of alternative rates and in the case of *legacy transactions* through the use of “synthetic LIBOR” or a legislative replacement. In sum, it’s the end of LIBOR as we know it (and I feel fine) — h/t to R.E.M.²⁹

Notes

¹ <https://www.newyorkfed.org/arrc>

² <https://bit.ly/3G4hnbK>

³ <https://bit.ly/3JQjdPN>

⁴ <https://bit.ly/3HKsYxi>

⁵ <https://bit.ly/3zyd198>

⁶ <https://bit.ly/3HMoNkC>

⁷ <https://bit.ly/3n4he0E>

⁸ <https://bit.ly/3eY6ht9>

⁹ <https://bit.ly/3JN57P7>

¹⁰ <https://bit.ly/32PW3Zq>

¹¹ <https://bit.ly/3t497Vs>

¹² <https://bit.ly/3n1tXBi>

¹³ <https://bit.ly/32PWEu8>

¹⁴ <https://bit.ly/3q2cwCf>

¹⁵ <https://bit.ly/3HKzdkl>

¹⁶ <https://bit.ly/3HDUDj6>

¹⁷ <https://bit.ly/3fh6Nmd>

¹⁸ <https://bit.ly/3JNlnjh>

¹⁹ <https://bit.ly/3t6l1Ni>

²⁰ <https://bit.ly/33aleVc>

²¹ <https://bit.ly/3G7MAL4>

²² <https://bit.ly/3zyghCA>

²³ <https://bit.ly/3t0JuoG>

²⁴ <https://bit.ly/3q3hCyf>

²⁵ <https://bit.ly/3qVxORs>

²⁶ <https://bit.ly/3zygyp6>

²⁷ <https://bit.ly/3t2UstO>

²⁸ <https://bit.ly/3n7idgC>

²⁹ <https://bit.ly/3HMBMW>

About the author



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