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LIBOR Transition Game Plan: A Guide for Asset Management Firms

What is LIBOR and why is it being phased out?

Asset managers have been hearing that the London Interbank Offered Rate (LIBOR) is being phased out. LIBOR is one of the most widely used global benchmarks for determining short-term interest rates for various debt instruments.[1]

LIBOR is used in the consumer market as the basis for consumer loans, including mortgages, credit cards and car loans, and it has wide impacts across the securities markets where certain derivatives and other financial products are created, launched and traded in reference to LIBOR, and where LIBOR is used as a reference rate for standard processes such as clearing, price discovery and product valuation.

In 2017, the United Kingdom regulator, the Financial Conduct Authority (FCA) announced that at the end of 2021, its intention is to no longer persuade or compel banks to submit LIBOR data or to sustain the benchmark through FCA legal powers. The FCA has determined that the "underlying market that LIBOR seeks to measure – the market for unsecured wholesale term lending to banks – is no longer sufficiently active.[2] It is the view of the FCA that it is both "potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them.[3]

What will the replacement rate be?

In 2014, the Federal Reserve Board (the Fed) and the Federal Reserve Bank of New York (the NY Fed) established the Alternative Reference Rates Committee (ARRC) to develop a plan for the phaseout of LIBOR and the transition to a new reference rate. The ARRC selected the Secured Overnight Financing Rate (SOFR) as the recommended alternative reference rate for the U.S.

SOFR is a broad measure of the cost of borrowing cash overnight, collateralized by Treasury securities, and has been published daily on the NY Fed's website since April 2018.[4] SOFR differs from LIBOR in the following ways:

	LIBOR	SOFR
Basis	Hypothetical unsecured transactions posted by selected banks	Completed secured repurchase agreement transactions
Calculation	Daily	Daily
Collateralization	Uncollateralized	Collateralized
Credit risk	Bank lending rate (includes credit risk)	Risk-free rate (no credit risk)
Prospective v. retrospective	Prospective	Retrospective
Publication	Daily by the Intercontinental Exchange Bench-mark Administration	Daily by the NY Fed
Term structure	Term structure	No term structure

These differences pose obstacles to the potential adoption of SOFR. For example, since LIBOR is an unsecured rate while SOFR is a risk-free rate, any transition could create unforeseen value transfers. SOFR also has been unexpectedly more volatile than LIBOR because the overnight repurchase agreement market, which serves as the basis for SOFR, has been susceptible to price swings tied to the issuance and supply expectations of the Treasury securities that are used as collateral for borrowing. Any surges in volatility due to such price swings, some of which have resulted in SOFR experiencing cumulative price movement in excess of 150% within a two-day period,[5] would be detrimental to the value of derivatives transactions based on SOFR. Moreover, unlike LIBOR, SOFR is backward-looking and does not include a term element, making it difficult to use SOFR for modeling.[6] The transition also raises accounting and tax issues, though efforts are being made to alleviate some of these concerns.[7]

The transition from LIBOR may be further complicated due to the fallback language currently utilized in existing LIBOR-related contracts. Most contracts that use LIBOR as a reference rate contain fallback provisions that only contemplate LIBOR being temporarily unavailable and do not account for permanent unavailability. For example, the International Swaps and Derivatives Association (ISDA) incorporated LIBOR into its 2006 definitions, which are incorporated by reference in most swap contracts.[8] ISDA has sought to amend the 2006 definitions, which will impact only transactions entered into subsequent to any such amendment, and to develop a new fallback protocol for existing contracts, both of which are anticipated by the end of 2019.[9] Market participants therefore must assess how to transition existing LIBOR-related contracts, which may require termination of the contracts or renegotiation of terms (potentially requiring the consent of all interested parties and/or resulting in value transfers), as well as determining the optimal terms with respect to future contracts. While market participants are still evaluating all the risks associated with LIBOR-related fallback language, it is anticipated that the adoption of standardized fallback language may be crucial to achieve a smooth transition away from LIBOR with minimal market disruption or litigation.[10]

Commission staff statement

On July 12, 2019, the U.S. Securities and Exchange Commission (the Commission) issued a joint statement from the Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets, and Office of the Chief Accountant with respect to the LIBOR transition.[11] In general, this statement should be seen as warning to the industry[12] that the Commission staff is actively monitoring industry preparations.[13]

In particular, the Commission staff encouraged market participants to identify any existing contracts that extend past 2021 to determine their exposure to LIBOR and mitigate risk of disruption. The Commission staff also encouraged market participants to consider whether to enter new contracts referencing alternative rates or, if continuing to reference LIBOR, whether such contracts contain adequate fallback provisions.

The Division of Investment Management specifically encouraged funds and advisers to consider whether discontinuation of LIBOR will impact the functioning, liquidity and value of investments in instruments referencing LIBOR. Funds should consider assessing any impact on the liquidity of their investments, including how those investments are classified and whether this could alter the effectiveness of their liquidity risk management programs, to ensure compliance with Rule 22e-4 under the Investment Company Act of 1940. Closed-end funds and business development companies that engage in direct lending should consider whether contracts need to be renegotiated. In addition, funds that have received exemptive orders that reference LIBOR (e.g., interfund lending orders) should consider evaluating implications for terms and conditions of relief. The staff encouraged both advisers and funds to consider whether additional risk disclosure regarding the impact of the transition from LIBOR is appropriate.

Practical steps

In light of the Commission staff's statement, asset managers should begin to evaluate their existing contracts and processes and catalog the following:

For each of the foregoing considerations, greater emphasis should be placed on investments that could potentially be held beyond the LIBOR phaseout in 2021.

A. Inclusion of LIBOR (e.g., reference rate in portfolio holdings or credit facility. benchmark or performance target; operations such as valuation, risk or pricing models).

B. Satisfaction with LIBOR fallback language in contracts.

C. Implications of updating such fallback language.

D. Any potential third-party exposure.

In addition to existing contracts, market participants should evaluate how they intend to approach new contracts. If continuing to use LIBOR, market participants should adopt appropriate fallback language to be used organizationally when entering new contracts, taking into account any industry-led protocols. Alternatively, when entering new contracts, market participants may identify alternative rates, include generic language with respect to alternative rates, or permit the flexibility to adjust rates at a later date. Firms will have to determine how much flexibility to allow in contracts to make changes in the future given the current uncertainties regarding alternative rates.

Fund complexes with funds that utilize investment strategies with significant exposure to LIBOR-related products should evaluate whether to add to their registration statements and shareholder reports risk disclosure on how the LIBOR transition may impact fund holdings. The SEC staff has indicated that it will be assessing the adequacy of LIBOR-related risk disclosure and that generic disclosure may not suffice.[14]

Investment advisers in particular must be cognizant of how the LIBOR transition may impact instruments they recommend to clients and how such instruments are to be monitored.[15] Investment advisers should consider:

A. Potential direct and/or indirect exposure to LIBOR when selecting and investment.

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B. Risks of investing in instruments with significant LIBOR exposure.

C. Appropriate disclosure relating to any investments with significant exposure to LIBOR (consistent with the themes listed above).

Conclusion

A permanent solution to the transition from LIBOR has not been determined, but it is clear that market participants in the asset management industry should begin preparation if they have not done so already. At a minimum, market participants can start to assess their LIBOR-related exposure and strategies to mitigate any disruptions to their businesses. Given that Chairman Clayton and the Commission staff have identified this as an area of concern for the industry, market participants should be prepared to demonstrate to the Commission staff steps they have taken to address the LIBOR transition.

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[1] LIBOR indicates average rates at which select major banks could obtain wholesale, unsecured funding for set periods in particular currencies. LIBOR is calculated daily, based on what certain panel banks report they would charge other banks for short-term loans at various maturities. LIBOR is not based on actual transactions because not every bank borrows substantial amounts at each maturity every day.

[2] The Future of LIBOR," Financial Conduct Authority (July 27, 2017), available at https://www.fca.org.uk/news/speeches/the-future-of-libor. According to year-end 2016 data from the Federal Reserve Bank of New York, $190 trillion worth of derivatives and $8 trillion worth of loans and mortgages referenced LIBOR, which was derived from just $500 million on average in daily trading volumes.

[3] Id.

[4] SOFR is based on the overnight repurchase agreement markets that generally are supported by approximately $1 trillion of transactions per day and is calculated by taking the average of certain Treasury repurchase agreement transactions that were entered into on the preceding day.

[5] On Sept. 17, 2019, SOFR increased by 282 basis points and then decreased by 270 basis points the following day; meanwhile, over the same two-day period, overnight USD LIBOR increased by approximately 4 basis points, then again by 3 basis points. See "Repo Rates Data Historical Search," Federal Reserve Bank of New York, available at https://www.stradley.com/-/media/files/publications/2019/09/repo-rates-data-historical-search-federal-reserve.pdf and "Historical Data," Intercontinental Exchange, available at https://www.stradley.com/-/media/files/publications/2019/09/ice-libor-historical-rates-sept-16-sept-17-and-sep.pdf.

[6] The development of a liquid SOFR-based derivatives market and a forward-looking term structure for SOFR will likely help alleviate these concerns. In 2018, the CME Group and the Intercontinental Exchange both launched SOFR-linked futures, and the LCH Group began clearing swaps. The establishment of these products has assisted with the creation of a "term curve" necessary to provide forward-looking one-month and three-month SOFR quotations, which permits market participants to speculate on SOFR price movements in order to hedge against interest rate risk and account for anticipated volatility due to market-disrupting events (e.g., changes to the federal funds rate). See Erik Heitfield and Yang-Ho Park, "FEDS Notes: Indicative Forward-Looking SOFR Term Rates," Board of Governors of the Federal Reserve System (April 19, 2019), available at https://www.federalreserve.gov/econres/notes/feds-notes/indicative-forward-looking-sofr-term-rates-20190419.htm.

[7] For example, the U.S. Department of the Treasury (the Treasury) proposed guidance stating that changes to existing financial instruments that switch from a LIBOR benchmark to an alternative rate would not qualify as a taxable event under current Internal Revenue Service rules. "Guidance on the Elimination of Interbank Offered Rates," Office of Information and Regulatory Affairs, available at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201904&RIN=1545-BO91. The Financial Accounting Standards Board proposed guidance that would provide temporary optional relief to permit an entity to not apply certain modification accounting requirements in GAAP to contracts affected by the transition. See "FASB Exposure Draft, Proposed Accounting Standards Update – Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting," Financial Accounting Standards Board (Sept. 5, 2019), available at https://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1175805074609.

[8] 2006 ISDA Definitions," International Swaps and Derivatives Association Inc., available at https://www.isda.org/book/2006-isda-definitions/.

[9] ISDA Publishes Two Consultations on Benchmark Fallbacks, Press Release," International Swaps and Derivatives Association Inc. (May 2019), available at https://www.isda.org/2019/05/16/isda-publishes-two-consultations-on-benchmark-fallbacks/. The ultimate protocol is unlikely be "one size fits all" given the large volume and wide range of terms. Moreover, any amendments to contracts may result in termination of swaps. Further, any swaps that are subject to certain grandfathering provisions (e.g., clearing or variation margin requirements) may lose such grandfathered status.

[10] SFA Libor Symposium: Key Takeaways," Structured Finance Association (Sept. 11, 2019), available at https://structuredfinance.org/wp-content/uploads/2019/09/SFA-LIBOR-Symposium-Key-Takeaways-1.pdf.

[11] Staff Statement on LIBOR Transition," U.S. Securities and Exchange Commission (July 2019), available at https://www.sec.gov/news/public-statement/libor-transition.

[12] On Sept. 4, 2019, the Financial Stability Oversight Council of the Treasury convened with the staff of the Treasury, Federal Reserve Board and Commodity Futures Trading Commission, and also stressed the importance of increased attention to the potential risks of the LIBOR transition by regulators and market participants. See "Readout of Financial Stability Oversight Council Meeting," Press Release, U.S. Department of the Treasury (Sept. 4, 2019); available at https://home.treasury.gov/news/press-releases/sm768.

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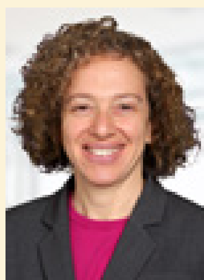
[13] SEC Chairman Jay Clayton reiterated this sentiment by emphasizing "market participants should assess their exposure to LIBOR and decide how to actively manage that risk, and they should ensure that any contracts that extend beyond 2021 either (i) reference LIBOR and have effective fallback language or (ii) do not reference LIBOR." Jay Clayton, "Remarks to the Economic Club of New York," U.S. Securities and Exchange Commission (Sept. 9, 2019), available at https://www.sec.gov/news/speech/speech-clayton-2019-09-09.

[14] LIBOR-related risk disclosure added by certain fund complexes must capture the following themes: Phaseout of LIBOR is imminent; there is not yet a globally accepted alternative; specific risks of any future transition currently are unknown; and any future transition could negatively impact the value of financial instruments, hedging transactions and the performance of funds, each of which have direct or indirect exposure to LIBOR.

[15] See "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," SEC Interpretive Release, U.S. Securities and Exchange Commission (June 2019) (discussing duty to monitor as being part of an investment adviser's duty of care); available at https://www.federalregister.gov/documents/2019/07/12/2019-12208/commission-interpretation-regarding-standard-of-conduct-for-investment-advisers.



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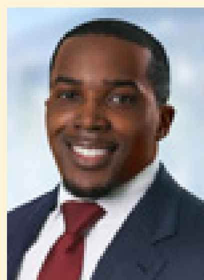

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