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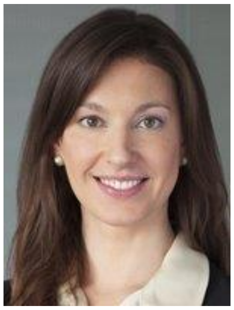
Welcome Libor Transition News For Market Participants

By **Katherine Buckley and Nichola Foley** (February 28, 2020, 5:43 PM EST)



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Recent updates from the Bank of England, the New York Federal Reserve, and the International Swaps and Derivatives Association and Bloomberg in connection with publication of interbank lending rate, or IBOR, fallback rate adjustments should be welcomed by market participants.

A screen rate for identification of risk-free rates, or RFRs, will greatly assist market participants who may no longer need to compound a daily rate for a given interest period themselves, and provides some certainty in how spread adjustments should be calculated.

As most people who are monitoring the phaseout of Libor have expected, since the start of 2020 we have seen a flurry of activity by working groups and market participants eager to lead the charge on the replacement of Libor (and other interbank lending rates) with alternative so-called risk-free rates.

The market seems to have generally accepted that these RFRs are the most appropriate interbank lending rate replacement and the discussion has now shifted to how best to deal with the differences between RFRs and IBORs.

There are some key challenges in the transition to RFRs. At the moment, there is no published screen rate showing the applicable rate of each RFR on a daily basis. Additionally, RFRs will typically be a lower rate than most IBORs, because the risk element that is factored into the calculation of Libor will be absent from an RFR. This means that a replacement of an IBOR with an RFR may require an adjustment to the margin or spread to ensure that the rate of return does not change.

The International Swaps and Derivatives Association and Bloomberg posted a joint publication on Jan. 20 on IBOR fallback rate adjustments. The publication tries to address the preexisting exposure to IBORs faced by firms in the derivatives market by amending the ISDA definitions for derivative contracts that reference IBORs. These amendments incorporate fallbacks to adjusted versions of the RFRs that will apply in the event of permanent discontinuation of a relevant IBOR. Bloomberg intends to publish the following calculations as of January 2020:

- Compounded setting in arrears for each RFR for each relevant term (adjusted RFR) — daily compounding of publicly available RFRs published by central banks (e.g., SOFR, SONIA);

- Spread adjustment being the median of the historical differences between the IBOR for the relevant tenor and the compounded RFR for that tenor over a five-year period prior to an announcement triggering a fallback; and

- The all-in fallback rate, which is the combination of the adjusted RFR and the spread adjustment for each relevant tenor.

The fallback rates are structured so that the contracts continue to align as closely as possible with the original agreement, resulting in a rate that is transparent and certain. The proposed fallback in the ISDA definitions will only be engaged upon the occurrence of a trigger event.

In their publication, ISDA confirmed that the spread adjustments for derivatives will be static, meaning they will not change after being determined and will be determined on the basis of feedback following consultations with market participants.

In addition, starting on March 2, the New York Federal Reserve begins publishing 30-, 90- and 180-day SOFR averages as well as a SOFR index. As yet, the SOFR averages that will be published by the Federal Reserve will not incorporate any adjustments to reflect a margin or spread and so market participants will need to apply their own methodology for calculation of the overall rate.

In a similar vein, the Bank of England announced on Feb. 26 that it will publish a daily SONIA compounded index. It has not yet committed to publishing SONIA averages, as the Federal Reserve as done and has sought to establish whether there is a market consensus as to the methodology of calculation.

It should also be noted that neither the Federal Reserve nor the Bank of England will publish rates for RFRs other than SOFR and SONIA respectively, whereas ISDA and Bloomberg will. As such, the rates published by ISDA and Bloomberg comprise more of a one-stop shop for market participants.

However, none of the rates published by ISDA and the Federal Reserve account for the backward nature of RFRs when compared with the forward-looking nature of IBORs and so the issues presented by these differences remain.

It is worth noting that the Alternative Reference Rate Committee and the Loan Market Association have confirmed that they are also publishing a consultancy seeking industry views on cash products, and these may not necessarily align with ISDA.

The announcement from ISDA and Bloomberg is a welcome development. The availability of a screen rate for identification of an RFR eliminates the requirement for market participants to attempt to compound a daily rate for a given interest period themselves. The announcement also provides comfort to market participants that there will be some certainty as to how spread adjustments should be calculated.

What are the consequences of these recent developments? By publishing its intended spread adjustments methodologies, ISDA is further ahead in the IBOR transition process than its counterparts in the bond and loan markets.

There should be a common goal across all markets to align the spread adjustment methodologies across all financial products, but while the ARRC and the LMA consultation confirms the desire to do so, it does leave the door open for its respondents to suggest alternative methodologies that may be better suited to cash products.

However, if the markets are to align, as they should do, there will be no need for calculation formulae or clauses in loan documentation on how to calculate adjusted RFRs — reference will just be made to, for example, the rate to be published by Bloomberg.

Any documentation already referencing RFRs will also be out of market, as it will be difficult to calculate how rates differ from the published Bloomberg rate. It may be the case that those who decided to wait until a screen rate became available have made the right decision.

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