Editor-At-Large
Reynolds Holding

THE CLS BLUE SKY BLOG
COLUMBIA LAW SCHOOL'S BLOG ON CORPORATIONS AND THE CAPITAL MARKETS

Editorial Board
John C. Coffee, Jr.
Edward F. Greene
Robert J. Jackson, Jr.
Kathryn Judge

Skadden Discusses LIBOR Replacement Plans

By Mark D. Young, Maureen A. Donley, Daniel B. O'Connell and Shekida A. Smith September 4, 2017

Plans to end the long reign of the London Interbank Offered Rate (LIBOR) as one of the world's most often-used interest rate benchmarks have recently been confirmed by several top financial regulators. On July 27, 2017, Andrew Bailey, chief executive of the U.K. Financial Conduct Authority (FCA), announced that LIBOR is to be transitioned to alternative rates during the next four years,[1] marking a sharp departure from the FCA's prior recommendation to reform the benchmark.[2] Less than a week later, J. Christopher Giancarlo, chairman of the U.S. Commodity Futures Trading Commission (CFTC), and Jerome Powell, a governor of the Federal Reserve, similarly voiced support for phasing out LIBOR.[3] These endorsements for gradually discontinuing LIBOR push plans for a phaseout in a more concrete direction, triggering significant regulatory and legal implementation questions for derivatives markets, market regulators and counterparties.

LIBOR. LIBOR is an interest rate index that measures the interest rates at which banks borrow from one another. It is calculated daily in five currencies, for maturities ranging from overnight to one year, based on the quoted rates that a panel of 11 to 17 banks now submit to the ICE Benchmark Administration.[4] The reported rate is used as a measure of the health of the banking system, a benchmark rate for swaps and futures, and a benchmark for pricing interest rates for many non-derivative financial instruments, such as home mortgages, car loans and student loans.[5] Despite this ubiquity, LIBOR has been perceived by some to have a number of shortcomings, which have driven the search for a comparable alternative. In announcing support for a transition away from LIBOR, regulators referenced historical issues surrounding manipulation of the benchmark and the fact that LIBOR is based on fewer and fewer actual transactions.[6]

Alternative Rates. In 2014, the Financial Stability Oversight Council (FSOC) recommended that U.S. regulators identify an alternative benchmark rate to LIBOR.[7] Later that year, the Federal Reserve created the Alternative Reference Rates Committee (ARRC) to identify alternative reference rates that are more closely tied to actual transactions and that comply with standards such as the International Organization of Securities Commissions Principles for Financial Benchmarks.[8] After examining six alternative rates, the ARRC settled on a broad Treasuries repo financing rate as its USD preferred LIBOR alternative.[9] The rate is tied to the cost of overnight borrowing collateralized by U.S. Treasury securities, and the New York Federal Reserve Bank has proposed to publish it in conjunction with the federal government's Office of Financial Research.[10] The ARRC selected this rate in part because of the depth of the market that the index would reflect — approximately $660 billion in daily transactions.[11] Although its plans for transitioning away from LIBOR are still being formulated, the ARRC currently envisions a phasing out of existing contracts referencing LIBOR in a manner that would allow market participants to use LIBOR under those contracts until they mature or expire.[12]

The ARRC's goal is to eventually replace all USD LIBOR fixings with its chosen alternative rate, with an expectation of corresponding volume increases in futures and swaps markets using the new rate.[13] The ARRC has taken initial steps toward introducing the broad Treasuries repo financing rate as an alternative benchmark and creating a sufficiently liquid overnight market. In particular, the ARRC has outlined an initial transition plan to move the market to the new rate, emphasizing the importance of building demand and liquidity for a new overnight rate.[14]

Events in the United States have been mirrored across the Atlantic. In April 2017, the U.K.'s Risk-Free Rate Working Group (RFRWG) selected SONIA — the Sterling Overnight Index Average — as its GBP preferred alternative to LIBOR.[15] Similar to the ARRC selected rate, SONIA is administered by the Bank of England and is a rate based on actual transactions in the U.K. overnight unsecured lending and borrowing market.[16] While the ARRC and RFRWG have not yet fully developed the mechanics of how their respective preferred alternative rates will replace LIBOR, they have taken steps to lay the foundations for an eventual transition.

Implications for Derivatives. The increasing regulatory attention to LIBOR's phaseout is sending a strong signal to derivatives markets and derivatives market participants to prepare for this major financial change. Some, however, are not ready to abandon LIBOR. ICE Benchmark Administration in particular has expressed a desire to preserve LIBOR and is said to view SONIA as an inadequate alternative, citing the range of currencies and maturities

that LIBOR covers. [17] ICE Benchmark Administration executives have suggested that they are working to make LIBOR more transaction-based and that bolstering confidence in LIBOR would be a less daunting undertaking than creating numerous new alternative rates.[18]

Meanwhile, futures exchanges already have begun to develop financial products based on these alternative rates. The Chicago Mercantile Exchange recently announced plans to develop derivatives based on the broad Treasuries repo financing rate.[19] Likewise, a Bank of England market group is preparing to create SONIA futures contracts, and the clearing branch of the London Stock Exchange, LCH, is preparing to extend SONIA swap clearing to include longer tenors presently covered by LIBOR.[20]

The LIBOR phaseout also will raise intriguing regulatory issues for derivatives markets. Possible questions include whether or when products based on the replacement rate will be subject to the derivatives clearing mandates adopted under Dodd-Frank, in the EU and elsewhere around the world, how the migration to new rates will affect legacy transactions and whether interest rate products based on LIBOR will vanish entirely. For the trillions of dollars of interest-rate swaps cleared through central clearinghouses and traded through swap execution facilities, there are likely to be numerous questions regarding whether the decreasing liquidity in LIBOR-based derivatives markets expected from new rates will cause regulators to eliminate clearing mandates for LIBOR-based swaps.

A LIBOR phaseout also will require regulators to reassess other requirements. For example, the CFTC rule governing how customer funds can be invested provides that with certain investments interest paid must “correlate closely and on an unleveraged basis” to one of several benchmarks, including the one-month or three-month LIBOR rate.[21] If new rates proceed as planned by the ARRC, the CFTC may need to consider adjusting this provision to reference the new rate and possibly remove references to LIBOR. The CFTC also may need to develop reporting levels for contracts using the new rate.[22] Similarly, exchanges and derivatives clearinghouses may need to consider revising their rules where they discuss or rely on LIBOR.

Over-the-counter derivatives market participants will be faced with significant documentation issues presented by LIBOR’s eventual discontinuation. LIBOR is a standard feature of derivatives documentation, including International Swaps and Derivatives Association (ISDA) terms. Although many derivatives based on LIBOR and papered under the standard forms of ISDA documents provide for a fallback rate, those fallback rates may be inconsistent with other transaction documents, unavailable or an inadequate substitute if LIBOR is discontinued. ISDA has established working groups focused on creating fallback rates to use if LIBOR is permanently discontinued. Recognizing the benefits of derivatives counterparties using a universal published fallback rate, ISDA also is in discussions on a protocol to assist counterparties in revising their contracts to incorporate the fallback rates now under development.[23] Regulators may also play a role, for example, with the possible consideration of imposing requirements on banks and other large counterparties to amend their ISDA documentation to reflect the new rates.

Counterparties also use LIBOR for other purposes in ISDA documentation, such as the rates for interest on collateral and late payments. Attention and discussion will be needed to develop a path to accommodate the many document revisions that would be necessitated should LIBOR end.[24] And, if a date is set on which LIBOR is to be entirely discontinued, the markets, regulators and derivatives counterparties may well experience pressure in the form of a compliance “big bang” of the kind that occurred with the Y2K transformation and, most recently, the implementation of variation margin requirements.[25]

ENDNOTES

1 *See* Andrew Bailey, “The Future of LIBOR,” Financial Conduct Authority (July 27, 2017) [hereinafter “The Future of LIBOR”]. LIBOR was introduced in 1984. *See* Jeff Patterson,”Post-LIBOR Framework Materializes, Looking to Spark a Transition,” Finance Magnates (Aug. 11, 2017). The FCA has regulated LIBOR since 2013. *See* “The Future of LIBOR.” *See also* Financial Conduct Authority, “Powers in Relation to LIBOR Contributions,” at 4 (June 2017).

2 *See, e.g*., Press Release, “FSA Finalises Proposals for the Regulation and Supervision of Benchmarks,” Financial Conduct Authority (Mar. 25, 2013); HM Treasury, “The Wheatley Review of LIBOR: Final Report,” at 7 (Sept. 2012).

3 *See* Jerome Powell & J. Christopher Giancarlo, “How to Fix Libor Pains,” *The Wall Street Journal* (Aug. 3, 2017) [hereinafter “How to Fix Libor Pains”].

4 *See id See also* “ICE LIBOR,” ICE (last visited Aug. 14, 2017) [hereinafter “ICE LIBOR”]. LIBOR is calculated for Swiss Franc (CHF), Euro (EUR), Pound Sterling (GBP), Japanese Yen (JPY) and U.S. Dollar (USD). *See id.*ICE Benchmark Administration is an independent subsidiary of Intercontinental Exchange. *See* “How to Fix Libor Pains.”

5 *See* “ICE LIBOR”; “How to Fix Libor Pains.”

6 *See, e.g*., “The Future of LIBOR”; “How to Fix Libor Pains.”

7 *See* “About Us,” Alternative Reference Rates Committee (last visited Aug. 14, 2017) [hereinafter “About Us”]. In its 2014 Annual Report, FSOC cited concerns about LIBOR including “the decline in unsecured interbank markets, the incentives to manipulate rates submitted to reference rate panels owing to the vast scale of derivatives tied to the reference rate, and the dominance of instruments tied to LIBOR in terms of market liquidity.” FSOC, “FSOC 2014 Annual Report,” at 117 (2014). *See also id*. at 117-20.

8 *See* “About Us.” The ARRC is chaired by Sandie O’Connor, chief regulatory affairs officer at JP Morgan Chase, and is comprised of 15 member banks, five banks and other financial institutions that serve as non-voting members, and several regulatory agencies that serve as *ex*

officio members. *See*"Governance," Alternative Reference Rates Committee (last visited Aug. 14, 2017). The ARRC is supported by an advisory group of financial institutions and regulatory entities. *See* "ARRC Advisory Group Membership," Alternative Reference Rates Committee, (last visited Aug. 14, 2017).

9 "The ARRC Selects a Broad Repo Rate as its Preferred Alternative Reference Rate," Alternative Reference Rates Committee (June 22, 2017) [hereinafter "June 22, 2017 Announcement"]. *See also* "Presentation Materials," Alternative Reference Rates Committee, at 4 (June 16, 2017) [hereinafter "June 16, 2017 Presentation"].

10 *See* "Statement Regarding the Publication of Overnight Treasury Repo Rates," Federal Reserve Bank of New York (May 24 2017).

11 *See* Alex Harris, "Sneak Preview in the Works for Timing of U.S. LIBOR Alternative," *Bloomberg* (July 31, 2017).

12 *See* "June 16, 2017 Presentation" at 18; Alternative Reference Rates Committee, "Interim Report and Consultation," at 21 (May 2016) [hereinafter "Interim Report"].

13 *See* "Frequently Asked Questions: The ARRC Interim Report," Alternative Reference Rates Committee (last visited Aug. 14, 2017).

14 *See* "Interim Report" at 21; June 16, 2017 Presentation at 16-18. The ARRC also has noted that it plans to consult end users in outlining its full implementation strategy for a new rate prior to releasing a final report, which is anticipated later this year. *See* "Interim Report" at 21; *see also* "June 22, 2017 Announcement."

15 *See* News Release, "SONIA Recommended as the Sterling Near Risk-Free Interest Rate Benchmark," Bank of England (Apr. 28, 2017).

16 *See id.*

17 *See* Tim Wallace, "Libor's U.S. Owners to Fight UK Plan to Scrap the Interest Benchmark," *The Telegraph* (July 29, 2017).

18 *See* Samuel Agini, "Ice Benchmark Chief: Libor Is Not Dead," *Financial News* (Aug. 11, 2017).

19 News Release, "CME Group to Develop Derivatives on Broad Treasuries Repo Financing Rate," CME (July 26, 2017).

20 *See* Huw Jones & Marc Jones, "Exclusive-Foundations for Post-LIBOR System Sliding into Place," *Reuters* (Aug. 10, 2017).

21 17 C.F.R. § 1.25(b)(2)(iv)(A)(1) (2017). *See also* 17 C.F.R. § 1.25(b)(2)(iv)(A)(2).

22 *See, e.g.*, 17 C.F.R. § 15.03.

23 *See* "Benchmark Transition Plans Will Be Critical," ISDA (June 29, 2017) [hereinafter "Benchmark Transition Plans"]; "Identifying Robust Fallbacks for the IBORs," ISDA (July 6, 2017). A protocol is a procedure that ISDA uses to allow counterparties to implement standardized changes to contracts. *See*"About ISDA Protocols," ISDA, (last visited Aug. 14, 2017) [hereinafter "About ISDA Protocols"]. *See also* "Benchmark Transition Plans." Although implementing ISDA protocols can be complex, they allow large numbers of counterparties to avoid expensive and time-consuming bilateral negotiations in favor of a standardized process. *See* "About ISDA Protocols."

24 *See* "Interim Report" at 22 ("[I]t is expected that counterparties will … seek to adjust the interest on collateral specified in their [Credit Support Annexes] to the new rate.")

25 *See* Philip Stafford, "Derivatives 'Big Bang' Catches Markets Off Guard," *Financial Times* (Feb. 2, 2017) . *See also, e.g.*, Skadden's previous client alerts on this issue here and here.

*This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the firm's alert, "*LIBOR Replacement Plans Bring Regulatory Considerations for Derivatives*," dated August 15, 2017, and available here.*

Leave a Reply

Your email address will not be published. Required fields are marked *

Comment

Name *

Email *

Post Comment

© Copyright 2017, The Trustees of Columbia University in the City of New York.