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REGULATORY INTELLIGENCE

Year-end Libor transition crush anticipated, industry officials don't yet see synthetic rates as solution

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There will be a year-end crush to transition existing loans and swaps off the London Interbank Overnight Rate (Libor) because some banks and clients are putting off the work, consultants said. Contracts that are not amended in time are unlikely to benefit from legislative solutions permitting synthetic Libor rates. These rates, as contemplated, will not replace Libor on screen on a like for like basis.

"Seriously what's going to happen with this is like elephants headed to the exit in Q4. What I'm concerned about, is, even most the people that we're speaking to — at least five or six out of every 10 clients we speak to will probably end up doing nothing. Even when we're telling them to do something even large PLCs are still doing nothing. The default position of everybody right now is to stick their head in the sand," said Abhishek Sachdev, chief executive at Vedanta Hedging, a derivatives and corporate finance advisory firm in London.

Vedanta is advising its clients to start transition now, because come the fourth quarter there will be a crush of companies seeking to change contracts.

"What will happen is only so many elephants can fit into the exit at one time. The problem is that the pricing is going to suffer. You're going to see people entering [revised] contracts without due diligence. You're going to see lawyers signing this stuff off without understanding it. You're going to see again, a greater asymmetry of information between the banks and the borrower," Sachdev said.

Firms should think about conduct risk related to Libor transition as they run into these key deadlines. Firms should stop selling sterling Libor loans by March 31, said the UK Financial Conduct Authority (FCA). Sterling Libor and other Ibors — euro, Swiss franc, Japanese yen and the one-week and two-month U.S. dollar settings — benchmark rates are scheduled to cease on December 31, 2021. Banks selling the remaining U.S. dollar settings have a little more time to transition.

"When you are going to stop selling Libor is integral to your conduct decision. I would have that date be explicit in a public statement specifying the date the firm will stop selling Libor. It's too close to the end of Libor or for customers to get anything other than the fallback, at some point time firms are just selling clients the fallback. Why don't they just do the new product business instead of the fallback?" said Adam Schneider, a financial services partner at Oliver Wyman in New York.

The Loan Market Association recently asked the Bank of England-backed Working Group on Sterling Risk-Free Reference Rates to show some flexibility on March 31 deadline to cease Libor lending but the request was rejected.

Synthetic Libor

With nine months to go before Libor cessation in most settings no synthetic Libor rates are in place. When the UK regulators do formulate synthetic Libor rates they will not permit unamended contracts to transition automatically to a synthetic Libor rate; UK legislation permitting synthetics will only apply to certain contracts.

The FCA will consult in Q2 on using new powers set out in the Financial Services Bill amending the Benchmarks Regulation permit continued publication on a synthetic basis for some sterling Libor settings and, for one additional year, some Japanese yen Libor settings. It will continue to consider the case for using these powers for some U.S. dollar Libor settings.

The Financial Services Bill, which could gain royal assent soon, does not indicate what synthetic Libor will look like, hence the consultation, and it does not define tough legacy contracts. That too will be determined by the FCA. Synthetic Libor will no longer be representative for the purposes of the Benchmarks Regulation and is not for use in new contracts, said the FCA.

There are a few synthetic Libor options being considered in the United States, where legislation would be required to apply them. Even so, these synthetic Libors are not a perfect solution even if the FCA allowed their use more widely.

"It is labelled synthetic Libor. It is not Libor. If I have an agreement on Libor I can't just cut and paste synthetic Libor, because it is not Libor. If Libor had been redefined to use different transactions and sources and inputs; add a bank, take a bank out, change tenors — then you'd have Libor. Libor's changed many times over the years, but synthetic Libor is another rate using the phrase Libor. Some lawyers do not think it has much water in our side of the pond [in the United States], because you can agree to use, but it would not be an automatic fallback," Schneider said.

There is a view, however, that synthetic Libor could be more widely used than the FCA currently envisions, precisely because of the rush- to-the-exit and tough legacy contracts problems. There may be other challenges related to operationalising new Sterling Overnight Index Average (Sonia) term rates or Sonia compounded in arrears, which in any case is not suitable for every client.

"Let's face it, synthetic Libor is a good tool for what's going to happen, which is tons of contracts, not only with banks, and with swaps, but leases and SPVs that link to Libor will not be able to be transitioned. Clients will not be able to find Sonia to calculate it or simply there will be no time and I actually doubt that it will ever happen. We're talking about billions of contracts," said Paco Carballo, head of derivatives accounting at Vedanta.

No perfect matches

Synthetic sterling Libor could end up looking much like the rate in ISDA's 2020 Ibor Fallbacks Protocol.

Edwin Schooling Latter, the FCA's director of markets and wholesale policy, told a webinar on September 18, 2020 hosted by the UK's Working Group on Sterling Risk-Free Reference Rates, the FCA and others that the regulator would use the same adjustment spread as ISDA, but with the adjusted risk-free rate being based on a forward-looking approach, wrote lawyers at Herbert Smith Freehills in a blogpost.

That approach will not be present value neutral and where one contract is converted to synthetic Libor via the legislative solution (for example, an unamended loan), but its associated hedge is converted via ISDAs 2020 Ibor Fallbacks Protocol, the hedge will no longer exactly match the cash product, wrote Herbert Smith Freehills.

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