ICAN

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Corporate Finance FacultyManagement Newsletter

LIBOR TRANSITION

London Interbank Offered Rate (**LIBOR)** is a reference rate at which some of the global banks lend one another given their outlook on local economic conditions. The LIBOR is an interest rate average obtained from submissions made by panel banks, representing an estimate of the rate at which the banks would be charged were they to borrow from other banks.

The LIBOR existed in five currency fixings: UK Pound Sterling, the Swiss Franc, the Euro, Japanese Yen and the U.S. Dollar across various maturities. The LIBOR was used to price different types of debts ranging from floating-rate mortgages, corporate loans, and asset-backed securities, amongst others. In pricing a typical loan anchored on Libor, a lending institution would take a Libor rate and add another percentage that represents the margin on the product pricing.

For decades, the LIBOR became a reference interest rate for tens of millions of contracts worth more than USD 240 trillion, hardwired into various financial activities ranging from risk, valuation, performance modelling to financial contracts (Oliver Wyman 2018). The acceptability of this reference rate stemmed from its ease of use given the wide range of currencies and tenor quotes that existed for the fixings.

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1.LIBOR TRANSITION

Following the 2007/2008 financial crisis, significant concerns about manipulation of LIBOR arose, and this ranged from panel banks reporting low rates to appear stronger than they were, to quoting false rates to record gains on LIBOR-based financial products. These irregularities prompted the Commodity Futures Trading Commission (CFTC) in June 2012 to levy a huge penalty against one of the banks on the LIBOR panel for manipulating the LIBOR and another reference rate based on the outcome of an investigation that had begun in 2008. Also, quite a number of large institutions that were implicated paid huge fines, while some senior bank executives, including the CEOs of two large banks, resigned.

Overtime, the credit risk-capturing ability, near ‘risk-free’ status and fairness of LIBOR became questionable. Several reforms were initiated by Policymakers in response to the scandal, one of which was the transfer of LIBOR publication from the British Bankers Association in the bid to improve transparency. Second, the British financial regulator commenced regulatory oversight of the production of the LIBOR. Third, there was modification in the calculation of the rate to assign increased weight on actual data and reduce the weight on “best guesses” in instances where there are no borrowings. Fourth, policymakers encouraged a transition away from the use of LIBOR.

Despite efforts identified above, data quality and integrity remained questionable as there was insufficient borrowing to determine LIBOR for all but the most popular currencies and tenors. Overtime, market confidence in the widely used London Interbank Offered Rates (LIBOR) was eroded. As a result, the Financial Conduct Authority (FCA) of the UK announced in 2017 that LIBOR panel bank submission will become discretionary from end of 2021, which meant availability of LIBOR as a benchmark rate becomes completely uncertain.
As a result, policymakers and market participants actively encouraged financial institutions to transition from LIBOR to alternative benchmarks. This will have a significant impact on the banking and financial services industry going forward.

LIBOR is being replaced for two major reasons: paucity of volume of interbank lending transactions, resulting in an unreliable benchmark; and the pervasive manipulation of LIBOR following the global financial crisis, which led regulators to question LIBOR’s future.

2. NEW ALTERNATIVE RISK-FREE RATES

Given the announcement to replace LIBOR, financial authorities across the world commenced crafting alternative benchmark rates to replace LIBOR. Below are reference rates after the deadline of Dec 2021:

Benchmark rate	Alternative Risk free rate	Jurisdiction	Administrator	Working Group
USD LIBOR	Secured Overnight Financing Rate (SOFR)	United States of America	Federal Reserve Bank of New York	Alternative Reference Rates Committee
GBP LIBOR	Sterling Overnight Index Average (SONIA)	United Kingdom	Bank of England	Working Group on Sterling Risk Free Reference Rates
EUONIA EUR LIBOR	Euro Short Term Rate (ESTR)	Euro area	European Central Bank	Working Group on Risk Free Reference Rates for the Euro Area
JPY LIBOR	Tokyo Overnight Average Rate (TONAR)	Japan	Bank of Japan	Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks
CHF LIBOR	Swiss Average Rate Overnight (SARON)	Switzerland	SIX Swiss Exchange	National Working Group on Swiss Franc Reference Rates

Source: King & Wood Mallesons (2021)

3.LIBOR CESSATION DATES

Cessation date	Cessation date
1 December 2021 USD LIBOR : One week, two months tenor GBP LIBOR: All tenors EUR LIBOR: All tenors CHF LIBOR: All tenors JPY LIBOR: All tenors	**30 June 2023** All remaining USD LIBOR settings including: • USD LIBOR – Overnight, one month, three, six and twelve months

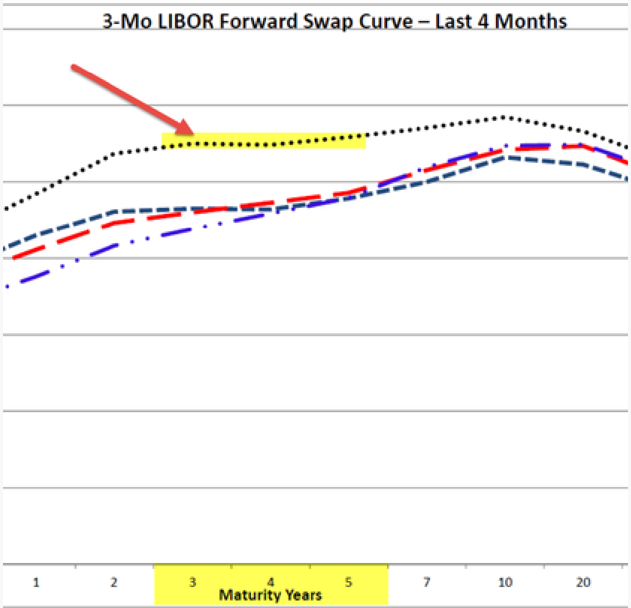
Source: Uwadia (2023)

The Financial Conduct Authority also announced that for all sterling and yen-denominated legacy LIBOR contracts that are yet to be changed at or ahead of end-31 December 2021, the FCA will permit the temporary use of 'synthetic' sterling and yen LIBOR rates.
The challenge with the use of the "synthetic" LIBOR is that quotes will not be based on the contribution of panel banks and will not be representative of the underlying market dynamics the LIBOR fixings are intended to measure.

4. LIBOR VERSUS NEW RISK-FREE RATES

IBOR	Alternative Risk free rate
USD LIBOR – Unsecured rate with multiple tenors; Based on quotes; Forward looking;	SOFR - Secure rate that covers multiple overnight repo market segments; Mostly backward looking; Fully transaction based;
GBP LIBOR - Unsecured rate with multiple tenors.; Based on quotes; Forward looking	SONIA - Unsecure rate that covers overnight wholesale deposit transactions; Backward looking
EUR LIBOR – Unsecured rate with multiple tenors; Based on quotes; Forward looking;	ESTR – Unsecure rate that captures overnight wholesale deposit transactions; a larger number of banks are contributing input data from the wholesale market that has a much higher transaction volume than the interbank market; Backward looking
JPY LIBOR – Unsecured rate with multiple tenors; Based on quotes; Forward looking;	TONAR – Unsecured and Overnight; Fully transaction based; Backward looking;
CHF LIBOR – Unsecured rate with multiple tenors; Based on quotes; Forward looking	SARON: Unsecured and overnight Not fully transaction based (trades and quotes); Backward looking;

Source: Asian Development Bank (2020)



5. CHALLENGES WITH LIBOR TRANSITION

The international financial system has been faced with challenges relating to transitioning away from LIBOR, and the following are some of the key issues encountered:

(a)Risk-free rates: Most of the alternative benchmark rates are risk-free, while the LIBOR incorporates a credit risk premium of borrowing from another institution.

(b)Term Structure: The LIBOR transition will require many markets to change from LIBOR to overnight RFRs, while some markets still require forward-looking rates for their product pricing. Different conventions are currently being adopted by financial institutions to address this, and the methodologies range from compounding the interest rates in arrears, compounding rates in advance, or adopting a term structure. As a result, a recommendation was made by the UK Working Group on Sterling Risk-Free Reference Rates on the use of Term SONIA benchmark by Refinitiv. The Term SONIA is a forward-looking sterling risk-free rate with available tenors ranging from 1-month, 3-month, 6-month to 12-month tenors, and was designed to be an alternative to LIBOR. This reference rate has a wider appeal among loan products however, the UK Working Group expects the use to be relatively limited. In a similar vein, the Alternative Reference Rates Committee (ARRC) proposed the use of the CME Group's forward-looking Secured Overnight Financing Rate (SOFR) term rates as a replacement for LIBOR, in the booking of syndicated and bilateral loans. The Term SOFR is a forward-looking interest rate estimate set on a daily basis and published for tenors ranging from 1 month, 3 months, 6 months to 12 months. There is currently no term structure for the other currencies.

(c) Tough Legacy Contracts: This refers to contracts referencing LIBOR, which are not able to either convert to a non-LIBOR rate or be amended to add fallback clauses on or before the relevant LIBOR cessation dates. This impacts loans, bonds, and derivative products. For such contracts, parties to the contract need to decide whether they are still able to provide financing based on the existing terms given the inherent risk that the underlying interest may not be able to be calculated in accordance with agreed terms. In the United States, where a legacy contract has no fallback or the fallback is based upon LIBOR, the law strikes out any existing language and replaces it with the ARRC's recommended fallback language which specifies that such contracts would fall back to the relevant Secured Overnight Financing Rate (SOFR) plus a fixed spread adjustment at the point of transition (Refinitiv, 2021).

(d)Adjustment Spread: Another challenge with the transition to a new risk-free rate is the selection of the appropriate credit adjustment spread. Understanding the differences between LIBORs and RFRs is essential and there will be need to consider these peculiarities when making relevant adjustments to client contracts or when assessing valuation impacts.

For legacy contracts, the ISDA has developed an adjustment spread to account for the difference between LIBOR and alternative risk-free with the objective of minimizing value transfer. The spread is calculated by using a historical median with a five-year lookback period from the date of cessation announcement or non-representativeness. This spread has now been fixed for all yen, Swiss franc, USD dollar, euro, and sterling LIBOR tenors, giving firms more information and guidance about the exact fallback rate that will be used in the event they do not complete their transition efforts before cessation or non-representativeness occurs.

(e) Change in IT infrastructure: This will largely depend on the choice of alternative rates and the type of compounding required. As most systems have been configured to accepting forward-looking rates, a choice of compounded overnight rates will require changes to the IT infrastructure.

CORPORATE FINANCE FACULTY MANAGEMENT

6. LIBOR TRANSITION UPDATE IN NIGERIA

The financial industry is yet to release any pronouncement or guidance with respect to the LIBOR transition. Currently, some banks operating in the country have adopted alternative risk-free rates similar to what has been recommended internationally, but with varying methodologies for compounding the risk-free rates and estimating the fixed adjustment spreads.

7. CONCLUSION AND RECOMMENDATIONS

As the sun finally sets on the LIBOR, banks have intensified efforts at ensuring a smooth transition, while also ensuring that fallback clauses are well integrated into legacy contracts.
LIBOR-linked loans have declined in volume given the increasing switch to alternative risk-free rates ahead of the LIBOR cessation, while lessons from the challenges of the December 2021 LIBOR discontinuation have helped shape decisions around cessation of the remaining LIBOR tenors.
As a result, we recommend as follows;

- Financial institutions to actively reduce remaining dependencies on LIBOR (i.e. fixings expiring in June 2023).
- Banks in Nigeria should collectively seek collaboration within the industry, and with the regulators, towards forging a common front to guide the LIBOR discontinuation across the financial industry.
- There is a need to continuously keep up-to-date with domestic and international developments as regards the alternative risk-free rates, given that conventions are still evolving till date.
- For institutions yet to update their loan contracts with counterparties, there is need to carefully review all fallback language to aid a seamless transition.

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