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LIBOR transition hedging closer

As LIBOR transition efforts race to the finish line for some settings on 31 December 2021, one question remains consistently implacable: how to transition hedged cash products and their related swaps at the same time and to the same destination?

Despite the publication of the ISDA 2020 IBOR Fallbacks Protocol (the ISDA Protocol) in October 2020 and incremental, but significant, progress in European loan markets towards re-papering LIBOR-based facilities, lenders and swap counterparties are still grappling to overcome the hurdles involved with transitioning legacy hedging arrangements. The questions that need to be answered in order to effect a successful transition are largely commercial. However the legal framework for these questions has been continually evolving as contractual market solutions and legislative solutions have emerged in parallel.

We set out below what will happen after 31 December and the key questions that lenders, borrowers and swap counterparties need to be asking themselves.

Key questions

Q Why are hedged loans such a problem?

Any loan or swap which references GBP, JPY, CHF or EUR LIBOR, or one week or two month USD LIBOR, will be affected by these LIBOR settings becoming, in the eyes of the regulators, “non-representative of their underlying market” or ceasing entirely from 31 December 2021 (see The coming end of LIBOR). If nothing is done to actively transition away from LIBOR ahead of this date, the impact will be determined by the combined effect of the existing contractual terms and any relevant legislative solutions (relevancy being, in the most part, determined by the governing law of the contract, whilst the jurisdiction of the parties may also have a bearing). The reasons hedged loans are so difficult to transition are many:

- the existing terms may be different between the loan and the swap in the way any cessation of LIBOR is dealt with (if at all);
- lender, borrower and swap counterparty need to come to the table and agree on a mutually acceptable replacement rate and transition date; in circumstances where the ideal replacement rate for the loan diverges from the direction of travel in the swaps market, a compromise needs to be found; and
- resources at all parties are stretched and not all parties have the capacity to analyse each loan and related swap in isolation.

Q Where is the broader swaps market going?

Interest rate swaps generally are documented under the 2006 ISDA Definitions (the 2006 Definitions) published by the International Swaps and Derivatives Association (ISDA). The 2006 Definitions contain details of the relevant interest rates, with fallbacks provided in the event of temporary unavailability of these rates. The existing fallbacks, however, did not contemplate a permanent cessation of the relevant rate. ISDA has therefore published an update to the 2006 Definitions (the ISDA Supplement) which provides for certain IBORs to transition to certain fallback rates based on Risk-free Rates (RFRs) in the event that the rate ceases to be published or is declared non-representative. The fallback rates for LIBOR provided in the ISDA Supplement are “all-in” rates comprising (i) a compounded-in-arrears RFR (for example SONIA in respect of GBP LIBOR), plus (ii) a credit adjustment spread (CAS) calculated and published by Bloomberg based on the historic five year median difference between the relevant LIBOR and the compounded-in-arrears RFR (the Bloomberg CAS). The Bloomberg CAS was fixed for all LIBOR currency-tenor settings on 5 March 2021.

Any interest rate swap entered into on or after 25 January 2021 which incorporates the 2006 Definitions will automatically incorporate the ISDA Supplement. For interest rate swaps entered into before 25 January 2021, the ISDA Protocol provides a mechanism by which parties can amend their swaps to incorporate the ISDA Supplement. Where both parties to a swap have adhered to the ISDA Protocol, the ISDA Supplement will be incorporated into the swap and the fallbacks set out in the ISDA Supplement will apply. Further, any new swaps incorporating the 2021 ISDA Interest Rates Definitions (published on 4 October 2021) will also include these fallbacks.

		31 December 2021								31 Dec 2022	30 June 2023	
Currency		GBP LIBOR		JPY LIBOR		CHF LIBOR	EUR LIBOR	USD LIBOR	USD LIBOR	JPY LIBOR	USD LIBOR	
Tenor		o/n, 1-week, 2-m and 12-m	1-m, 3-m and 6-m	Spot Next, 1-week, 2-m and 12-m	1-m, 3-m and 6-m	All settings	All settings	1-week and 2-m	o/n, 1-m, 3-m, 6-m and 12-m	1-m, 3-m and 6-m	o/n and 12-m	1-m, 3-m and 6-m
Event		Permanent Cessation	Non-representative; published on a synthetic basis	Permanent Cessation	Non-representative; published on a synthetic basis	Permanent Cessation	Permanent Cessation	Permanent Cessation	No change	Permanent Cessation	Permanent Cessation	Non-representative; may be published on a synthetic basis
Existing OTC swap transactions	ISDA supplement incorporated	Transaction will move to compounded-in-arrears SONIA + Bloomberg CAS from first Calculation Period starting after 1 January 2022		Transaction will move to compounded-in-arrears TONA + Bloomberg CAS from first Calculation Period starting after 1 January 2022		Transaction will move to compounded-in-arrears SARON + Bloomberg CAS from first Calculation Period starting after 1 January 2022	Transaction will move to compounded-in-arrears €STR + Bloomberg CAS from first Calculation Period starting after 1 January 2022	Transaction will move to an interpolated rate from first Calculation Period starting after 1 January 2022	No change	No change	Transaction will move to compounded-in-arrears SOFR + Bloomberg CAS from first Calculation Period starting after 1 July 2023	
Existing OTC swap transactions	ISDA supplement not incorporated; English governing law	**Seek urgent legal advice**	Consider effect of any other contractual fallbacks. If none effective, contract will remain on synthetic LIBOR provided no restriction applies	**Seek urgent legal advice**	Consider effect of any other contractual fallbacks. If none effective, contract will remain on synthetic LIBOR provided no restriction applies	**Seek urgent legal advice**	**Seek urgent legal advice**	**Seek urgent legal advice**	No change	**Seek urgent legal advice**	**Seek urgent legal advice**	Consider effect of any other contractual fallbacks. If none effective, contract may remain on synthetic LIBOR provided no restriction applies
New OTC swap transactions		New use impossible	New use prohibited for UK supervised entities	New use impossible	New use prohibited for UK supervised entities	New use impossible	New use impossible	New use impossible	New use prohibited for UK supervised entities except in certain circumstances	New use impossible	New use impossible	New use prohibited for UK supervised entities

Is basis risk really that bad?

Basis risk could arise between the loan and the swap in two main areas:

i. timing of transition: if the loan and swap have different triggers for fallback or "switch" provisions to be invoked, the same events could have different effects for each instrument – for example, if the loan has only a permanent cessation trigger and the swap also has a non-representativeness trigger, the swap may transition ahead of the loan (and, where available, synthetic LIBOR may become relevant to the loan – see below); and

ii. replacement rate: the replacement rate for the loan may be based on the same RFR as the swap but use different conventions (for compounding or applying a floor, for example) or a different CAS from the ISDA Supplement.

It is important to note that, from a legal perspective, parties are contractually free to agree whatever amendments they like (subject to the existing amendment provisions of the documents and within the confines of their regulatory framework, including requirements as to the fairness of their dealings). However, from a practical and commercial perspective, the hurdles are greater.

- The commercially preferred replacements for LIBOR for loans which are viable from a regulatory perspective differ across geographies and sectors – for example, the Alternative Reference Rates Committee (ARRC) in the US has recommended Term SOFR for certain USD business loans (see: Beyond LIBOR: transatlantic divergence in loan markets).
- Even where a compounded-in-arrears RFR is the chosen replacement for both the swap and the loan, the Working Group on Sterling Risk-Free Reference Rates' (the Sterling Working Group) recommended compounding conventions for GBP loans differ in a number of ways from the compounding applied by the ISDA Supplement – for example, the ISDA Supplement applies a two banking day lookback with observation shift whereas the Sterling Working Group recommendation is a five banking day lookback without observation shift.
- CAS for loans is up for negotiation and a variety of methodologies and approaches have been observed. Whilst the Bloomberg CAS is the most common (certainly for a switch which is to take place upon cessation or non-representativeness), it is not always used.

Parties will need to consider:

i. the economic effect and cashflow impact of mismatches between the loan and the hedge;

ii. the effect this may have on the tax and accounting treatment of each instrument – particularly if the borrower is relying on the swap receiving the benefit of hedge accounting; and

iii. from a legal perspective, any contractual covenants to maintain hedging for the loan.

Q What are the UK regulators doing?

The FCA and the UK Government have taken a number to steps towards ensuring an orderly wind-down of LIBOR.

i. The FCA will use its new powers under the UK Benchmarks Regulation to compel publication of one month, three month and six month GBP and JPY LIBOR on a synthetic basis after 31 December 2021.

ii. On 16 November 2021 the FCA confirmed that it will allow the temporary use of this synthetic GBP and JPY LIBOR in all legacy contracts apart from cleared derivatives.

iii. The UK Government has introduced to Parliament the Critical Benchmarks (References and Administrators' Liability) Bill to provide for LIBOR-referencing contracts to transition smoothly to this synthetic LIBOR (see our previous note in this regard).

The FCA has published Q&A in relation to the iterative legislative process which has led to these developments and their implications.

Under the UK Benchmarks Regulation, the FCA must review the publication of synthetic LIBOR annually. In relation to JPY LIBOR, the FCA has stated its intention to cease publication of all JPY LIBOR settings after 31 December 2022 (see the FCA's announcement on 5 March 2021, paragraph 5).

In relation to GBP LIBOR, the FCA has concluded that there is no need at the present time to apply a time limitation to the permission granted for legacy use. However, it did state that "*only uncleared legacy derivatives that are structurally or explicitly linked to other uses of [GBP LIBOR] need to be permitted to use [GBP LIBOR]*". This could pave the way for the FCA, or the UK Government, taking a narrower view in the future as to the pool of hedge transactions that are permitted to use synthetic GBP LIBOR.

Q USD LIBOR isn't going away for a while - do I still need to worry about it?

While the overnight, one month, three month, six month and 12 month USD LIBOR settings will remain published on the existing panel basis until 30 June 2023, the FCA has confirmed that new use of these settings after 31 December 2021 will be prohibited except in the following circumstances:

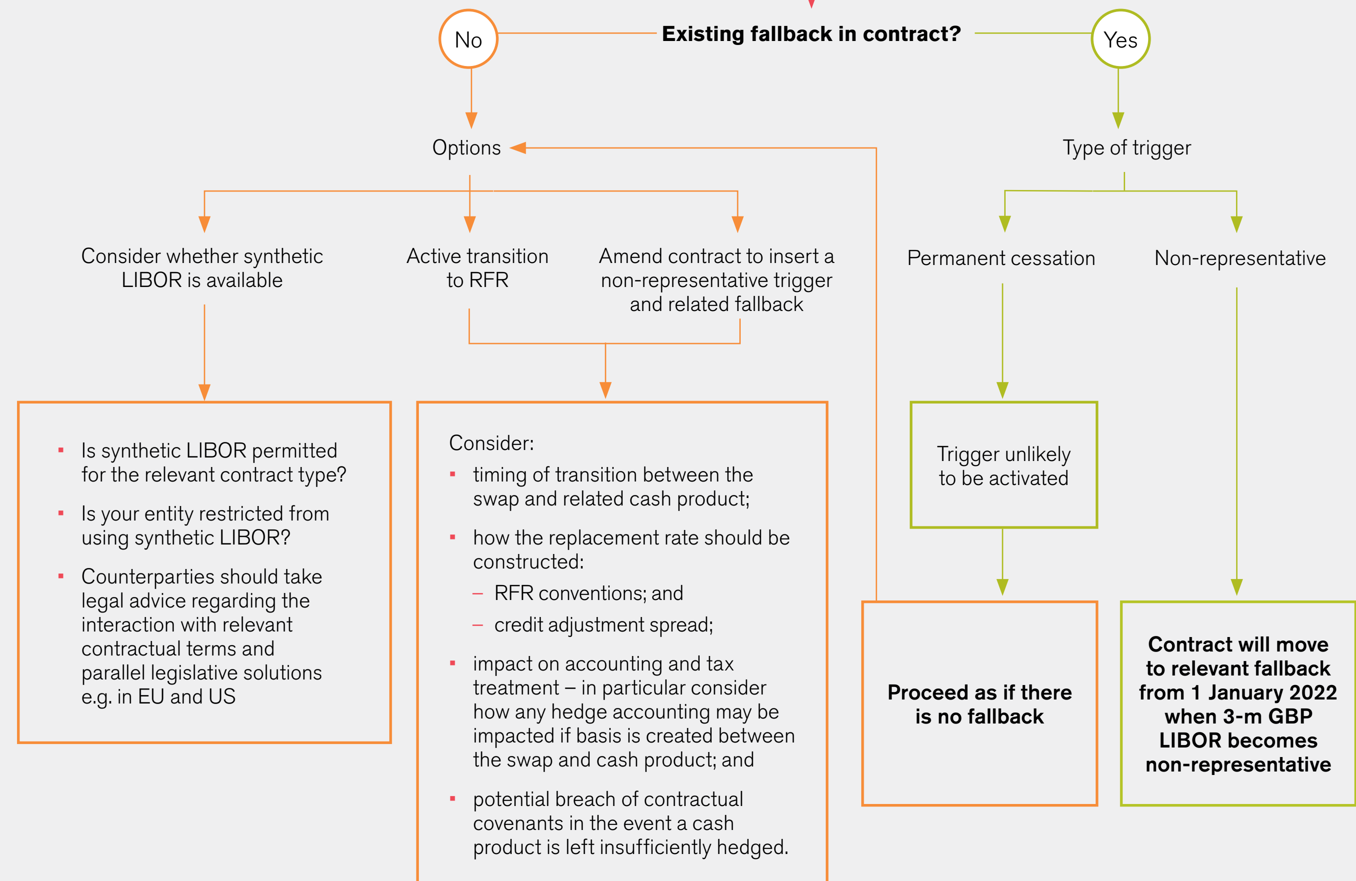
- market making in support of client activity related to USD LIBOR transactions executed before 1 January 2022;
- transactions that reduce or hedge a supervised entity's USD LIBOR exposure (or the exposure of any client of a supervised entity) entered into before 1 January 2022;
- novations of USD LIBOR transactions executed before 1 January 2022;
- transactions related to a clearing house action procedure in the case of a member default; and
- for the purpose of interpolation within contractual fallback arrangements for the one week and two month USD LIBOR settings that are ceasing.

This specific prohibition would only apply to UK supervised entities and activity within scope of the UK Benchmarks Regulation.

Q How does all this affect the contractual position?

It is important to note that the availability of synthetic LIBOR is not intended to override contractual terms which specifically contemplate LIBOR becoming non-representative or being determined using a changed methodology. In principle, such terms include fallbacks incorporated by the ISDA Supplement for derivatives and standard Loan Market Association (LMA) rate switch mechanics for loans. Therefore, if you have a loan and a related swap which reference, say, three month GBP LIBOR, and already include a fallback or switch provision which will be triggered when three month GBP LIBOR becomes non-representative, these provisions are likely to apply according to the terms of the contract such that synthetic LIBOR will not be relevant. However, the interaction between any legislative solution and existing contractual terms is complicated. The outcome will depend on the precise meaning of the contract, the relevant governing law, the jurisdictions where the parties are located and any parallel legislative solutions in other jurisdictions which may be relevant. It will be very important to read the terms of your existing contracts carefully and seek legal advice as necessary.

What will happen on 31 December 2021 to legacy contracts referencing 3-m GBP LIBOR?



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