Coming SOON

The Libor deadline will be here before you know it

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Corporate treasury departments still have time to prepare for the transition away from the London Interbank Offered Rate (Libor), but time is running out. That was the view from both a June meeting at the U.S. Chamber of Commerce and a July warning issued by the U.S. Securities and Exchange Commission (SEC).

David Bowman, special adviser of the Board of Governors of the Federal Reserve, stressed to attendees of the Chamber event that corporates need to begin working on their transition plan now. The crux of the problem, he explained, is that many of the existing contracts out there were poorly structured because people didn't think Libor could ever stop. “Because these contracts didn't take into account an end for Libor, if the rate went away, it could be devastating to the financial system,” he said.

The Alternative Reference Rates Committee (ARRC), which has been working diligently to help prepare businesses for this massive change, is nearly at the point where it is ready to work on the implementation of a new rate, said Tom Wipf, Vice Chairman, Institutional Securities, Morgan Stanley and Chair of the ARRC. With the prep work finished, he also urged companies to begin to consider moving on from Libor, describing the time period between the meeting and the end of 2021 as “the blink of an eye.”

SOFR

Participants in several different panels throughout the Chamber event agreed that the Secured Overnight Financing Rate (SOFR) is the only viable alternative to Libor. “The $200 trillion-plus on Libor will move somewhere,” Wipf said. “So we have to think about where the safest place it is for it to land. [The ARRC thinks] the safest is overnight SOFR.”

Unfortunately, the market as a whole is still apprehensive about SOFR. Ann Battle, assistant general counsel for the International Swaps and Derivatives Association (ISDA), who also participated on the AFP 2018 panel with Bowman, called on market participants to educate themselves on the rate, as there’s really only so much trade associations and regulators can do. “We've given the market the tools they need, now the market needs to learn how to use SOFR,” she said.

The goal of SOFR is to be a durable, IOSCO compliant rate, Wipf said. The ARRC sees SOFR is the key pillar that could support the vast majority of current market activity. “We don't want to do this again,” he said. “We want to do it once and do it right.”

However, the ARRC isn’t going to be the one to move U.S. companies onto the new rate. Bowman, who participated in a Libor panel discussion at AFP 2018, stressed that the transition from Libor to SOFR needs to be decided by businesses. “Ultimately, we can’t dictate what prices you pay for your contracts or what rates you use in your contracts,” he said. “So this transition ultimately has to be up to the private sector. So we're giving you one path that you can choose to go down if you're going to transition.”

An attendee asked Bowman and Wipf about how corporate treasurers are going to handle the spread between Libor and SOFR. He specifically wanted to know whether the Fed would be offering some sort of independent benchmark that would help to mediate this spread. "If we're all going to the banks individually, it is going to be a tough challenge," he said. "It would help a lot if there was an independent benchmark that we could look to and tell our boards, 'We were at Libor plus 125 and now we're at SOFR plus 140; here's the independent view that the spread is reasonable.'"

Bowman responded that it wouldn't really be the Fed's place to establish a benchmark. "I don't think the ARRC or the Fed can say, 'This is a fair price.' That needs to be settled in the market," he said. "But I agree that it's an issue for corporate treasurers who might say, 'I'm used to Libor and I think I know what a fair spread is, but don't know what a fair spread is now with SOFR. I don't want to have to go to my board after the fact and say that it should have been 30 and I got 25 or 40.'"

Tess Virmani, associate general counsel and senior vice president of public policy for the Loan Syndications and Trading Association (LSTA), noted that what many stakeholders desire is a forward-looking term rate. However, that may not actually be attainable without first moving to a rate like SOFR. "It's starting to dawn on people that if everyone in the cash markets waits on a forward-looking term rate, we have a problem there," she said. "If we wait, we may not get that rate."

Battle agreed. "The reality is, you don't get a forward-looking rate based on SOFR until you have a robust market based on SOFR," she said. "The derivatives market has to be based on SOFR for there to be a forward-looking term rate."

Making the transition

Jennifer Earyes, CTP, director of corporate development for Navient, and a member of AFP's Treasury Advisory Group who will also discuss Libor at AFP 2019, provided some insights on how legacy loan contracts will transfer from Libor to SOFR. Navient provides student loans, and consumers likely aren't following the Libor transition the way corporates are. Thus, consumers need to be educated by anyone who lends to them.

However, the uncertain future of benchmark rates creates new problems. Contract fallback language may state that if Libor becomes unavailable, then the lender will be able to select a comparable rate. "Off the bat, that sounds great, until you realize that we don't know when this is going to happen," Earyes said. "And so we need to coordinate and we need more folks at the table who are nonbank lenders who are participating in that kind of market to bring voices and perspectives that are not present right now."

Earyes advises companies who provide loans to educate their frontline employees on this transition. "Are your call centers prepared to explain this quickly and simply to a borrower in a way that they realize that they are not being harmed?" she asked. "Are they understanding that authorities are compelling us to consider a world where Libor does not exist?"

SEC warning

In a joint statement, the staffs of the Division of Corporation Finance, the Division of Investment Management, the Division of Trading and Markets, and the Office of the Chief Accountant of the SEC warned of the potential impacts if Libor either stops publication in 2022 or is degraded to the point where it is no longer seen as a benchmark rate. As a result, the SEC urges regulators and market participants to implement alternative reference rates ahead of deadline to stave off any market disruptions.

The SEC added that the risks posed to public companies will be exacerbated if the necessary prep work for an orderly transition isn't completed in a timely fashion. As such, the Commission said it is "actively monitoring" how market participants address these risks.

Existing contracts

Market participants need to identify existing contracts that extend past 2021 to determine their exposure to Libor. Many contracts have interest rate provisions referencing the rate that didn't take into account its potential discontinuation when they were drafted. As a result, there may be discrepancies over how contracts should be interpreted. Conversely, even if contractual interpretation is clear, the adjustment still may not be consistent with expectations of affected parties.

Since these types of issues can be difficult to fix, the SEC recommends market participants get to work now. For example, corporates should do their best to determine what effect a Libor discontinuation would have on the operation of existing contracts, what alternative rate might replace Libor in such contracts, and whether said alternative rate might introduce new risks altogether.

Lawton B. Way, partner with Hunton Andrews Kurth LLP, noted that many businesses are not addressing these contracts now because they feel they still have plenty of time. He encourages them to do so, because 2022 is coming fast. "I don't think many companies are actually doing this," he said. "The window has been out there for a while, but I don't think companies are acting very quickly to take these projects on."

New contracts

For new contracts, the SEC recommends participants reference an alternative reference rate to Libor, such as SOFR. If they still opt to use Libor, then it would be wise to include effective fallback language in the event that Libor does go away. Fortunately, this does seem to be happening overall. "New contracts are generally picking up the language of what to do if Libor goes away," Way said. "But contracts that are older than a couple years likely don't have that in."

Other business risks

The SEC noted that an impact assessment of Libor's end extends beyond mitigation efforts related to contracts; there may be other consequences on corporates' strategy, products, processes, and information systems. For example, treasury teams should ensure that their systems are set up to incorporate new instruments and rates with features that differ from Libor. Depending on the corporate's market exposure to Libor, it may be necessary to establish a task force to assess the potential impact.

Division-Specific Guidance

The SEC also offered specific guidance on how the Libor transition could impact groups regulated by the four divisions.

- Division of Corporation Finance: Investors need to be kept in the loop about the discontinuation of Libor, and that includes disclosing risk factors, management's discussion and analysis, board risk oversight, and financial statements.
- Office of the Chief Accountant: Moving to a new benchmark rate can severely impact financial reporting and accounting for debt instruments, hedging activities, inputs used in valuation models, and potential income tax consequences. Constituents are urged to participate in the standard-setting process with the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB).
- Division of Investment Management: If Libor is discontinued, it could affect floating rate debt, bank loans, Libor-linked derivatives, and certain asset-backed securities.
- Division of Trading and Markets: The end of Libor may also impact broker-dealers, central counterparties and exchanges. These entities should assess and respond accordingly.

Next Steps

The SEC welcomes comments from market participants on Libor discontinuation. Corporates may find it beneficial to share the issues and challenges they are facing with the agency.

Way noted that many corporates may be waiting to act because they want to see if the market comes to a consensus on what to do about Libor. "That's slowly emerging but I don't think it's emerged yet," he said. "There's been a lot of talk [from regulators] that 'the end is near,' but we're not seeing a lot of action yet. But we're encouraging people to start taking inventory of their contracts, to identify which ones you're going to need to amend or renegotiate."

AFP 2019 has multiple sessions on **Libor** in the **Treasury Management** track.