Economic Issues To Watch In The Libor Transition

By **Ioannis Gkatzimas, Ryan Leary and Musa Isani** (June 15, 2023)

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The official retirement of the London Interbank Offered Rate is just around the corner, with publication of the five remaining U.S. dollar Libor settings — which outlasted their non-USD counterparts and two other USD Libor settings by 18 months — set to end after June 30.[1]

The recent successful conversions of cleared USD Libor trades by the CME Group Inc. and clearinghouse LCH ensured that a large majority of outstanding USD Libor derivatives switched to Secured Overnight Financing Rate-based trades well ahead of June 30.[2]

The U.K. Financial Conduct Authority announced its intention to stop requiring panel banks to provide the data needed to calculate Libor in 2017.[3] Market participants had several years to prepare for the cessation event, aided by policymakers' guidance and several industry initiatives to facilitate an orderly transition from the USD benchmark.

Many market participants have already voluntarily adopted the Secured Overnight Financing Rate — the leading Libor replacement rate in the U.S. — and have integrated language to facilitate the switch from USD Libor to SOFR.

Most recently, LCH completed two conversion events on April 22 and May 20, successfully converting around 600,000 USD Libor-linked contracts — corresponding to $45 trillion of aggregate notional — into SOFR-based trades.[4] CME Group likewise converted 7.5 million of Eurodollar futures and options open interest and $4 trillion in cleared USD Libor swaps on April 21, with a second conversion for remaining swaps scheduled for early July.[5]

Despite these efforts and the legislation that exists to address legacy contracts without transition paths in place, numerous outstanding contracts — especially those for cash products and some uncleared derivatives — will continue to reference USD Libor beyond June 2023. Thirty days before the cessation date, the Depository Trust and Clearing Corporation estimated that upward of 150,000 legacy contracts could require action.[6]

This means that disputes could arise, including in circumstances where contracting parties have differing perspectives and preferences for which reference rate should replace USD Libor.

While the eventual type and scope of litigation related to USD Libor's retirement remains to be seen, legal scholars have identified several potential conflicts that would benefit from economic analysis.

This article discusses certain challenges in cases without a clear transition path, highlights the types of disputes that may materialize, and details how economic analysis will be crucial in helping litigators and their clients to navigate such challenges.

Contracts Not Subject to Mandatory Conversions and Lacking Alternative Transition Paths

So-called tough legacy contracts, which have no USD Libor replacement in place, are perhaps those most prone to being the subject of disputes.

Many of these contracts are likely for cash products, such as loans, bonds and securitizations, since the mandatory clearinghouse conversions covered most derivatives. In the lower-rated corporate loan market alone, it was estimated that — as of mid-May — anywhere from $700 to $900 billion in loans were still priced using USD Libor; this accounts for about half of this market, estimated at $1.4 billion.[7]

The Alternative Reference Rates Committee, the group of financial market participants and policymakers tasked with guiding the USD Libor transition, consulted on and issued recommended "fallback" language that automatically kicks in an alternative rate after June 30 for different cash products, but this language is voluntary. If parties do not agree to add such language, no clear transition path may exist after USD Libor's cessation.

While legislation, including the Adjustable Interest Rate (Libor) Act signed by President Joe Biden in March 2022, aims to address tough legacy contracts, inadequacies remain — chief among them being numerous USD Libor contracts governed by non-U.S. law.

To facilitate the transition, primarily for such non-U.S. law contracts, the U.K. Financial Conduct Authority announced that it would compel the ICE Benchmark Administration to publish an unrepresentative synthetic USD Libor through September 2024.

For USD Libor uncleared derivatives, the International Swaps and Derivatives Association IBOR 2020 Fallbacks Protocol — a voluntary agreement providing consenting counterparties with SOFR-based fallback rates — has the potential to address most of the uncleared derivatives market, conversion of which, unlike cleared derivative trades, was not automatic via the CME and LCH conversions.

ISDA conducted a series of open and transparent market consultations to determine the SOFR-based fallback rates in the protocol, which has been adopted by at least 15,967 entities since it was published in 2020.[8]

There was some earlier evidence that certain market participants may forgo ISDA protocol adoption altogether and could opt for litigation instead.[9] However, the consultations mentioned above could mitigate against some risks related to potential litigation.

What Types of Litigation Could We See?

While policymakers and industry leaders have repeatedly warned market participants of USD Libor's cessation and highlighted the implications of not switching to alternative rates, investors could potentially accuse companies with Libor-based liabilities or portfolios of Libor-indexed assets of misrepresentation.

Investors may also claim that companies failed to fully disclose the risks and potential impact of USD Libor's cessation — including, for instance, related value adjustments incurred as part of the transition process. This is separate from possible actions by the official sector or regulators triggered by a failure to follow transition guidelines.

For example, investors and other capital providers to financial institutions may argue that USD Libor's replacement rate in particular preexisting contracts or transactions — whether SOFR-based or otherwise — provides inadequate returns, while borrowers could claim they incur higher borrowing costs or other less-than-desirable features with the new rates. It is possible that lenders of mortgages, credit cards and other Libor-linked consumer products could face litigation from borrowers if the replacement rate is perceived as unfair or less favorable than USD Libor.

Some USD Libor contracts may be subject to contractual disputes, including in instances where there are differences in the methodologies used to calculate a fallback rate, on the choice of an appropriate replacement rate itself, or an inability to get unanimous consent on a fallback rate among interested stakeholders.

The continued publication of synthetic Libor could introduce further issues, as some contracting parties could argue that USD Libor does not actually end until synthetic Libor rates stop being published in 2024. Per the FCA, the unrepresentative, synthetic versions of USD Libor will only be allowed in legacy contracts, except those for cleared derivatives, after June 30.[10]

In some cases, investors may argue that prior contracts have been overridden and that using synthetic USD Libor is not what was originally agreed to. Especially if the transition path leads to a synthetic Libor rate that is not representative of USD Libor, an investor can claim that they are getting a rate that was not consistent with the rate they originally agreed upon.

In the cases outlined above, market participants may simply attempt to withdraw from contracts referencing USD Libor or seek counterparty approval to use an alternative reference rate they prefer.

Weighing Proposed Alternatives and Economic Analysis

The facts and circumstances of each potential dispute will necessitate careful examination, and the availability of several alternative replacement rates for USD Libor indicates to counsel that economic analysis will be beneficial for all stakeholders.

Though SOFR is the leading replacement rate and the one endorsed or recommended by the ARRC and several policymakers, there are a number of other possible USD Libor alternatives. These range from the Bloomberg Short-Term Bank Yield Index, or BSBY, and the American Interbank Offered Rate, or Ameribor — whose proponents argue better mirror Libor's credit-sensitive nature than SOFR, which is nearly risk-free — to the prime rate and others.

The features and composition of the various alternative rates vary, and counterparties understandably have different preferences and incentives for the use of each over SOFR-based rates. Specific lenders may prefer the domestic index nature of Ameribor since it may be more representative of the borrowing costs and revenues of small and medium-sized local and regional U.S. banks. Others may favor Ameribor or BSBY because those credit-sensitive rates tend to increase in crises in contrast to SOFR, which decreases.

Since there is no one-size-fits-all approach to which Libor replacement rates are best in potential contract disputes, further analysis of the economic incentives of each party is necessary for weighing the various options.

For example, if contracting parties initially selected USD Libor since they considered it to be the rate least likely to undergo significant changes relative to other interest rates, SOFR would arguably be an appropriate replacement. However, if parties were more interested in a hedge against a specific credit risk, a credit-sensitive rate such as Ameribor or BSBY may be more appropriate.

Custom USD Libor proxy rates may also be desirable in certain circumstances, the calculation of which must be informed by analysis. Such analysis can evaluate the original economic position of counterparties and what they negotiated, and can present reasonable alternatives to reflect the earlier contractual agreement.

Conclusion

With USD Libor's cessation fast approaching, market participants and their counsel should be prepared for potential disputes that may arise for contracting parties that, for whatever reason, are not covered by the mandatory conversions of cleared USD Libor trades and do not have a clear alternate transition path in place for after June 30.

Regardless of circumstances and motivations, such disputes will greatly benefit from the careful analysis of economic facts and circumstances, and parties should consider the pros and cons of the many different alternative replacement rates.

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Disclosure: Brattle previously consulted with ISDA in the IBOR series of consultations from 2018 to 2021.

[1] See https://www.theice.com/iba/libor.

[2] Remaining cleared Eurex and HKEx USD LIBOR trades were converted over the weekends of April 21 and May 20, 2023, respectively.
See https://home.barclays/content/dam/home-barclays/documents/misc/CCP%202023%20FAQs.pdf.

[3] See https://www.fca.org.uk/news/speeches/the-future-of-libor.

[4] See https://www.thetradenews.com/lch-swapclear-completes-libor-to-sofr-transition/.

[5] The secondary CME conversion for the remaining USD LIBOR swaps, as well as zero

coupon swaps, is scheduled for July 3, 2023. See https://www.cmegroup.com/media-room/press-releases/2023/4/24/cme_group_completeskeymilestonesinconversionofeurodollarfutureso.html.

[6] See https://www.reuters.com/business/finance/uk-regulator-makes-final-call-switch-off-libor-2023-05-31/.

[7] See https://www.ft.com/content/564a9c11-ffaf-484d-9176-20f5b962ee11.

[8] As of June 5, 2023. See https://www.brattle.com/understanding-ibor-benchmark-fallbacks/.

[9] In a 2021 Bloomberg/PRIMA survey, 51% of industry respondents reported that they did not plan to adopt the ISDA protocol or were unsure.
See https://www.bloomberg.com/professional/libor-transition-for-derivatives-bloomberg-prmia-survey-report/.

[10] See https://www.fca.org.uk/news/news-stories/fca-announces-decision-synthetic-us-dollar-libor#:~:text=On%201%20January%202022%2C%20we,prohibited%20under%20the%20Benchmarks%20Regulation.