



Plan for LIBOR Phase Out Announced by U.K.'s Top Financial Regulator

Market, Regulators Seek Transaction-based Alternatives

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Drama-Rich, Data-Poor LIBOR Benchmark Planned to Expire in 2021

In a speech at Bloomberg's London office, Andrew Bailey, the head of the U.K. Financial Conduct Authority (FCA), a regulator of financial services firms and financial markets in the U.K., stated that the FCA will plan for the phase out of LIBOR with a target end to the index in 2021.¹ He concluded his speech with ongoing support for LIBOR through 2021 to allow for an orderly transition to alternative reference rates that are firmly based on market transactions.² The benchmark, also known as the London interbank offered rate, is used for interest rate calculations for approximately \$350 trillion in securities worldwide.³ The global financial markets' reliance on LIBOR is widespread, and includes securities, products and instruments such as mortgages, derivative contracts, car, student and consumer loans, credit cards and a subset of municipal debt, to name just a few.

While the planned phase out of LIBOR was clearly stated in Bailey's speech, the financial governing bodies which ultimately drive such decisions, such as the FCA in the U.K. and the International Swaps and Derivatives Association (ISDA), have not issued formal directives or plans. LIBOR's current administrator, the Intercontinental Exchange (ICE), intends to continue publishing LIBOR rates, while acknowledging that Bailey's comments will promote a transition from the current LIBOR to an "evolving, ...long-term sustainable future" for LIBOR.⁴ Despite the uncertainty surrounding a specific timeline or how markets will handle the implementation of a replacement, many regulators are well underway considering replacements. In the U.S., the Alternative Reference Rates Committee (ARRC) recommended in June an alternative rate to LIBOR that would be based on the U.S. Treasury repurchase ("repo") market – called the "broad Treasuries repo financing rate." This rate would be based on the borrowing of short-term cash (overnight) with U.S. Treasury bonds serving as collateral, and would be published by the U.S. Federal Reserve.

The move away from the current reliance on LIBOR seems to be motivated by a desire for rates grounded in an index based on actual transactions executed in the market and not prone to manipulation by participants, as has been the case for LIBOR. Investigators and regulators found that leading up to and during the 2008 financial crisis a small number of banks and bankers involved in setting the daily LIBOR rate were colluding on the daily indications for LIBOR's reset to specifically benefit their positions and holdings. These findings resulted in several convictions and over \$9 billion in fines paid by the banks involved.

¹ Ring, Suzi. "Libor Funeral Set for 2021 as FCA Abandons Scandal-Tarred Rate." *Bloomberg Markets*, July 27, 2017. Accessed August 1, 2017. <https://www.bloomberg.com/news/articles/2017-07-27/libor-to-end-in-2021-as-fca-says-bank-benchmark-is-untenable-j5m5fepe>.

² Bailey, Andrew "The Future of Libor." Speech given to Bloomberg, London, July 27, 2017. Accessed August 2, 2017. <https://www.fca.org.uk/news/speeches/the-future-of-libor>.

³ Ring, Suzi. "Libor Funeral Set for 2021 as FCA Abandons Scandal-Tarred Rate." *Bloomberg Markets*, July 27, 2017. Accessed August 1, 2017. <https://www.bloomberg.com/news/articles/2017-07-27/libor-to-end-in-2021-as-fca-says-bank-benchmark-is-untenable-j5m5fepe>.

⁴ Arnold, Martin, Emily Dunkley, and Paul McClean. "Regulator calls on banks to replace Libor by 2022." *Financial Times*, July 27, 2017. Accessed August 3, 2017. <https://www.ft.com/content/04dd3316-72ab-11e7-aca6-c6bd07df1a3c>.



While LIBOR rates represent a taxable rate index, it is also widely used in the tax-exempt market. In the municipal market, LIBOR is most commonly used in interest-rate swaps and floating-rate, both publically issued and privately placed bonds, notes and loans. Often times, the LIBOR rate is modified to approximate a tax-exempt proxy (e.g., utilizing a percentage of the resetting LIBOR rate) and/or used as a base rate with a credit spread added to it, to represent the credit quality of borrowers and lender costs of capital.

U.S. Fed Still Configuring a Replacement

Both the pervasive nature of LIBOR and its use in swaps meant as interest rate hedges complicates a speedy replacement. The Federal Reserve-sponsored ARRC has been considering the issue since 2014. Their directive is to “identify a set of alternative reference interest rates that are more firmly based on transactions from a robust underlying market and that comply with emerging standards such as the International Organization of Securities Commissions (IOSCO) Principles for Financial Benchmarks and to identify an adoption plan with means to facilitate the acceptance and use of these alternative reference rates.”⁵

Based on a June 22, 2017 press release,⁶ the ARRC is further along on the first half of its mission than the second. They have selected a preferred replacement – named Broad Treasuries Repo Financing Rate.⁷ It would be based on the cost of overnight loans that use U.S. government debt as collateral. Since publishing that report, and in light of the FCA’s planned phase out of LIBOR, the ARRC plans to refine its proposed transition plan and publish a final report before the end of the year.

At the moment, the only known fact is that nothing is definitive. The ARRC is fielding comments from the public on the planned U.S. replacement rate for LIBOR. Analysts and market participants still have questions on whether and how a new benchmark could be effectively utilized and transitioned to in the broad universe of products and securities that currently rely on LIBOR. How current contracts and products will address future changes to LIBOR or competing benchmarks with the LIBOR index remains to be seen.

Municipal Issuers Should Plan for Alternatives

Should LIBOR cease to exist or cease to be used as a reliable rate index, all products that use the index (including derivatives and swaps, bonds, notes and loans) will need to address the transition to an alternative rate. Issuers should work with their financial advisors, legal counsel and related parties with which they have outstanding contracts (e.g., swap counterparties, loan providers, etc.) to prepare for an orderly transition and settle on terms for this transition that are the least onerous and costly. Issuers should pay special attention to changes to referenced indexes that trigger events, such as a reissuance, in which terminations and potential payments could be involved. While direct action is not necessitated at the current time — LIBOR has not yet been discontinued — issuers should begin to put a team in place to discuss risks, options and solutions.

5 Alternative Reference Rates Committee - Federal Reserve Bank of New York. Accessed August 03, 2017. <https://www.newyorkfed.org/arrc>.

6 Alternative Reference Rates Committee. “The ARRC Selects a Broad Repo Rate as its Preferred Alternative Reference Rate.” News release, June 22, 2017. Accessed August 3, 2017. <https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Jun-22-2017.pdf>.

7 Alternative Reference Rates Committee. “The ARRC Selects a Broad Repo Rate as its Preferred Alternative Reference Rate.” News release, June 22, 2017. Accessed August 3, 2017. <https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Jun-22-2017.pdf>.



Additionally, issuers in the process of finalizing transactions that use LIBOR in any fashion should structure the related terms and agreements to allow for an orderly and flexible transition to an alternate rate, minimizing disruption and potential negative impacts to the issuer itself. While the market's eventual transition away from LIBOR is uncertain, issuers should work with their financing team to build in the flexibility to address future changes and potential replacements related to this index.

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⁸ Based on par amount and number of transactions according to Thomson Reuters.

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