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LATEST DEVELOPMENTS ON LIBOR DISCONTINUATION

The end of an era is fast approaching and after 2021 the FCA will no longer require from LIBOR panel banks to publish quotes for the various LIBOR tenors. After the events of 2012 where major international lending banks were fined after allegations that they have manipulated LIBOR, steps have been taken to re-form the LIBOR market and develop new alternative rates that will be based on actual overnight transactions and not the “expert judgement” of the LIBOR panel banks due to the declining amount of unsecured, wholesale borrowings by banks since the financial crisis.

In 2014 US Federal Reserve Bank, in co-operation with other US regulators, banks and other market participants, created the Alternative Reference Rates Committee (“ARRC”) which was tasked to find a new alternative rate to US$ LIBOR, the Secured Overnight Financing Rate (“SOFR”). SOFR is considered the most suitable alternative as it is IOSCO compliant, transaction based, nearly risk free as it correlates closely with other market rates and covers multiple repo market segment allowing for future market evolution. Similar panels have been formed in other jurisdictions from other Central Banks and stakeholders around the world to develop alternative rates to the other IBORs with similar characteristics to SOFR.

LIBOR has been widely used as a benchmark rate for loan agreements, floating rate notes (“FRNs”), leasing arrangements and derivatives among others. It is estimated that US$ Libor is used as a benchmark rate for more than US$200 trillion worth of financial contracts in the cash and derivatives markets. Its discontinuation creates a series of issues with the most prevalent being how comparable SOFR is to US $ LIBOR. There are fundamental differences between SOFR and US$ LIBOR. SOFR is a backward-looking rate whereas LIBOR is forward looking, quoted for different tenors. LIBOR is not risk-free and contains an element of credit risk and a liquidity premium on longer term tenors. Given these fundamental differences US$ LIBOR may be higher from SOFR.

In order to address the above differences and eliminate any pricing gaps , ARRC has recommended to establish a static spread adjustment that would be fixed at a specified time at or before US$ LIBOR’s cessation and make the spread-adjusted rate comparable to LIBOR by minimising the expected change in the value arising from the move to a replacement benchmark based on SOFR[1]. A similar approach will be adopted by the International Swaps and Derivatives Association (“ISDA”) to address the implications on legacy derivative contracts which use Libor as the benchmark rate. The similarities in the approach between ARRC and ISDA will reduce the basis risk and potentially reduce operational, legal, tax and accounting issues between loans, securitisations and any related hedges.

ARRC is recommending that the methodology above will be applied to each US$ LIBOR tenor separately so that there is a separate spread adjustment for 1-month, 2-month, 3-month, 6-month and 1-year LIBOR. The calculated spread adjustment should be different for each US$ LIBOR tenor despite the same methodology applied.

Additionally, there is the intention to develop a forward-looking term rate based on SOFR derivatives markets after 2021. These forward-looking term SOFR would be available at the beginning of each interest period, similar to LIBOR. Unfortunately, the production of these forward-looking terms is not guaranteed.

1) https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Spread_Adjustment_Consultation.pdf, page 1.

Market participants and counterparties will be able to monitor the spread-adjusted rates through various platforms in the same way as they did with US$ LIBOR. More specifically, ISDA has partnered with Bloomberg which will publish the spread adjusted rates based on the methodology described above, through various distribution channels. Bloomberg will report an all-in reference rate which means that this will be SOFR plus the spread adjustment.

But when will it be the time the spread adjustment calculation to be triggered? The Committee and ISDA suggest that as soon as they find that LIBOR is no longer representative of its market by the U.K. Financial Conduct Authority (FCA), even if it continues to be published.

The transition from LIBOR to SOFR will require management to consider carefully the implications that will arise in the entity's financial statements under IFRS 9 – Financial Instruments. The International Accounting Standards Board ("IASB") published an exposure Draft ("ED") – Phase 2 to provide specific accounting relief and minimise the impact of the LIBOR reform and the transition to the new reference rates in financial statements.

With the existing standard any change in any financial instrument contract with the activation of the fallback language and the transition to the new reference rate, this may be considered a modification to the debt contract and/or related hedge and this may result in changes in the carrying value of the existing financial instrument on the balance sheet.

Through the ED, IASB tries to minimise the impact to the carrying value of loans and/or related hedges by offering practical expedients which will simplify the accounting treatment from the transition to the new reference rate. For a discussion of the Phase 2 ED, please refer to an analysis prepared by Wong Koon Min, Partner & Head, Technical, Compliance and Financial Services at Moore Stephens LLP, Singapore.

HOW CAN WE HELP?

Moore Global is considered one of the world's leading shipping consultancy networks due to our specialist sector knowledge and wide-ranging advice and assistance. The analysis above does not cover all the implications of US$ LIBOR discontinuation and its transition to a new reference rate. We are available to provide guidance on debt restructurings, modifications and hedge accounting and how this will affect your business.

For more information or to discuss how we could help you with transitioning from US$ Libor to a new reference rate, please contact us.

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