Financial institutions: Fundamentals of LIBOR phase out and transition

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Background

The London Interbank Offered Rate (LIBOR) was a common rate used by financial institutions since the 1980s. In both lending and borrowing capacities, LIBOR was commonplace as a standardized base (reference) rate in financial contracts such as lending agreements, interest rate swap contracts and bonds. LIBOR was calculated based on the submissions of hypothetical borrowing transactions from a number of banks; after the top and bottom rates were removed, the remaining average was taken. 35 variations of LIBOR rates were published daily (five currencies at seven maturities).

A major criticism of LIBOR following the financial crisis was that it lacked the market-driven inputs necessary to serve as a benchmark. In other words, it was based on hypothetical transactions and not fully supported by data from an active market of observable, arm's-length transactions. Additionally, the volume of data points used varied depending on the number of submissions. As a result, various global working groups were formed starting as early as 2014 to explore alternatives to LIBOR and its global counterparts. In the United States, the Alternative Reference Rates Committee (ARRC) concluded in 2017 that it would officially endorse the use of the Secured Overnight Financing Rate (SOFR), an overnight rate, as the preferred alternative reference rate. Additionally, in July 2021, the ARRC formally announced its recommendation for use of the CME Group's forward-looking SOFR term rates as the preferred alternative reference rate for term rates.

The following benchmark rates ceased publication at various dates between January 1, 2022 and June 30, 2023, as outlined below:

- January 1, 2022
    - All tenors of Euro (EUR) and Swiss franc (CHF) LIBOR
    - Overnight, one-week, two-month and twelve-month Japanese yen (JPY) and British pound sterling (GBP) LIBOR
    - One-week and two-month U.S. dollar (USD) LIBOR
- December 31, 2022
- *Synthetic* LIBOR for one-month, three-month and six-month JPY and GBP LIBOR tenors (to allow for an orderly transition on legacy contracts that referenced those tenors)
- June 30, 2023
    - Overnight, one-month, three-month, six-month and twelve-month tenors of USD LIBOR

Replacement reference rates

The overnight SOFR was officially launched in April 2018 and provides a broad measure of the cost of borrowing cash overnight against U.S. Treasury securities. The rates and volumes are published daily by the Federal Reserve Bank of New York. The overnight SOFR is populated using actual inputs from three data sets with significant trading volume and is *risk free* in nature, both of which are key principles for establishing benchmark rates.

While the ARRC is officially endorsing overnight SOFR as the LIBOR replacement rate, there are other replacement rate alternatives available in the market, such as the following:

- American Interbank Offered Rate (AMERIBOR), which was developed by the American Financial Exchange
- Bloomberg Short Term Bank Yield Index (BSBY), which was developed by Bloomberg Professional Services
- Euro short-term rate (ESTR), which was developed by the European Central bank

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- Sterling Overnight Index Average (SONIA), which was developed by the Bank of England
- Swiss Average Rate Overnight (SARON), which was developed by the Swiss Infrastructure and Exchange, or SIX
- Tokyo Overnight Average Rate (TONAR), which was developed by the Bank of Japan

The CME Term SOFR reference rates are administered by CME Group Benchmark Administration and represent a daily set of forward-looking interest rate estimates, calculated and published for one-month, three-month, six-month and twelve-month tenors. The CME Term SOFR reference rates provide forward-looking measurements of the overnight SOFR based on market expectations drawn from the derivatives market. Currently, Term SOFR is calculated using transaction data from a number of future contracts during several intervals throughout the trading day. A set of volume-weighted average prices is calculated using the transaction data, which is then used in a projection model to determine the CME Term SOFR reference rates.

Transition considerations

For financial institutions, the transition from LIBOR to a replacement rate was expected to be complex. First, there was a large volume of transactions that referenced LIBOR, including variable-rate loans and derivative contracts. In addition, some leasing contracts for which the financial institution is the lessee or the lessor had variable lease payments that reference LIBOR.

Most contracts contain *fallback language*, which refers to legal provisions that dictate how the rate will be determined when the stated reference rate is no longer available. Financial institutions should have inventoried all contracts that referenced LIBOR and reviewed their contracts to determine what changes were necessary to both existing and new contracts through the transition period, including the consideration of any fallback language that may be present in those contracts. Upon cessation of the publication of a given reference rate, it should no longer be included in new or legacy contracts.

Recommendations from the ARRC regarding fallback language included in contracts for a variety of products can be found here. Additional helpful information from the ISDA about the transition away from LIBOR and associated fallback language can be found here.

Additionally, changes in reference rates will impact several operational areas of financial institutions, including lending, treasury and accounting departments. Changes will likely require adjustments to policies and procedures surrounding credit underwriting, credit monitoring, asset and liability management, treasury management, interest rate risk and sensitivity and accounting. Management, as well as those involved in daily operations, need to understand the differences between LIBOR and the available replacement reference rates and how to negotiate, write, account for and monitor contracts with the new reference rate.

Accounting for transition

Specific to accounting for the LIBOR transition, in March 2020 the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting* (which added Topic 848, “Reference Rate Reform” to the FASB’s Accounting Standards Codification [ASC]). The guidance in ASC 848 provides temporary optional expedients to existing guidance on how to account for certain contract modifications involving the replacement of LIBOR or other reference rates affected by reference rate reform. The temporary optional expedients outlined in ASC 848 apply to contracts that are modified to directly replace, or have the potential to directly replace, LIBOR or other reference rates that are expected to be discontinued and replaced because of reference rate reform. Examples have been provided in ASC 848 to assist in the determination of whether contract modifications are within its scope. As an example of the temporary optional expedients in ASC 848, if debt is changed in conjunction with the discontinuation

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of LIBOR to refer to a different reference rate and no other changes are made to its contractual terms, election of the applicable expedient would result in accounting for the changes on a prospective basis by adjusting the debt's effective interest rate. In other words, it would not be necessary to perform an analysis to determine if the changes should be accounted for as a modification or extinguishment. Similarly, election of the applicable temporary optional expedients in ASC 848 for modifications to leases and certain other contracts (such as a portfolio of loans held for investment or receivables) due to reference rate reform would result in accounting for the modifications as a continuation of the contracts with no requirement to reassess previous determinations. For loans and receivables in particular, if the entity elects the applicable temporary optional expedient, it would account for all modifications to contracts within the scope of ASC 310, "Receivables," that qualify for the expedient as if the modifications were only minor in accordance with ASC 310-20-35-10. ASC 848 also provides a temporary optional expedient that, if applicable and elected, would result in the continued application of hedge accounting for hedging relationships that are impacted by reference rate reform yet remain highly effective.

The guidance in ASC 848 was effective upon the issuance of ASU 2020-04 on March 12, 2020. The ASU was originally effective until December 31, 2022, but in December 2022 the FASB issued ASU 2022-06, *Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848*, which extended the temporary optional guidance until December 31, 2024. As such, ASC 848 applies to: (a) contract modifications made between its effective date and December 31, 2024, and (b) hedging relationships in existence on or after the effective date of ASC 848 and hedging relationships entered into through December 31, 2024.

Refer to our white paper, *Optional accounting expedients can make LIBOR transition easier*, for a detailed discussion about reference rate reform and the temporary optional expedients and exceptions provided by the FASB, as well as the circumstances under which an entity may elect those expedients and exceptions. Various types of contracts and products, including debt, held-to-maturity debt securities, receivables, leases and hedging relationships, are addressed. Our white paper also discusses the effective date and transition guidance in ASC 848, along with the sunset date for the temporary optional expedients (i.e., the date after which the optional expedients may no longer be applied).

Conclusion

At this point, financial institutions should fully understand all their exposures; have completed the evaluation of operational, reputational and consumer impacts; and have implemented change management activities related to the use of an alternative index for pricing loans, deposits and other products and services. Financial institutions should continue to monitor future developments related to other alternative reference rates, accounting guidance, fallback language and transitional guidance from regulators, associations, counterparty financial institutions, accounting standard setters (e.g., FASB) and other market participants.

Additional Resources

For additional resources with respect to the LIBOR transition, refer to the following:

- Federal Reserve Bank of New York's ARRC webpage
- FDIC Supervisory Insights, *Transitions in Financial Instruments Reference Rates*
- SEC staff, *Staff Statement on LIBOR Transition*
- Board of Governors of the Federal Reserve System LIBOR Transition webpage

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