
S&P Credit FAQ: How S&P Global Ratings Thinks About LIBOR Risks In U.S. Public Finance

On March 5, 2021, the U.K. Financial Conduct Authority (FCA) announced the cessation of one-week and two-month U.S. dollar London Interbank Offered Rate (LIBOR) publication by ICE Benchmark Association (IBA) effective Jan. 1, 2022, followed by the cessation of overnight and 12-month LIBOR publication effective July 1, 2023. Although these announcements were expected, the 2023 date provides a longer time for issuers to prepare to transition their legacy contracts than was once anticipated.

Below, we answer some frequently asked questions regarding this announcement and the impact to U.S. public finance market participants

Frequently Asked Questions

How could this change affect a credit rating?

S&P Global Ratings' analysts continue to assess the financial exposure U.S. public finance (USPF) issuers could face due to financing and hedging transactions tied to LIBOR as well as management's preparedness to mitigate risks through proactive transitionary measures.

S&P Global Ratings' issuers need to remain mindful of the approaching deadline when considering and managing LIBOR-based debt instruments and derivatives by assessing potential exposure to LIBOR across all obligations. Additionally, we believe sound credit quality hinges on management demonstrating a strategy for transitioning to an alternative benchmark, including assessing the financial exposures of replacing it and limiting exposure to basis risk throughout the transition.

Although many market participants have yet to work with their counterparties to identify a successor benchmark or quantify the financial magnitude of transitioning to an alternative, we believe there is enough guidance from authorities to initiate the transition.

Nevertheless, S&P Global Ratings believes that the low notional amount of LIBOR exposure relative to overall debt portfolios should limit the extent of financial pressures and credit implications for USPF issuers. Given the recent announcement and permitted extension of LIBOR publication, S&P Global Ratings believes the transition of LIBOR has become less of an immediate threat as USPF issuers now have longer to prepare.

Does this announcement mean LIBOR is definitely going away?

We think it is likely the IBA and FCA will stop publishing LIBOR and that issuers should be ready to transition as the recent announcement may affect trigger clauses in certain documents.

While the IBA has the ability to continue to post one-month, three-month, and six-month LIBOR for a period beyond June 30, 2023, the announcement by the FCA on March 5, while not unexpected, does potentially trigger LIBOR events found in many documents tied to issuer debt and derivative obligations and, consequently, issuers should be aware of the associated fallback language and how a replacement benchmark will be implemented with the cessation of LIBOR.

Despite the extension of LIBOR cessation through June 30, 2023, and potentially beyond for some tenors, U.S. authorities are still encouraging banks and borrowers to transition away from LIBOR by the end of 2021. As a result, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency are no longer allowing new contracts to use LIBOR beyond December 2021 and, that being the case, we expect to experience an increase in alternative benchmark securities throughout the sector.

What ramifications will these trigger events have on issuers?

The trigger event indicates that a benchmark transition is underway, and issuers should identify the scope of impact and potential costs associated with transitioning to a new benchmark.

We believe that LIBOR trigger events that will affect the majority of USPF issuers will be predominately found in derivative agreements and are considered an index cessation event. The International Swaps and Derivatives Association (ISDA) published IBOR Fallbacks Protocol and Supplement, effective Jan. 25, 2021, where parties can adopt the protocol to amend outstanding agreements where upon the cessation of LIBOR, the replacement benchmark will be the Secured Overnight Financing Rate (SOFR) plus a credit adjustment spread.

In the U.S., the Alternative Reference Rate Committee (ARRC) was established to guide the transition away from LIBOR to SOFR. The ARRC has provided fallback language recommendations for floating rate notes as well as loan documents which provides issuers guidance to adopt new LIBOR based securities as well as amend existing obligations. On March 24, 2021, New York State's Senate and Assembly approved legislation that assists in the transition of legacy LIBOR contracts governed by New York State law that does not have fallback language. If signed into law, the legislation will provide fallback language similar to the ARRC and the replacement rate will be SOFR-based. Since most contracts reference New York State law, we believe this legislation could mitigate potential transition risks relating to fallback language.

The change in benchmark carries the potential for an increased cost of capital as well as reissuance costs that could negatively affect an issuer's budgetary performance, flexibility, and liquidity; consequently, management should be aware of the implication and act accordingly.

What will the new benchmark be and how has the U.S. market responded?

SOFR, a transaction-based interest rate which is based on overnight loans collateralized by U.S. Treasuries, will be the new benchmark rate supported by the ARRC and the U.S. market has been slow to shift to SOFR.

SOFR is traded with an average daily volume of more than $1 trillion in overnight treasury repo transactions, whereas LIBOR pales by comparison with a transaction volume of about $500 million. While the Federal Reserve Bank of New York began publishing SOFR overnight rates in April 2018, markets have been slow to adopt SOFR as a replacement rate despite seeing SOFR-linked debt issuances, derivatives, futures, and options all being exercised. Compared to the U.K's equivalent replacement Secured Overnight Index Average (SONIA) that has traded derivative notional totaling $3.4 trillion YTD compared to SOFR's $475.1 billion, we believe this indicates the U.S. market's burgeoning acceptance of this transition from LIBOR to SOFR. For more on the comparison between

LIBOR and SOFR benchmark rates, see “SOFR Emerging as Alternative to LIBOR in U.S. Debt Markets,” published Dec. 4, 2020, on Ratings Direct.

USPF exposure tends to be limited because of moderate use of variable-rate debt in the past decade thanks to an exceptionally low-interest-rate environment, which in turn limited the use of related swaps and hedges with LIBOR benchmarks

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