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Fitch: New US Dollar Libor Deadline Doesn't Guarantee a Smooth Transition

Fitch Ratings-New York/London-01 December 2020: Pushing the Libor transition deadline for the U.S. dollar (USD) market back 18 months would lessen the risk of disorderly outcomes at YE21 but using this extra time productively is the key to a smooth transition, Fitch Ratings says. Primary markets have yet to shift to alternative indices, regulators and legislators might need to facilitate orderly transition for hard-to-fix legacy contracts and liquidity needs to develop in derivatives based on the Secured Overnight Financing Rate (SOFR).

ICE Benchmark Administration Limited (IBA) on Monday announced a consultation that could see the cessation of the widely used one-, three-, six- and 12-month USD Libor reference delayed to end-June 2023. IBA will also consult on ceasing publication of one-week and two-month USD Libor at end-2021, in line with the original timetable.

Additional preparation time should avoid the potential operational and market disruption if all USD Libor settings ceased publication after 31 Dec 2021. As we have previously noted, delays in creating a robust SOFR-based derivatives market and the failure to develop a SOFR term rate sufficiently far in advance of cessation could materially increase risks to financial institutions arising from transition, while legacy Libor exposure is significant, particularly in structured finance.

The IBA consultation appears part of a coordinated effort by regulators to avoid such disruption. The UK Financial Conduct Authority (FCA), which regulates IBA as Libor's administrator, and the Federal Reserve Board (the Fed) both welcomed the prospect of 'a clear end-date' for USD Libor that left enough time to deal with legacy contracts where amending fallback language remains difficult, partly by reducing the number of affected contracts as most of these would mature before cessation. The backing of U.S. and UK regulators illustrates the magnitude of the transition challenges facing USD market participants.

Addressing legacy contracts also depends on moving primary market activity from USD Libor to SOFR or other alternative indices. SOFR adoption has been uneven and lagged other markets (sterling issuance largely references the Sterling Overnight Index Average), although most recent USD primary market issuance has included Alternative Reference Rates Committee (ARRC) fallback language, which will make the process of switching to SOFR in the future less challenging.

Delaying USD Libor cessation would allow more time for liquidity to develop in the SOFR-based derivatives market that remains a fraction of size of the interest rate derivatives market referencing Libor. This could support ARRC's efforts to build a term reference rate by the middle of 2021, facilitating more primary market issuance referencing SOFR. ISDA has published a protocol to include fallbacks in legacy derivative contracts referencing Libor. A delay would give market participants additional time to make the necessary amendments (adoption is voluntary). It would also leave more time to enact possible state or federal legislation to reduce litigation and operational risks from legacy contracts.

However, an extension would not automatically mean a smooth transition in mid-2023. We believe the slower shift to using SOFR as the benchmark rate for newly originated dollar cash products has reflected a 'wait-and-see' approach from some market participants, as well as SOFR's lack of credit spread and term structure. Proactively embracing workable solutions would reduce, rather than simply delay, disruption.

The 'wait-and-see' approach also reflects a less forceful approach by U.S. banking regulators relative to their UK counterparts, particularly in the transition's early stages, although U.S. regulators have increased efforts to make sure risks are addressed. The Fed, Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation said in response to IBA's announcement that they 'encourage' banks to stop using Libor in new contracts as soon as possible and no later than end-2021.