

Wednesday, January 6, 2021
12:00 – 1:30 p.m. Central Time

SWAPs, Derivatives and the Death of LIBOR: What Have We Gotten Ourselves Into?

Session Leader:

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Team Members:

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Introduction: SWAPs and the Death of LIBOR

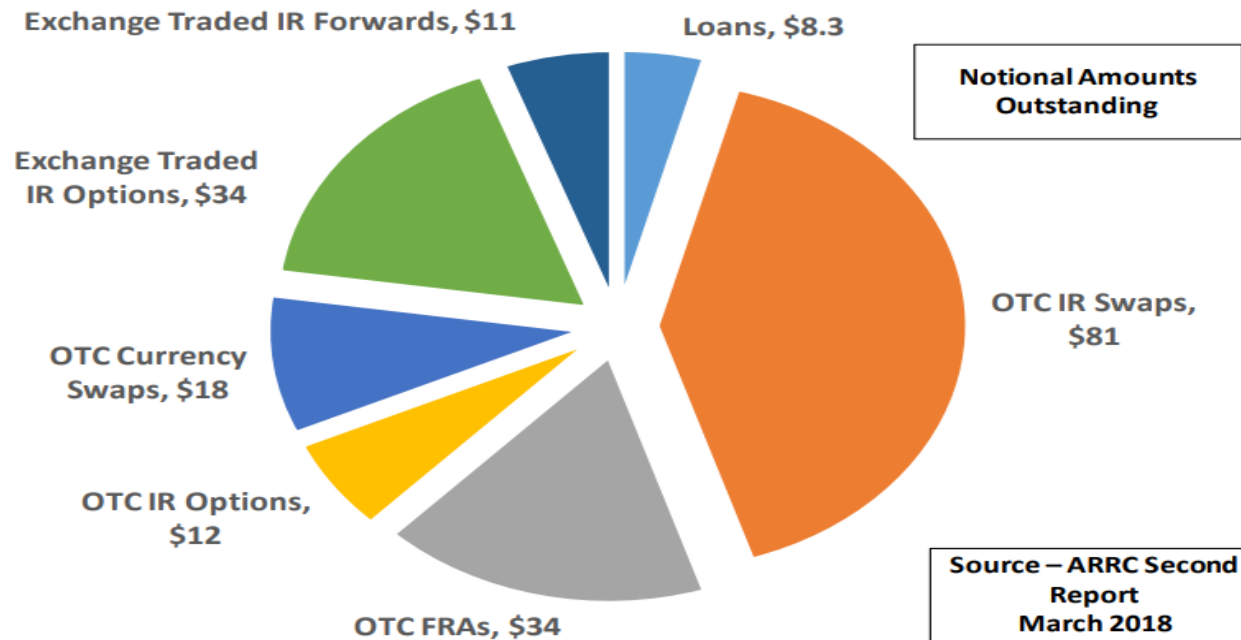
- There are more than 200 trillion of U.S. dollar (USD) LIBOR contracts outstanding
- There is ~\$500M of daily 3M LIBOR trades, which are the basis for creating the LIBOR curve
- This created huge reliance on a small, fragile, and potentially shrinking base rate



SOURCES OF LIBOR EXPOSURE

– from ARRC and NY Fed SOFR Summer Series Event “SOFR Explained”

LIBOR Exposures (\$200 Trillion) – Most Sources of Exposure are Important for Corporates



POLL # 1: Experience with SWAPs and LIBOR Lending

1. Verified SWAP expert
2. Significant Expertise in LIBOR lending and Conversant in SWAPs
3. Occasional Experience in LIBOR lending, with SWAP expert on speed dial when needed
4. Interested in learning more but not a regular practice area



LIBOR: History and Background

- History of London InterBank Offered Rate (LIBOR)
 - Most **widely used** variable interest rate benchmark in the world
 - Intended to reflect the **cost at which large banks can borrow** on an unsecured basis in “wholesale” markets
 - Based on **daily estimates** of borrowing costs for a range of currencies and periods from a panel of global banks
- The abuse/manipulation problem
 - It has relied on expert judgment rather than actual transaction data
 - During the financial crisis, investigations revealed a plot by certain banks to manipulate LIBOR rates for their own gain
 - Multiple banks were fined by regulators or settled LIBOR-related **lawsuits** totaling over \$9 billion

LIBOR: Transition



- The end of LIBOR – 12/31/2021/Extension to 6/30/2023
- Which LIBOR? (30 day, 3 month, etc.)
- SOFR (or other replacement index(es))

LIBOR: Recent Developments in Transition

- The New York legislative Solution and ARRC endorsement
- Federal Legislative Efforts
- Joint Agency Statements and Other Recent Developments
 - Phase out of various LIBOR Tenors
 - USD and Other Markets

Current Regulatory Environment: Recap of Differences Between LIBOR and SOFR

LIBOR

- Forward-looking/various terms
- Established (30 years+)
- Survey +\$500 million of daily trading
- Unsecured
- Available for five currencies
- Hypothetically reflects bank cost of funds
- Rises in a market disruption/time of increased credit risk

SOFR

- Backward looking/overnight
- New as of April 2018
- \$1 trillion of daily trading
- Secured
- Only for USD
- Risk-free rate
- May stay the same or even fall in a market disruption/time of increased credit risk

Current Regulatory Environment: Impact of SOFR

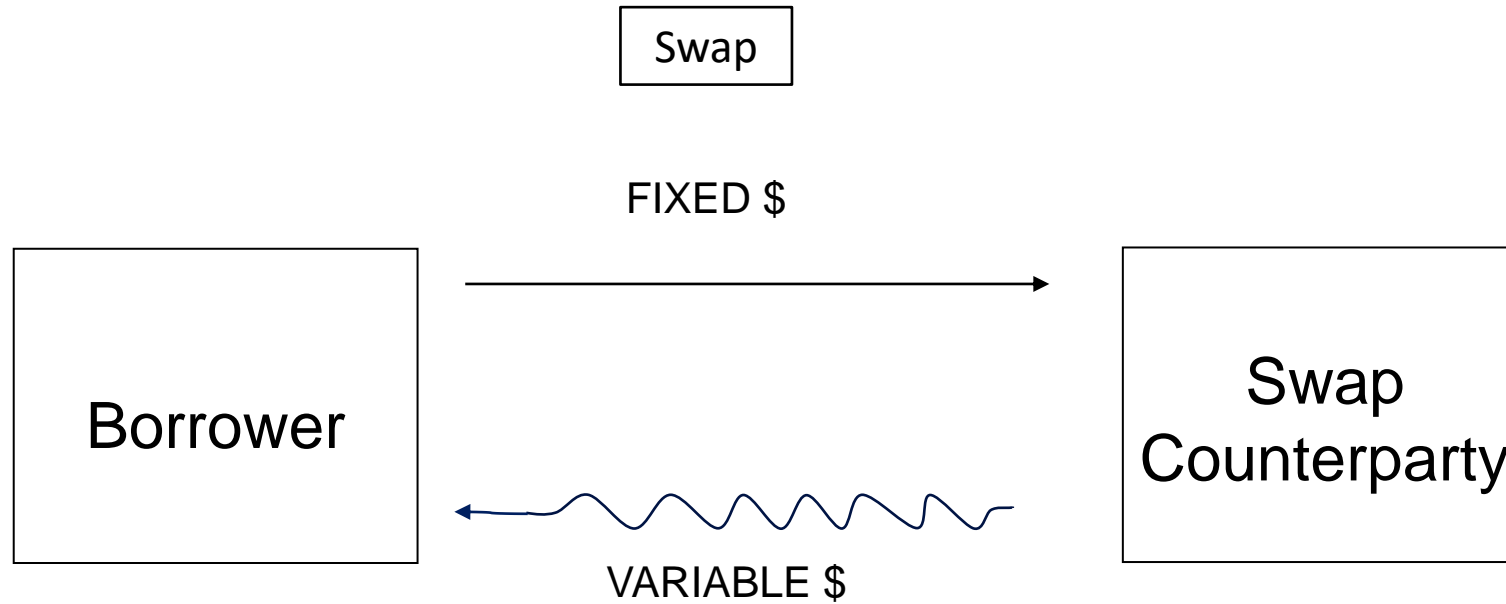
- Separate transactions – swap and loan [each involves a separate capital charge/extension of credit]
- Pricing *vis-à-vis* naturally fixed rate loans - liquidity of swaps results in lower % cost than naturally fixed rate deals
- Balanced book/liquidity goal of the banks



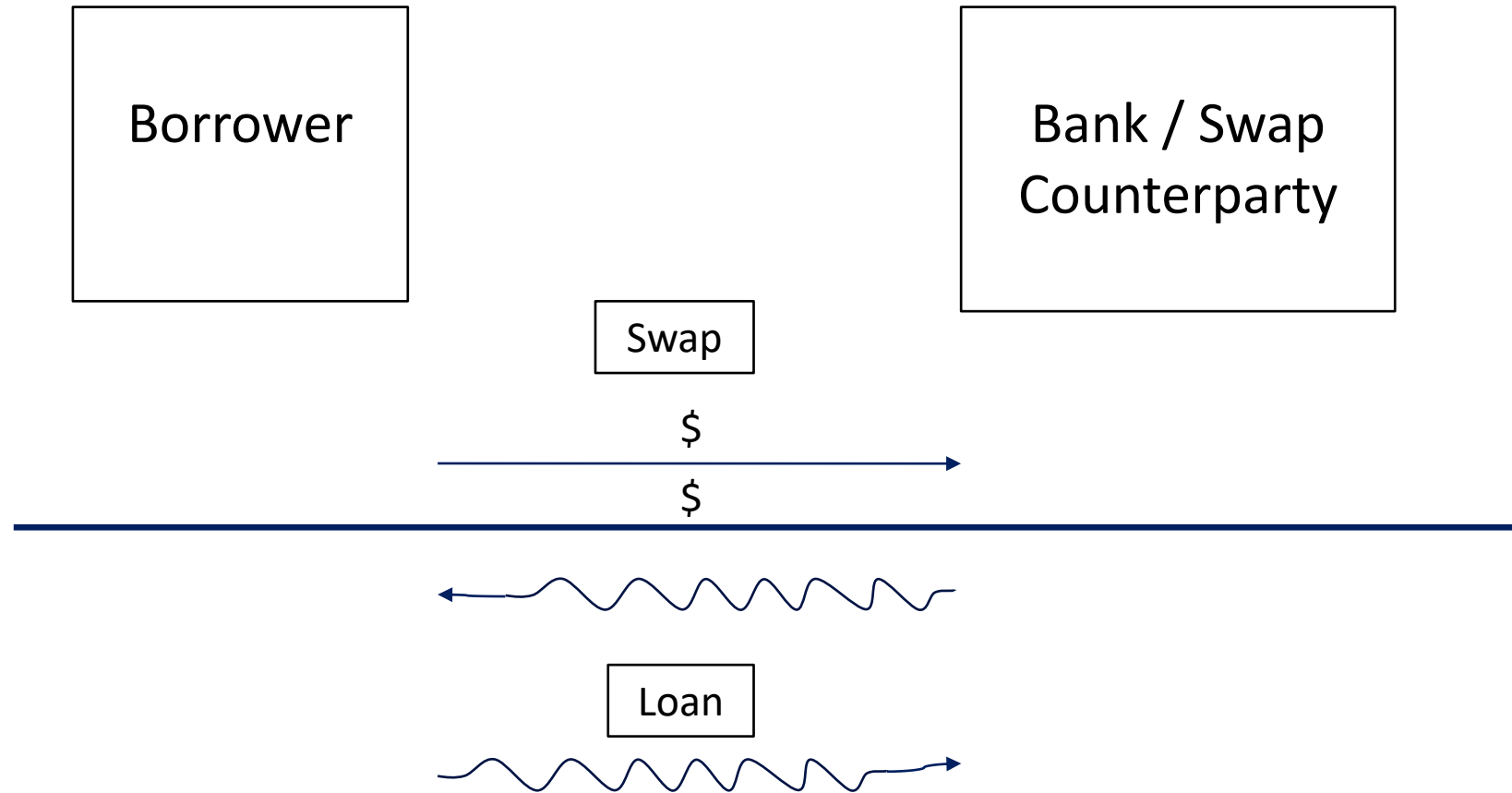
Current Regulatory Environment: Ongoing Dialogue on Transition

- Dialogue with Regulators on SOFR and LIBOR Transition – “Credit Sensitivity Group” Workshops
- Too big to fail banks – SWAP executory contract protocol

SWAPs 101: The Overall Picture



SWAP and Loan



SWAPs 101: Exchange of Payments

- Netting
- Notional amount
- Counterparty
- ISDA Forms
 - Master, Schedule
 - Confirm
 - Credit Support Annex

SWAPs 101: Principal Risks

- “Basis” risk – “Perfect swap”/matched swap/not matched swap
- Counterparty risk
- Termination/duration risk

SWAPs 101: Termination Value

- Mark-to-market vs yield maintenance
- First method/second method
- Market quotation/loss
- Calculation agent

POLL # 2

- What interest rate measure are you seeing in current SWAP transactions?
- 1. LIBOR
- 2. SOFR
- 3. Other: _____[add what you are seeing to chat]

Document Provisions for Alternative Rate

- Comparable outcome
 - Correlation between LIBOR and SOFR (may change in high rate environments)
- Specified fall back rate
- Agreement to agree/ MFN
- Unilateral choice by one party
- Silent

Current Status of Transition Issues

- Problems with existing documents (silent on end of LIBOR)
- “Tough Legacy” contracts
- New York law – possible “fix”



Poll #3: What are you seeing in Current Transition Documents?

1. Agreement to agree/ MFN
2. Unilateral choice by one party
3. ARRC or Similar Hardwired Fallback
4. ARRC or Similar Hardwired Fallback with Term SOFR if/when available
5. Fixed rate
6. Other

Mismatch Problem Between Loan and Swap Rates

- New Basis Risk
- Actual Out-Of-Pocket Cost
- IRS' position on Reissuance
- FASB/AICPA

