

KEY POINTS

- Contracts will revert to their fallback clauses once LIBORs cease to exist.
- The author estimates that the “Last LIBOR” fallback is worth £300,000 for a £50m, 5-year loan.
- Similarly, the “Cost of Funds” fallback is worth £2.15m.
- Frustration of a payer swap is the most valuable for the borrower.

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The demise of LIBOR: the value of fallbacks

As the date on which the publication of LIBOR is stopped approaches, many questions abound on the method of the transition and the effect on contracts. There is much legal debate about the efficacy of the fallback language. Each fallback clause has a financial impact whose value can be estimated.

INTRODUCTION

The legal implications of the end of LIBOR on 31 December 2021 (Cessation Date) have been discussed at length in many articles.¹ There will be much more as regulators attempt to untangle the legal Gordian knot. Little has been said about the monetary consequences. Here I calculate the financial impact of various fallback clauses and the way in which LIBORs are converted to their replacements, the so-called risk-free rates (RFRs).

THE COST OF “COST OF FUNDS” FALLBACK

The “Cost of Funds” fallback, which can be found in many facility agreements, provides that the rate, in the event of LIBOR not being published, is: “to be that which expresses as a percentage rate per annum the cost to the relevant Lender of funding its participation in that Loan from whatever source it may reasonably select”.² Historically, banks would not have wanted to make the result public for competitive and credit³ reasons; now there is another motive. It has been estimated that for Lloyds Banking Group in 2018 the “Cost of Funds” was LIBOR minus 0.86%.⁴ Given the complexity of banks’ balance sheets, this is a difficult number to calculate with precision (including for banks). Nevertheless, it is certain that their funding must be substantially below LIBOR; after all their business model is to borrow low and lend high.

The aggregate impact of the “Cost of Funds” fallback will be eye-watering. Consider a corporate borrower with five years of a £50m loan outstanding at the Cessation Date. Assuming the “Cost of Funds” clause is triggered, the calculation of the borrower’s saving is as follows:

$$\begin{aligned} \text{Interest Saving} &= \text{Loan Amount} \times \\ &\quad (\text{LIBOR} - \text{“Cost of Funds”}) \times \text{Remaining} \\ &\quad \text{Term of Loan} \\ &= £50\text{m} \times (\text{LIBOR} - \\ &\quad (\text{LIBOR} - 0.86\%)) \times 5 \\ &= £50\text{m} \times 0.86\% \times 5 \\ &= £2.15\text{m} \end{aligned}$$

THE VALUE OF “LAST LIBOR” FALLBACK

The “Last LIBOR” fallback simply states that should the relevant LIBOR not be available at the beginning of the interest period, the last published LIBOR should be used. Presumably, the author of the clause had in mind a temporary stop in publication rather than a permanent cessation. Nevertheless, the effect is that the loan becomes a fixed rate

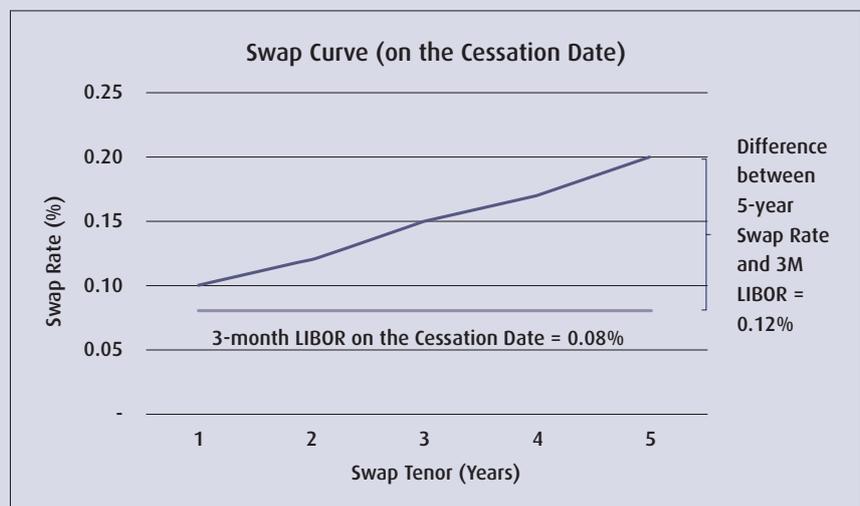
instrument. Whether this is beneficial or not will depend on the market circumstances at the time of cessation.

Suppose that the 5-year swap rate on the Cessation Date is 0.20% and the last LIBOR is 0.08%. Had LIBOR continued and the borrower wanted to fix the rate of interest, they would have had to pay 0.20%. In the circumstances, the fixed rate effectively becomes 0.08%; a saving of 0.12%. This represents an interest saving for the borrower (a loss for the lender) because the fixed rate can be converted to the new variable rate minus 0.12%. See Diagram 1 below.

The calculation of the borrower’s saving is as follows:

$$\begin{aligned} \text{Interest Saving} &= \text{Loan Amount} \times (\text{5-year} \\ &\quad \text{Swap Rate} - \text{Last} \\ &\quad \text{LIBOR}) \times \text{Remaining} \\ &\quad \text{Term of Loan} \\ &= £50\text{m} \times (0.2\% - 0.08\%) \\ &\quad \times 5 \\ &= £50\text{m} \times 0.12\% \times 5 \\ &= £0.30\text{m} \end{aligned}$$

DIAGRAM 1: SWAP CURVE (ON THE CESSATION DATE)



Feature

Of course, if the 5-year Swap Rate is less than the last LIBOR then the borrower will pay greater interest than anticipated (to the lender's benefit).

THE BENEFIT OF FRUSTRATION

Suppose that the corporate borrower had hedged the risk against rising LIBOR by entering into an interest rate swap (IRS). See Diagram 2 below.

The IRS would have reflected the terms of the loan such that the swap counterparty (usually the lender) paid the company LIBOR and the company paid the swap counterparty a fixed rate, 2.70% in the example. In this way, the payment and receipt of LIBOR cancel each other out and the company's interest repayment becomes the swap fixed rate. Assume further that the loan and the swap had maturities of 15 years, they were transacted 10 years prior to the Cessation Date, ie in December 2011, when the then 15-year swap rate was 2.70%, and the 5-year swap rate on the Cessation Date is 0.20% (because 5 years remain of the swap).

Should the company wish to cancel the swap, a payment has to be made to the swap counterparty (Break Cost). The Break Cost is calculated as the present value of

the difference between the transacted fixed rate (2.70%) and the current swap rate (0.20%) for the remaining period of the swap (5 years). For clarity I shall ignore the present value process (which in any case will only have a small effect because of the low prevailing level of interest rates). The Break Cost is then calculated as:

$$\begin{aligned} \text{Break Cost} &= \text{Swap Notional} \times (\text{Fixed Rate} - \\ &\quad \text{5-year Swap Rate}) \times \text{Remaining} \\ &\quad \text{Term of Swap} \\ &= £50\text{m} \times (2.70\% - 0.20\%) \times 5 \\ &= £50\text{m} \times 2.50\% \times 5 = £6.25\text{m} \end{aligned}$$

"At its most extreme, the effect of the permanent cessation of the publication of LIBOR may be to frustrate a contract – that is to say ... bring the contract to an end."⁵

If this were to occur, the swap contract would be terminated with no further amounts payable by either party to the other (legally, unperformed (ie future) "performance obligations" under the contract are brought to an end as a result of – and upon occurrence

of – the frustrating event; ie on this argument, the cessation of publication of LIBOR).

Importantly, if cessation of publication is a frustrating event, the Break Cost would not be payable. Accordingly, in circumstances where interest rates have fallen, the party paying the fixed rate will benefit from *frustration* and the receiving party will lose.

THE REPLACEMENT RFRs

The RFRs for every currency are numerically different to the LIBORs they replace. It follows that LIBOR cannot be simply replaced by its RFR. For example, the table shows SONIA and 1-month, 3-month and 6-month LIBORs (GBP) on 1 June 2020: see Table 1 below.

The RFRs cannot be used in the same way that LIBOR is used – they are overnight rates. Therefore, the method of calculating interest is fundamentally different. But even after adjusting for the technical difference, one issue remains – the difference between RFRs and LIBORs are not static and change daily. Diagram 3 opposite shows the difference between 3-month GBP LIBOR and SONIA.

The values range from -20 basis points to +60 basis points; the wide range is largely because of the impact of the pandemic. Even, pre-COVID, though, the range was +3 basis points to +35 basis points. Clearly, it is beneficial for borrowers (and those paying LIBOR on a swap) to argue for the difference to be at the lower end of the range and lenders (and those receiving LIBOR on a swap) the higher end of the range. What is the "fair" method of determining the difference?

DETERMINING THE DIFFERENCE: IF IN DOUBT, USE STATISTICS

After adjustment has been made to the way in which interest is calculated using RFRs, one has a set of historic differences in the interest rates from which *the* difference – termed the "Spread Adjustment" – can be calculated. The Spread Adjustment can then be used to calculate the new interest rate as follows:

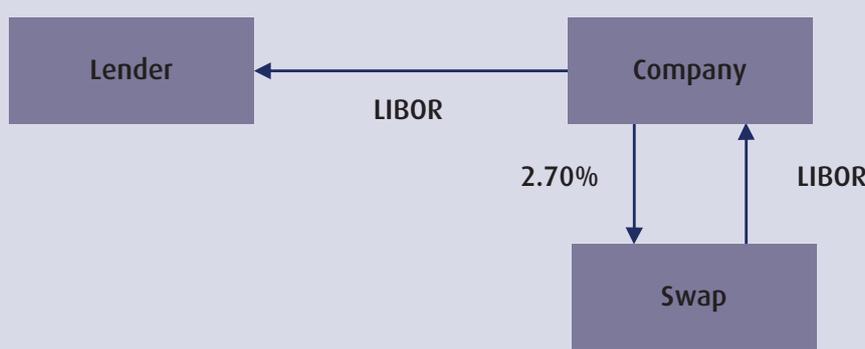
$$\text{Old Interest Rate} = \text{LIBOR} (+ \text{Margin})$$

$$\text{New Interest Rate} = \text{RFR} + \text{Spread Adjustment} (+ \text{Margin})$$

TABLE 1: SONIA AND 1-MONTH, 3-MONTH AND 6-MONTH LIBORS (GBP) ON 1 JUNE 2020

INDEX	RATE (%)	DIFFERENCE (BASIS POINTS)
SONIA	0.06650	-
1-month LIBOR	0.10263	3.6
3-month LIBOR	0.21263	14.6
6-month LIBOR	0.38225	31.6

DIAGRAM 2



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One way is to average the historic data in some way. Two questions arise immediately:

- how much data should be included? and
- which averaging method is to be used?

To address these questions, ISDA conducted a market consultation (published in November 2019⁶).

On the first question, two choices were provided: 5 years or 10 years. The majority chose 5 years. On the second question, again two choices were provided: median or trimmed average. The median method was chosen. Both of these choices are arbitrary – there is no reason why another method or period cannot be used. Nor is any party compelled to use the suggested method whether for a swap, a loan, or any other LIBOR-linked contract. Such contracts are bilateral agreements and it will be for the parties to decide.

The issue of the method employed to calculate the Spread Adjustment has monetary consequences because every method produces a different answer.

The physicist Ernest Rutherford said:

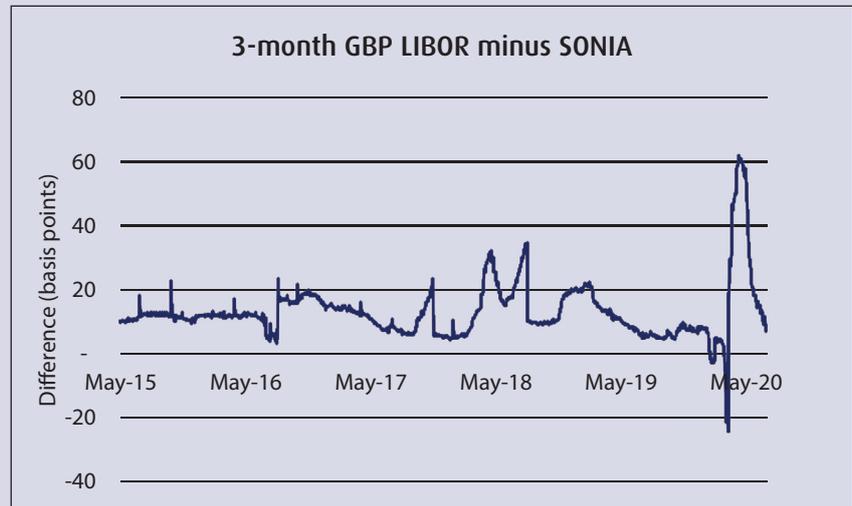
“If your experiment needs a statistician, you need a better experiment.”

The problem is that we have only the one experiment.

CONCLUSION

The loss (or gain) can be substantial depending on which of the methods of transitioning from LIBOR to RFR is used and which of the fallbacks, if any, take effect following the Cessation Date. The regulator in the UK has said that all customers have to be treated fairly. It did not, however, shed light on what *fair* might look like. Alexander wielded his sword to cut through the knot; the regulators hope a legislative⁷ solution will do the same. ■

Disclaimer: this article is not advice and the author accepts no liability for reliance upon any of the facts or matters stated. Financial and legal advice on the issues discussed should be sought in the ordinary way.

DIAGRAM 3: : DIFFERENCE BETWEEN 3-MONTH GBP LIBOR AND SONIA

- 1 For example, Virji *et al.*, ‘Facing the End of LIBOR: the financial and legal implications’, *Butterworths Journal of International Banking and Financial Law*, December (2019) 11 JIBFL 715-722.
- 2 Hanif Virji and Paul Marshall, ‘Facing the end of LIBOR Addendum: a “Cost of Funds” fallback?’, *Butterworths Journal of International Banking and Financial Law*, February (2020) 2 JIBFL 84-85.
- 3 Some banks’ borrowing costs are higher than that assumed by the market. Public knowledge of their true costs risks a re-appraisal of their credit rating with deleterious consequences.
- 4 Hanif Virji and Paul Marshall, p 84.
- 5 Virji *et al.*, p 718.
- 6 International Swaps and Derivatives Association, Inc. <https://www.isda.org/a/935TE/2019.11.15-ISDA-Final-Parameters-Consultation-Report.pdf>. Only 90 firms responded, including two non-financial corporations. Given the very low numbers of respondents it cannot be said that the results represent consensus.
- 7 <https://www.fca.org.uk/markets/transition-libor/benchmarks-regulation-proposed-new-powers>