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# Financial institutions: Fundamentals of LIBOR

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# Financial institutions: Fundamentals of LIBOR phase out and transition

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## Background

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

A major criticism of LIBOR following the financial crisis, however, was that it lacked the market-driven inputs necessary to serve as a benchmark. In other words, it is based on hypothetical transactions and is not fully supported by data from an active market of observable, arm's length transactions. Additionally, the volume of data points used varies depending on the number of submissions. As a result, various global working groups were formed between 2014 and 2017 to explore alternative reference rates 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) as the preferred alternative reference rate moving forward, and that banks would no longer be compelled to submit LIBOR reference quotes after 2021.

## Replacement reference rates

The 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 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 SOFR as the LIBOR replacement rate, there are other replacement rate alternatives available in the market such as the following:

- AMERIBOR, which was developed by the American Financial Exchange
- Euro short-term rate (ESTR), which was developed by the European Central bank
- Sterling overnight index rate (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

## Transition considerations

For financial institutions, the transition from LIBOR to a replacement rate is expected to be complex. First, there are a large volume of transactions currently referencing LIBOR, including variable-rate loans and derivative contracts. Some leasing contracts for which the financial institution is the lessee or the lessor may also have variable lease payments that refer to LIBOR. It is expected that LIBOR may be a less reliable reference rate moving toward its complete phase out by the end of 2021, which may impact current contracts that are reliant on that reference rate even prior to the final phase out date.

Most contracts currently contain *fallback language*, or legal provisions that dictate how the rate will be determined when the stated reference rate is no longer available. Financial institutions should first prepare an inventory of all contracts that reference LIBOR and then review their contracts now to determine what changes may be necessary to both existing and new contracts through the transition period and beyond, including the consideration of any fallback language that may be present in those 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 International Swaps Dealer Association about the transition from LIBOR and associated fallback language can be found [here](#).

Additionally, the change in reference rate will impact a number of operational areas from the lending department to the treasury department to the accounting department, likely requiring changes to policies and procedures surrounding credit underwriting, credit monitoring, asset and liability management, interest rate risk and sensitivity and accounting. Management, as well as those involved in daily operations, will need to understand the differences between LIBOR and SOFR (or other replacement rates) and how to negotiate, write, monitor and account for contracts with a 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 as a consequence of reference rate reform and replaced with another interest rate index. 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 expedient offered for debt instruments, if a debt instrument is modified in conjunction with the discontinuation of LIBOR to refer to a different reference rate with no other changes to contractual terms, the modification would be accounted for on a prospective basis by adjusting the effective interest rate. In other words, it would not be necessary to perform an analysis to determine if the modification should be accounted for as a modification or extinguishment. Similarly, modifications to leases and certain other contracts, such as portfolio loans held for investment or receivables, which are due to reference rate reform should be accounted for as a continuation of those contracts with no requirement to reassess previous determinations. For loans and receivables in particular, if the entity elects the temporary optional expedient, it should account for all contracts within the scope of ASC 310, “Receivables,” that were modified and qualify for the temporary optional expedient as if the modifications were only minor in

accordance with ASC 310-20-35-10. The guidance in ASC 848 also promotes the continued application of hedge accounting for hedging relationships that are impacted by reference rate reform yet remain highly effective.

The guidance in ASU 2020-04 was effective upon its issuance, which was March 12, 2020, and continues to be effective until December 31, 2022, which is a year after the date that LIBOR is expected to be discontinued. As such, ASC 848 applies to: (a) contract modifications made between the effective date of the ASU and December 31, 2022, and (b) hedging relationships in existence on or after the adoption date of the ASU and hedging relationships entered into through December 31, 2022.

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 instruments, 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

The transition process from LIBOR to the selected replacement rate(s) will likely be a multi-year, integrated process between various internal and external parties. Federal banking regulators expressed at an ARRC roundtable meeting on June 3, 2019, that there is a regulatory expectation that banks actively plan and prepare for LIBOR's ultimate cessation, and that the regulators may request that banks provide their plans during future examinations. Financial institutions should continue to monitor future developments relating to the establishment of SOFR term rates (in process with no available date currently set), other alternative reference rates, fallback language and transitional guidance from regulators, associations, counterparty financial institutions, accounting standard setters (e.g., FASB) and other market participants throughout the transition process.

## 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*

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