



CRA Insights: International Arbitration

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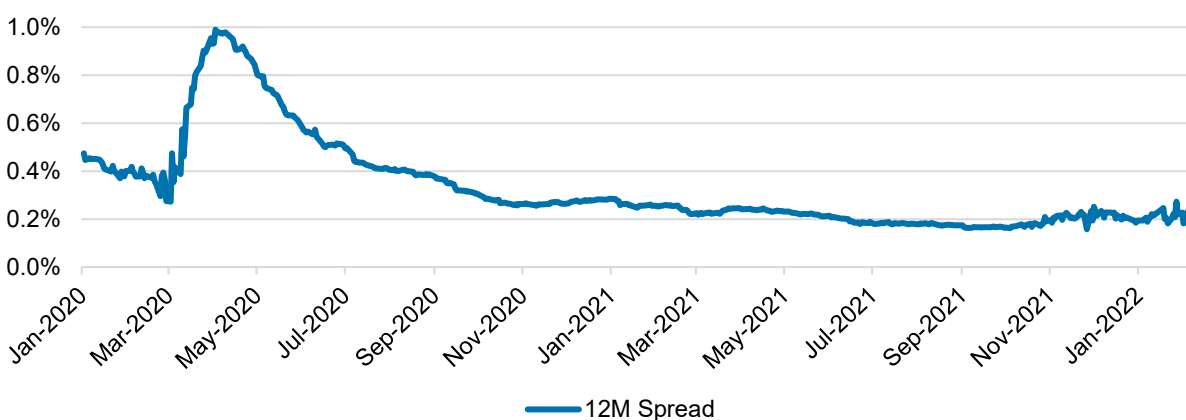
June 2022

The end of LIBOR: Which benchmark rate for pre-award interest?

LIBOR was discontinued for most currencies at the end of 2021, with only USD LIBOR set to be discontinued in 2023.¹ As noted earlier, LIBOR has been widely accepted as a reference by tribunals in their decisions on pre-award interest rates.² The question now is what will replace it as the new benchmark lending rate. The Secured Overnight Financing Rate (SOFR) has emerged as a leading benchmark in financial markets.

SOFR shares considerable similarities with LIBOR. It is based on the rates that large financial institutions pay to one another for overnight loans.³ Because LIBOR was an unsecured rate and SOFR is secured, SOFR is associated with lower risk than LIBOR. This fact is illustrated by, for example, SOFR rates being lower than LIBOR rates in both the overnight and 12-month tenors. Figure 1 below shows LIBOR's spread over SOFR for the 12-month tenor.⁴ Since 2020, SOFR has been lower than LIBOR by an average of 26 bp (i.e., 0.26 percentage points).⁵

Figure 1: LIBOR spread to SOFR, 12M tenor⁶



¹ Various forms of LIBOR across currencies, including GBP LIBOR, and tenors have already been discontinued, with the publication of USD LIBOR set to end in June 2023.

² Tiago Duarte-Silva and Swati Kanoria, "The importance of interest in arbitral awards," CRA Insights, 2022.

³ Federal Reserve Bank of NY. <https://www.newyorkfed.org/markets/reference-rates/sofr>.

⁴ Note that SOFR is an overnight rate by definition; 12M-term SOFR is based on swaps.

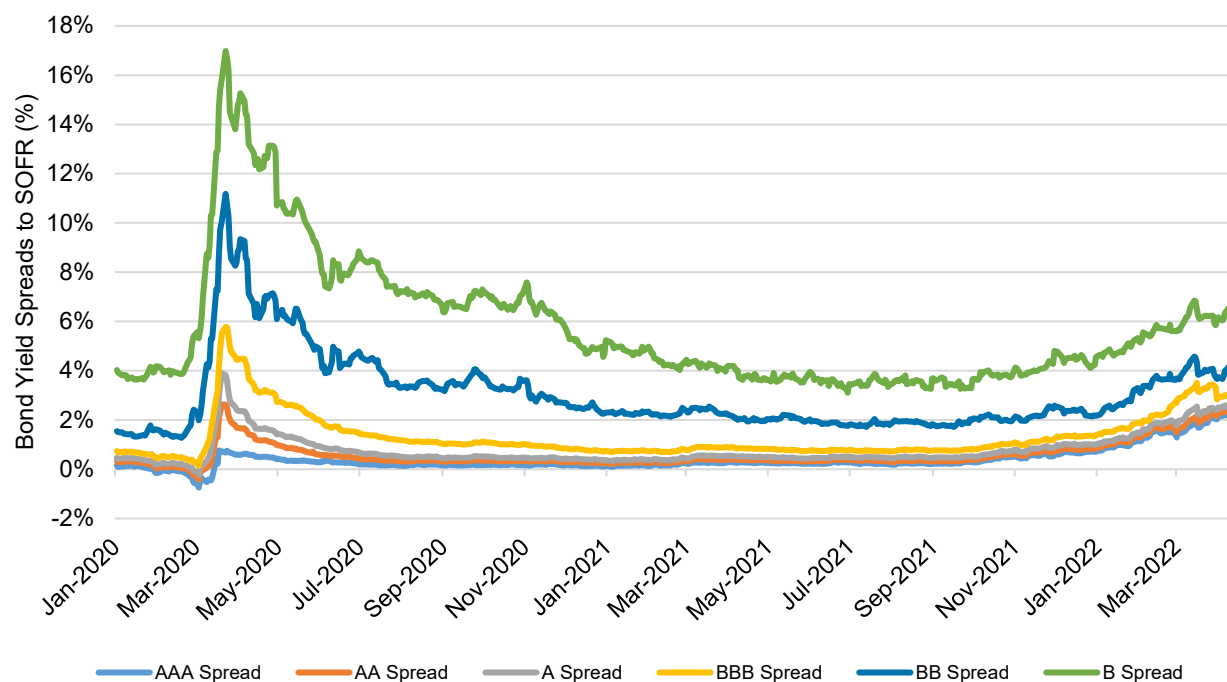
⁵ Median LIBOR spread over SOFR, 12M tenor, January 2020–February 2022. Data from Eikon and ICE.

⁶ Data from Eikon and ICE.

Although SOFR and LIBOR are similar, it is important that tribunals not simply move the goalposts by changing pre-award interest rates such as LIBOR+2.00% to SOFR+2.26%, for example. Recall from *Pre-award interest: Is LIBOR+2% a reasonable commercial rate?* that true borrowing costs vary with the borrower's risk and with market conditions. The same principles apply to SOFR.

Figure 2 below shows bond yield spreads to SOFR since 2020, (i.e., how much higher than SOFR were the rates on debts of different risks/ratings). For example, the green line shows rates on debts rated B (within the junk debt category), whereas the orange line shows rates on debts rated AA.

Figure 2: Bond yield spreads to overnight SOFR across credit ratings⁷



It is too early to observe a full business or credit cycle of how these spreads vary over time; nevertheless, it is clear that SOFR plus a standardized spread (e.g., 2.00% or even 2.26%) does not capture the variety of commercially reasonable rates. For example, AA-rated debts have had spreads between 42 basis points below and 263 basis points above SOFR (i.e., -0.42 to 2.63 percentage points), and B-rated debts' spreads over SOFR have always been at least 300 basis points (i.e., 3.0 percentage points).

It is also clear that SOFR plus a standardized spread does not capture changing market conditions. For example, the spread on B-rated debts has varied more than 1,387 basis points since 2020 (i.e., 13.87 percentage points).

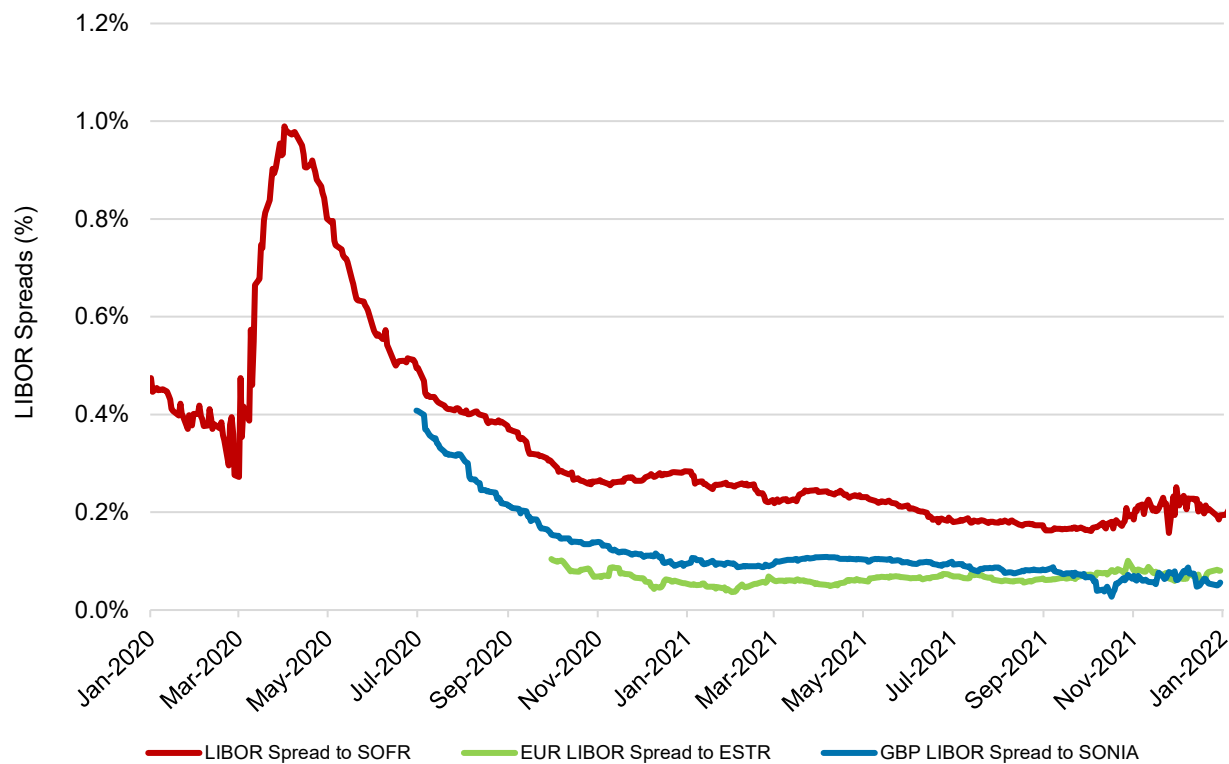
The discontinuation of LIBOR has implications for lending rates in foreign currencies as well. ESTR has replaced EUR LIBOR, while SONIA has replaced GBP LIBOR.⁸ Like LIBOR, they do little to capture risk profiles and market conditions, two essential components of interest rates.

⁷ Bond yield ratings based on indices of one-to-three-year corporate bond yields at each credit rating. Data from Eikon.

⁸ ESTR is the Euro Short-Term Rate, and SONIA is the Sterling Overnight Index Average. HSBC on "IBOR Reforms," <https://www.gbm.hsbc.com/financial-regulation/ibor>.

Figure 3 below shows LIBOR spreads to its replacements across currencies. It shows that LIBOR rates are higher than their currency equivalent replacement benchmarks, indicating that these new benchmarks represent lower-risk lending rates – they are not the same as LIBOR.

Figure 3: LIBOR spreads to SOFR, SONIA, and ESTR, 12M tenor⁹



As these transitions take place, it will be important to consider that the LIBOR replacements should not be accepted as perfect substitutes for LIBOR when it comes to selecting rates for pre-award interest. It will be just as important to realize that, like LIBOR, these replacements will do little to account for changing market conditions and risk profiles.

⁹ Data from www.global-rates.com, Eikon, ECB, and ICE. ECB began publishing 12M ESTR in October of 2020. 12M SONIA not available on Eikon prior to July of 2020.

CRA's International Arbitration experience

CRA experts have extensive experience in commercial and investment treaty arbitrations and have provided testimony in all the major international arbitration forums, including ICSID, PCA, ICC, LCIA, SIAC, HKIAC, SCC, and under UNCITRAL rules. With the highest average claim among top-10 expert firms, we have been engaged in some of the most complex and high-profile disputes of recent years. We combine finance and quantum expertise with industry expertise from energy, oil and gas, metals and materials, mining, pharmaceuticals and life sciences, banking, financial services, and various other industries to offer a one-stop solution for clients in disputes that might otherwise require several firms.

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