

The End of LIBOR

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Both lenders and borrowers who have or are negotiating credit facilities with LIBOR-based interest rates need to be aware that LIBOR is being phased out. Parties should review and understand what their loan documents, swap documents and other financial contracts say about how interest will be calculated in the absence of LIBOR, which is slated to be eliminated completely by the end of 2021, if not sooner.



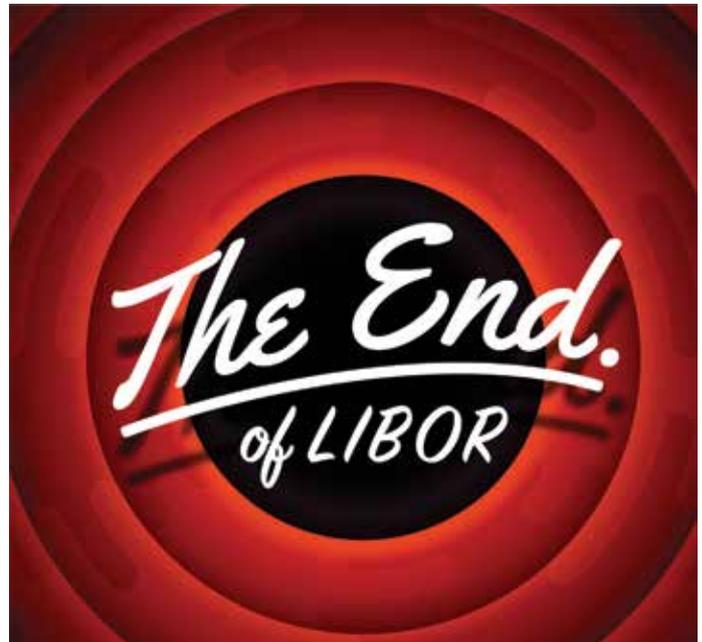
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LIBOR is an acronym for London InterBank Offered Rate. Originally, LIBOR was the average interest rate at which a bank could borrow from leading banks in London. A brief history of LIBOR may be helpful to understand how we arrived at where we are today. LIBOR loans first appeared in London in the early 1970's when growing inflation and rising interest rates made banks reluctant to make loans at a fixed rate for a long period of time¹ (i.e., a classic term loan). An alternative developed in the form of syndicated loans which allowed several banks to share the risk by each making only a portion of a large loan, which was originated, structured and administered by an agent bank. In addition, LIBOR allowed the syndicate banks to set the interest rate on the loan for a relatively short period of time (each an "interest period") at a rate that was determined

by consulting other banks to ascertain the rate at which the lending banks could borrow (and often actually did borrow, a process known as "match-funding") from other banks an amount equal to the loan for a period of time equal to the interest period. This turned a large fixed rate loan into a series of smaller adjustable rate loans with the interest rate reset periodically to reflect market conditions, which reduced the risk of the then volatile interest rate environment. When the Prime Rate (then the dominant benchmark for interest rates on U.S. corporate loans) reached an unprecedented high of 21.50% in 1980, large U.S. borrowers turned in growing numbers to the London Eurodollar market. Eurodollars are U.S. dollar deposits held outside of the U.S. At the time, Eurodollar deposits were not subject to the same regulatory restrictions as U.S. dollar deposits within the U.S. This resulted in the ability to make Eurodollar loans at interest rates that were several percentage points lower than the Prime Rate. LIBOR loans came to be perceived as loans that enjoyed favorable terms typically reserved for blue chip borrowers. As the London financial markets grew in importance, LIBOR evolved to become the preferred benchmark for short-term interest rates around the world. LIBOR rates are now published each business day for five major currencies (U.S. dollar, British pound sterling, euro, Japanese yen and Swiss franc) and several borrowing periods, ranging from overnight to one year. It has been estimated that



over \$350 trillion dollars' worth of financial derivative contracts, mortgages, bonds, and commercial and consumer loans bear interest at rates based on LIBOR.²

WHY CHANGE A BENCHMARK THAT IS SO WIDELY USED?

Originally, LIBOR was the average interest rate at which a bank could borrow from leading banks in London and was ascertained on an individual basis by the bank making the loan. In 1986, the British Bankers Association (BBA), a U.K. trade organization, took over the administration of LIBOR and began to compile and publish the rates. Various investigations after the 2008 financial crisis revealed that since the early 1990's, BBA had colluded with reporting banks to falsely inflate or deflate rates to their advantage. By 2012, the breadth of the manipulation scandal had become evident and about 20 major banks worldwide were the subject of criminal and civil investigations and lawsuits. Thereafter, the Financial Conduct Authority (FCA), a UK regulatory agency, assumed responsibility for overseeing LIBOR.³

While regulatory reform could overcome the problem of market manipulation, post-financial crisis regulation diminished bank appetite to make wholesale loans. As a result, banks now rely on judgment calls more than actual transactions to set LIBOR. In 2017, Andrew Bailey, FCA's CEO, in a widely-reported speech, questioned the sustainability of LIBOR as a benchmark. Bailey noted that "the underlying market that LIBOR seeks to measure—the market for unsecured wholesale term lending to banks—is no longer sufficiently active."⁴ According to Bailey, "[i]f an active market does not exist, how can even the best run benchmark measure it?" Acknowledging that the unexpected and unplanned disappearance of LIBOR would cause market disruption,

Bailey announced that the current panel banks had agreed voluntarily to sustain LIBOR until the end of 2021 to allow time for a transition to alternative reference rates that are based on actual transactions.

WHAT WILL REPLACE LIBOR?

In the U.S., in a press release published on December 14, 2017, the Federal Reserve Board released final plans to create new reference rates based on overnight repurchase agreements (commonly known as “repos” and pursuant to which banks lend money to each other on a secured basis), including the Secured Overnight Financing Rate (SOFR), which was identified as the recommended alternative to U.S. Dollar LIBOR⁵. SOFR is a broad measure of the cost of borrowing overnight, calculated as a volume-weighted median of transaction-level tri-party repurchase agreement transaction data.⁶ Since early April 2018, the New York Federal Reserve Bank has published SOFR on its website each business day at approximately 8:00 a.m. To-date, historical SOFR has ranged from a low of 1.65% on May 22 to a high of 1.92% on June 22.⁷

This action by the Federal Reserve does not, however, solve the problems that arise from the end of LIBOR. This new benchmark will not be a successor rate to LIBOR in any technical sense. There is no mandate to use SOFR as a replacement for LIBOR and, in its current form, SOFR may not actually be the most relevant benchmark for many financial products. LIBOR transition needs to deal with the structural differences between the two rates. Two notable differences exist between LIBOR and SOFR. First, SOFR is based on secured transactions, while LIBOR reflected the pricing on unsecured transactions. Generally secured borrowing rates are lower than unsecured rates. Second, SOFR is an overnight rate only, while LIBOR is published for several periods ranging from overnight to one year. As a result, there is no reason to believe that financial contracts with pricing based on LIBOR will be construed, wholesale, to have intended that this new rate replace LIBOR (with whatever effect that may have on pricing). Thus, prudence dictates that financial contracts that utilize LIBOR as a reference rate and have a term extending beyond 2021 (or even earlier, if the lender has a right to reprice in the event LIBOR cannot adequately be determined or if LIBOR fails to cover the lender’s cost of funds) need to be reviewed to identify each party’s rights in the event that LIBOR is no longer available, and to further ascertain if the alternative (if any) provided in those contracts is both workable and will result in pricing reasonably tailored to compensate the financial institution for its risk and provide a reasonable return, and to offer the borrower a market interest rate.

For example, a traditional credit agreement may include boilerplate that if LIBOR is unavailable, the lender has the right to switch to Prime Rate pricing. The problem with that is that the Prime Rate right now is about 5.00% per annum, while one month LIBOR is 2.10% (according to The Wall Street Journal Money Rates). Even with the lower “spread” or margin that usually goes with Prime Rate pricing, a borrower typically would be paying a materially higher interest rate. The Prime Rate alternative to LIBOR was never intended to be a long term solution; it was designed to operate when a temporary disruption of the financial markets prevented the lender from timely obtaining a LIBOR quote in the short term. In addition, if the parties are forced to rely on a

provision of this type for any period of time, there will be a mismatch with the terms of any applicable interest rate swap. That is, interest rate swaps tied to LIBOR may no longer be effective to hedge against the floating rate obligations they were intended to cover.

In recent years, as the potential for financial market disruptions became more evident, the variety of alternative rate provisions included among the boilerplate in credit agreements has grown to include provisions that do not simply state a certain specified alternative interest rate, but instead provide the lender with an often vaguely-stated right to re-price if LIBOR becomes unavailable, e.g., a provision that permits the lender to substitute for LIBOR a rate determined by the lender from “another recognized source or interbank quotation.” In addition, the variations on such alternative rate provisions are nearly limitless. And there is no assurance that the alternative rate provisions in a swap contract match the alternative rate provisions in the covered credit agreement.

Financial institutions are faced with a large and complex transition from LIBOR. Currently, however, there appears to be a degree of complacency among financial institutions about assessing and reducing exposure to LIBOR-based pricing. Financial institutions need to inventory their LIBOR-based exposure. They should also be reducing the amount of new LIBOR-based contracts undertaken. Financial institutions will need to determine whether SOFR is the best replacement for LIBOR or if another benchmark is more appropriate for each financial product. In light of the dearth of historical SOFR data, updates to risk and pricing models will be complicated and time-consuming, and may require considerable lead time to implement. Informing and educating customers about the new benchmarks and rates and the reasons for transition will need to be handled thoughtfully. Addressing the issues attendant to the transition from LIBOR-based interest rate provisions now is the best way to avoid confusion, uncertain pricing, damage to customer relations and other unintended consequences in the near future. ■

*Sources:

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