Briefing

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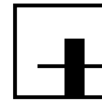

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The financial crisis claims another victim – LIBOR

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LIBOR, the London Interbank Offered Rate, used worldwide in an array of financial instruments and contracts will be phased out by 2021.

LIBOR is used around the world to price financial products and to calculate interest rates in a wide range of financial transactions (including personal loans and residential mortgages, as well as large scale corporate and commercial lending and derivatives). It is estimated to influence around $350 trillion worth of financial contracts. The LIBOR benchmark is, essentially, the average interest rate at which a panel of leading banks in the London market are prepared to lend to each other, in various currencies and on various terms (from overnight to 12 months).

The panel banks submit their rates each morning to ICE Benchmark Administration (ICE), and the LIBOR rate is calculated and then published around 11.45am each day. However, due to the downturn in banks lending to one another, it has become increasingly difficult for the panel banks to base their estimates on actual transactions and accurately represent market conditions. For example, the Financial Conduct Authority (FCA) recently announced that for a particular currency and term, there were only 15 transactions throughout the whole of 2016. Therefore, the panel banks' submissions are often based on hypothetical figures and the bank's 'expert judgement'.

Several banks have expressed discomfort about providing submissions based on so little underlying activity. The 'self-selecting' nature of the rate has also led to questions over its sustainability and its susceptibility to manipulation.

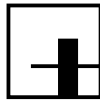
Indeed, the LIBOR rigging scandal, where certain rates were being 'set' to the advantage of a particular bank and which came to light following the 2008 financial crisis, led to LIBOR being brought under the regulatory control of the FCA in 2013.

Phase out

On 27 July 2017 Andrew Bailey, CEO of the FCA, announced that LIBOR would be phased out by 2021. He recommended a change in the status quo, phasing out the widespread use of LIBOR in its current form in favour of a rate which better represents the underlying market. While ICE has indicated that it will continue to publish LIBOR, without the backing of the FCA compelling the panel banks (some of whom are already reluctant to make submissions) to submit rates it is difficult to see how sustainable the rate will be in practice.

Possible alternatives

In May 2017, the Bank of England's Risk Free Rate Working Group recommended the Sterling Overnight Night Index Average (SONIA) be used as the preferred benchmark in place of LIBOR for sterling derivative and relevant financial contracts. This would follow the introduction of similar mechanisms in Europe (EONIA), Switzerland (SARON) and Japan (TONAR). These benchmarks are seen as being more robust than LIBOR due to the higher transaction volumes underpinning them and therefore less susceptible to manipulation. It should be noted that most



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of the Risk Free Rate Working Group's work has focused on the derivatives market as opposed to the loan market.

Difficulties with SONIA

Some concerns have been raised in relation to SONIA being used as a benchmark in the loan market. In contrast to LIBOR, SONIA is backward looking. With LIBOR, a borrower and lender will know at the start of the relevant interest period what interest will be payable. With SONIA, the figure will only be known at the end of the period. This lack of certainty is clearly unattractive. In addition, SONIA only covers the Sterling overnight rate, whereas LIBOR covers several currencies and maturities. This raises concerns that the phase out of LIBOR will lead to a more fractured market with multiple new benchmarks being introduced globally.

Repercussions for finance agreements/lending transactions

The impact of the LIBOR phase out on existing financial contracts is difficult to quantify. Much will depend on whether they contain clauses providing an alternative interest rate or procedures for determining an alternative to LIBOR if it is unavailable. Most loan agreements which are based on one of the Loan Market Association (LMA) forms will contain fall back provisions to provide for the unavailability of LIBOR. However, these provisions are generally intended to be used only in the case of short term market disruption and will not be a sustainable or practical long term option. It is also likely that a significant number of non-LMA style financial agreements currently in place worldwide will not cater for a LIBOR alternative. Clearly, this could give rise to uncertainty and disputes as to applicable interest rates.

The LMA announced in October 2017 that it is involved in discussions with the Bank of England, the FCA and various trade associations with the aim of representing the loan market in the transition to a LIBOR replacement. It has also stated that it does not propose to update the relevant provisions of its standard documents until a market-led solution is identified.

Conclusion

The decision to move away from LIBOR over a four and a half year period was made by the FCA, in consultation with the panel banks, in order to give those in the marketplace time to transition to a new benchmark rate as smoothly as possible. Although 2021 seems far off, parties to existing financial contracts which reference LIBOR may wish to consider the terms of these instruments over the coming years in order to minimise risk, uncertainty, disruption and costs in the future. It will also be prudent to give consideration to the issue when preparing to enter into new financial contracts which may endure past the proposed LIBOR phase out date.

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