ROPES & GRAY

ALERT

Finance

September 14, 2017

Lights Out for LIBOR by 2021

Questions regarding the sustainability and desirability of the London Interbank Offered Rate (LIBOR) have prompted the UK Financial Conduct Authority (FCA) to urge the phasing out of LIBOR and a transition to alternative reference rates by the end of 2021. Market participants will need to consider the impact of this transition and potential alternative benchmarks in the context of new and existing loan documents.

On July 27 of this year, Andrew Bailey, chief executive of the FCA, delivered a speech in which he questioned the sustainability of LIBOR in its current form. The FCA has regulated LIBOR since April 2013 and while significant improvements have been made to LIBOR during that time, the continuing decline in liquidity in interbank unsecured funding markets has undermined confidence in the reliability of LIBOR. The message, in essence, is that the underlying market is not robust enough to allow the determination of LIBOR to be based on actual transactions. As a result, the benchmark relies on judgments made by panel banks that are not supported by sufficient actual borrowing activity, which subjects the financial system to greater vulnerability to manipulation and creates uncertainty in stressed market conditions.

In light of LIBOR's unsustainability, the FCA has decided to replace rather than reform LIBOR, and therefore not to encourage or compel panel banks to continue to contribute quotes and maintain LIBOR after 2021. Market participants are urged to begin planning a transition to replacement rates anchored in observable transactions by 2021.

What will happen to LIBOR after the end of 2021?

The answer to this question, according to Mr. Bailey, depends on LIBOR's administrator and the panel banks. They could continue to produce LIBOR (which is based on estimates submitted by major London banks) on its current basis, but if LIBOR is no longer sustained through the FCA's support, they might not be able to do so. Much depends on whether the FCA can encourage market participants to make a collective effort to change market practice. First, the loan market needs to settle on a replacement for LIBOR, which is estimated to be referenced in financial instruments worth US$350 trillion. Although there is currently no suitable replacement rate that has gained traction in the loan market, in the U.S. derivatives market, the Alternative Reference Rates Committee (ARRC), set up by the Federal Reserve, has recommended a broad Treasuries repo rate. In the U.K., a working group set up by the Bank of England announced SONIA as the preferred benchmark for use in sterling derivatives and relevant financial contracts. SONIA is, however, still subject to reform and, like the Treasuries repo rate, is backward rather than forward looking.

What will happen to existing loan agreements that reference LIBOR as a benchmark?

Parties to existing loan agreements referencing LIBOR are advised to review the benchmark provisions in order to understand whether they provide for a replacement rate or a process for determining a substitute benchmark rate if LIBOR is discontinued. They should also review the amendment provisions to assess the feasibility of amending the agreement to cater for an alternative rate if necessary.

In loan agreements based on the Loan Market Association (LMA) and the Loan Syndications and Trading Association (LSTA) recommended forms of facility agreements, LIBOR is principally defined by reference to a Screen Rate administered by ICE Benchmark Administration Limited (previously BBA LIBOR) and displayed on Thomson Reuters pages. The recommended forms of facility agreements provide fallback options for use if the Screen Rate is unavailable that are structured as a "waterfall" mechanic, including options such as, among others, the use of (i) a Reference Bank

Rate (the average of quotes of borrowing rates in the wholesale markets supplied by Reference Banks), (ii) the cost of funds (either of each Lender or a single weighted average rate that is applied to payments to all Lenders), or (iii) an alternative rate. Another fallback in the LMA and LSTA recommended forms of facility agreements is the "market disruption event" clause, pursuant to which lenders are entitled to suspend making loans at interest rates calculated by reference to LIBOR upon a trigger event, whereupon the loans become base or prime rate loans.

What should market participants consider when entering into new loan documents?

For new loans that still use LIBOR for the calculation of the interest rate, it is not yet clear what alternative reference rate will be used. Until the market settles on an alternative, we can expect that parties will continue to use LIBOR. Parties should ensure that their loan documents include appropriately broad fallback provisions and the flexibility needed to amend agreements to reflect the unavailability of and the need to replace LIBOR in the future. Appropriate language for loan agreements will eventually be proposed by both the LSTA and the LMA for consideration by the market.