

We need to talk about LIBOR

November 2018

Like Brexit to the political landscape, the phasing out of the LIBOR index by the end of 2021 is a major development that will fundamentally change the banking and finance landscape as we currently know it. However, again like Brexit, no one is too sure what that new landscape is going to look like.

This article is a quick refresher on what LIBOR is, how it is used, where things stand on its replacement and what actions our clients should take during this transitional period.

Firstly, what is LIBOR?

LIBOR is the London Interbank Offered Rate, a set of benchmarks that reflect the average interest rate at which the major global banks will borrow from each other. A group of select banks are asked the same question each day: "at what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11am London time?". The banks confidentially provide their answers based on a range of loan maturity dates and specified currencies, which are then averaged out by the ICE Benchmark Administration (IBA). The IBA then publishes the 35 different LIBOR rates (based on seven different maturity dates for five major currencies) each day at around 11:45 a.m.

How is LIBOR used?

LIBOR is the leading index used to price loans and debt instruments. The interest you receive or pay on a loan will generally be linked to the LIBOR rate applicable to a certain maturity period (usually 1, 3 or 6 months), plus an agreed margin. Whether it's an advance under a revolving credit facility or the selection of a new interest period under a term loan, the interest payable (LIBOR plus the margin) for that interest period will be calculated on the interest period's start date with reference to the applicable LIBOR rate published that day.

What will happen when LIBOR is phased out?

When LIBOR is phased out by the end of 2021, it will be replaced as a Sterling benchmark by SONIA, the Sterling Overnight Interbank Average Rate. The SONIA rate has been around for 20 years and is calculated using the rates paid on eligible overnight unsecured deposit transactions reported to the Bank of England's Sterling Money Market. The published SONIA rate is a look-back rate based on the previous day's activity. By contrast, the LIBOR rates published on any given day are forward looking rates based on certain banks' expectation of the average cost of lending over specific periods of time.

Should we start using SONIA as a benchmark now?

Whilst it is certainly possible to draft legal documents that use a SONIA benchmark, there isn't much appetite in the loan market to do so because banks and borrowers don't want to use a backwards looking rate.

Why does a backwards looking rate cause problems for borrowers and lenders?

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For lenders it creates unwanted operational issues such as daily re-rating of loans and backwards compounding. Their existing systems and settlement processes are not built to accommodate payment amounts which are only known with certainty at the end of the interest accrual period. In short, it would necessitate additional investment in system updates and staff re-training.

For borrowers, forward looking rates like LIBOR are useful for risk management needs, such as cash flow forecasting and managing interest rate risks. With a LIBOR benchmark, a borrower knows at the start of an interest period what they will owe at the end of it.

How do we go forward from here?

The Bank of England are on the case and recognise the need for a forward looking term SONIA reference rate. They have established the Working Group on Sterling Risk-Free Reference Rates which is working with the loan market to establish a term SONIA reference rate based on expected average SONIA over a given period. A consultation paper was produced and circulated, with feedback due on 26 October 2018 – all stakeholders eagerly await the results.

What can I do now?

We understand that despite the current uncertainty, the loan market will continue on unabated. The concern for our clients is that loan products entered into today need to be able to address the transition period as we move from LIBOR to SONIA. If you have any concerns about the adequacy of your loan documentation to handle this transition, please contact a member of Collas Crill's Banking and Finance Team and we will be happy to advise you on how best to adapt your documentation during this transitional period.