Where the land lies for LIBOR in the new world we are in

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At a time when COVID-19 has overtaken Brexit in column inches, we are reminded that the show must go on.

It's perfectly understandable to feel that if your lives have so far been untouched by LIBOR, it's probably okay to keep ignoring it. But for those of us involved in finance that may not be the best response, even if there are other pressing matters.

There is a timeline for LIBOR to fall away on **31 December 2021**. Despite the impact on global stock markets, economies and businesses of the current pandemic, there has been no clear indication that this deadline will be pushed back.

So, what and why do you need to know about LIBOR?

LIBOR stands for **The London Interbank Offered Rate**.

It's a set of benchmarks that are intended to reflect the average interest rate at which the major global banks will borrow from each other. LIBOR is the most common interest rate benchmark in the UK but is also widely used elsewhere; over $350 trillion of financial contracts globally use it.

LIBOR has been around since the 1980s but in less than two years, it will cease to exist.

Because LIBOR underpins a vast number of financial products and contracts (for example mortgages, commercial and personal loans, bonds, securitisation, derivatives) LIBOR's journey into the future will have an impact beyond just credit transactions.

Here are our responses to some questions that we have encountered.

How does LIBOR work?

LIBOR is calculated by reference to submissions made daily by participating banks answering the question:

'*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 11 am London time?*'

Participating banks use available transaction data to provide their forward-looking rates for five currencies (sterling, US dollars, yen, Swiss francs and the euro) with seven maturities (ranging from overnight to 12 months) quoted for each – producing 35 rates each business day.

LIBOR would have continued in its happy existence had it not been for certain unfortunate developments.

What went wrong with LIBOR?

The market that LIBOR measures (being unsecured wholesale term lending between banks) is not active enough – there are simply not enough transactions representative of the market. Consequently, 'expert judgment' rather than real transactions sustained LIBOR.

LIBOR-rigging became a thing before the financial crash in 2008. A number of major banks were caught up in the scandal and were fined by regulators. Although certain steps were taken, including bringing it into the regulatory fold of the FCA, this became the death knell for LIBOR.

In 2017, Andrew Bailey, at the time Chief Executive of the FCA (now governor of the Bank of England), announced its demise, which will take place at the end of 2021. This would, in theory, give the market ample time to come up with a successor rate to LIBOR. It has been made clear that the responsibility for finding a solution rests with the market players, not the regulator.

Business as usual until a solution is found?

Many of the affected financial products and contracts have maturity dates after 2021. As we write, new contracts are still being documented in LIBOR despite warnings from regulators.

Various industry bodies are working hard to source a workable replacement rate. There are a number of obstacles to overcome, some of which are operational. The main concern is finding a 'one-size-fits-all' alternative rate in a complex financial market.

What will replace LIBOR?

The front runner for sterling is the **Sterling Over Night Index Average** also known as SONIA.

In brief terms, SONIA:

- is a measure of the rate at which interest is paid on eligible (unsecured) sterling-denominated deposit transactions. It is administered and published by the Bank of England;
- is considered a stronger interest rate benchmark due to it being based on an active, liquid, underlying market; and
- tends to be predictable and tracks the Bank of England base rate very closely,

all of which would put SONIA in a good light relative to LIBOR.

Having said that, SONIA is a 'backward-looking' rate whereas LIBOR is a 'forward-looking' rate. Therefore, LIBOR provides certainty of funding costs (which is important for cash flow management for banks and borrowers), and SONIA does not. The lack of visibility as to future financing costs for borrowers is problematic.

SONIA also raises operational challenges for banks whose IT systems and clearing procedures are set up to manage LIBOR–based transactions.

Variations of SONIA are being worked on to address these concerns.

Has SONIA been tested?

We are aware that NatWest Bank was the first off the mark in granting 2 bilateral facilities: one to National Express Group and the other to South West Water.

SONIA has not been tested on syndicated facilities.

In the Bond Market, Associated British Ports successfully converted a floating rate bond from LIBOR to SONIA, with consent from bondholders. Usually, bondholders are paid a fee when they are asked to give consent to changing the terms of the debt they hold, but in this instance, no fee was paid. The new debt was also designed to flip over to the new rate in a way that did not unduly benefit or harm either the borrower or the investors.

What would happen if no solution was found in time?

It would be unthinkable that at midnight on 31 December 2021, trillions of dollars worth of transactions would fall off a cliff. Much effort is being expended to try to avoid this outcome.

If parties to a contract were unable to find a solution in time, they might need to seek assistance from the Courts. The Courts have various tools available to them to try and achieve contractual continuity:

- **Contractual interpretation**. One of the issues for a Court in interpreting contractual provisions which reference LIBOR is the 'natural and ordinary meaning' of the provision. It is likely that Courts would be slow to interpret LIBOR as meaning a completely different reference rate.

- **Alternative calculation mechanisms**. Depending on the particular wording of certain provisions in a contract, Courts could determine that certain references to LIBOR can and should be interpreted as encompassing something wider than LIBOR itself. However, we expect that such circumstances would likely be limited.

- **Implication of contractual terms.** Courts could imply contractual terms into contracts in order to reflect the parties' intentions at the time the contract was entered into. In order to do so, the Court would need to be satisfied of a number of conditions and the term to be implied be either (i) the only contractual solution or (ii) the one which would, without doubt, have been preferred. Given this, and noting that there will be multiple alternative rates available to replace LIBOR, it would be very difficult for Courts to imply a term providing for a replacement rate.

If Courts are unable to use any of the above tools, then they would be left to consider whether the contract has become frustrated. This would mean that the contract is immediately 'killed' – the contract would fall away and the parties could no longer be bound by its terms. This would be the worst case scenario and Courts are generally reluctant to render contracts frustrated in the commercial context. We would expect Courts to take a pragmatic approach, given the potential wide impact and significant adverse consequences of a decision to frustrate certain LIBOR-referencing contracts.

Don't most contracts have a clause which points to a solution?

Some loan documentation will contain 'fall-back provisions' in case LIBOR cannot be sourced on a particular occasion. These provisions were designed to cover one off situations; providing a temporary short term fix. They don't address how interest should be calculated if LIBOR becomes permanently unavailable.

A change of this nature requires the parties to agree to a solution and for amendments to be made to existing documents. In a bilateral loan, agreement needs to be reached between the lender and the borrower. In complex syndicated facilities with multiple lenders and differences in approach, this raises many logistical difficulties for the parties.

Who will be most affected?

- **Lenders and borrowers.** We have discussed above the impact on both; intermediaries, advisers and brokers also need to be aware of these changes so that they can advise their clients. Apart from needing to engage with borrowers to agree on a solution, lenders will have to make fundamental operational changes to their IT systems and infrastructure to move away from LIBOR. They will also have to manage a re-papering exercise for existing contracts.

- **Funds, custodians, investment managers, fund administrators.** It is not uncommon to have valuations, pricing and fee calculation, amongst others, linked to LIBOR. Funds with hedging contracts will also need to assess the impact. Those involved in funds need to ensure that their systems will be compatible with LIBOR's successor. Fund documents will need to be checked to ensure that the relevant changes are made in good time.

What should we be doing?

Currently there is no industry recommended solution for a LIBOR replacement, therefore it would be premature to amend any existing documents.

It is not however too early for everyone to consider the extent of their exposure to LIBOR, ie:

- for lenders and borrowers with facilities maturing after 2021 to start engaging on the issues
- to review all documents to see where LIBOR is used, in relation to funds and related investment activities, e.g. hedge contracts
- to undertake portfolio reviews
- to consider whether alternative rates may be a suitable replacement. A simple example of this would be interest for late payment of fees: does this need to be LIBOR-linked or could you use the Bank of England base rate instead?
- to establish a timetable and framework to manage the transition of legacy LIBOR-based loans
- to agree transitional arrangements with counterparties
- to consider operational changes to be made (e.g. to IT and other internal systems)
- to consider any staff training needs

If you are looking to enter new debt funding arrangements, you may wish to discuss with your lender or borrower the possibility of adopting SONIA, or a variation of it (see above).

Where do things stand today in light of the COVID-19 pandemic?

The recent spread of coronavirus to the UK and across the globe is having significant impact on businesses and economies, bringing new challenges to banks, borrowers and other market players.

Regulators have, to date, been firm in their message that LIBOR will disappear at the end of 2021 and that no firm should plan otherwise. However, in light of current global circumstances, and the impact of this on firms' transition plans and their ability to meet the deadline, it's currently under consideration by the regulators.

The transition from LIBOR is of huge scale and significance, not just in the UK, but globally. It is imperative that by the time LIBOR is phased out, banks, borrowers and other market players have appropriate contractual, operational and technical infrastructure in place to accommodate new reference rates. Right now, regardless whether the transition period is extended, it is important that firms understand the scale of the task ahead.

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