Finance

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Reports of the Death of LIBOR are No Longer Exaggerated

The death of LIBOR (the London Interbank Offered Rate), the standard measure of interest rates for many financial products, has long been forecast. In a speech on July 27, Andrew Bailey, the Chief Executive of the United Kingdom's Financial Conduct Authority, seems to have put the nail in LIBOR's coffin, stating that the use of LIBOR should terminate by December 2021 and that the financial community should institute a different benchmark by that time.

The demise of LIBOR will affect both the loan market and the derivatives market. Trillions of dollar-equivalent-valued products use LIBOR in some fashion, so — at the risk of stating the obvious — this is a significant issue. While at this stage it is not at all clear what the replacement for LIBOR will be or how the markets will respond, several issues need to be addressed, including:

- Determining an alternative rate to LIBOR.
- Incorporating protective language in existing loan agreements should LIBOR no longer exist during the term of the particular financing.
- Making sure the impending changes do not disrupt markets.

A number of alternatives to LIBOR have been discussed, including, for the U.S. market, the preferred benchmark of the Alternate Reference Rate Committee, known as the Broad Treasuries Repo Financing Rate. This committee, created by the Federal Reserve and made up of the major financial institutions most affected by the demise of LIBOR, has studied several alternatives and has recommended this reference rate as a broad and deep market-based benchmark that solves some of the perceived problems with LIBOR. However, market participants already recognize some of the problems of utilizing this reference rate, including that it is not a published rate (it is set to be published starting in mid-2018), is an overnight rate that does not provide a term rate, and is based on U.S. government-secured lending and is therefore lower than LIBOR, which is an unsecured rate. Even with this recommendation, the industry appears much closer to the beginning than it is to the end of this discussion on an alternative benchmark.

While lenders holding loans that mature prior to December 2021 likely won't have to contend with these issues, lenders holding loans that extend beyond December 2021 will need to address these issues sooner rather than later. Even lenders with loans maturing before the announced LIBOR demise may want to have the ability to switch to a market-accepted rate sooner than 2021.

How should financial institutions address LIBOR's demise?

As a starting point, lenders should consider actions such as:

- **Agree on an Alternative Rate** — Lenders will have to coalesce around a new market standard. In addition to the Broad Treasuries Repo Financing Rate, other options are being discussed. ICE Benchmark Administration, the current LIBOR-setting entity, is still pushing its suggestion to reform, but continue using, LIBOR. The U.K. has its own suggested replacement rate, the Sterling Overnight Index Average, or SONIA. The only certainty is that there is going to be a new "market standard," but what it will be and when it will become a reality (probably closer to December 2021 than to today) remain unclear.

- **Review Outstanding Loan Documentation** — Lenders should review current documentation for outstanding loans to ensure that it contains language for alternative rates in the event that LIBOR is discontinued. This is crucial for loans maturing after 2021 and likely not necessary for those maturing prior to or in 2021. Most current loan documentation contains provisions designed to deal with temporary disruptions in the availability of LIBOR (typically a prime-based backup), but lenders should review them with an eye toward permanent LIBOR discontinuance. Before the market agrees on a new replacement rate standard, current loan documents will have to live with the current, less-than-perfect temporary replacement through maturity, or at least until an amendment can be made.

- **Develop New Loan Documentation** — Lenders should be thinking of including language in new loans giving the parties the ability to amend the applicable loan documentation to include language for the new benchmark if and when it is adopted (and if the particular loan is syndicated, the lender parties should be thinking of the percentage of votes from the lenders necessary to allow for this change). Of course, once new language is developed, lenders should review all their templates and forms for these issues so any agreed-upon language is incorporated in deals going forward.

While we don't know what the new benchmark replacement for LIBOR will be or how the various markets will react to and address these issues, proactively preparing for LIBOR's eventual demise will help smooth the way and minimize market disruption.

If you have any questions concerning LIBOR, the upcoming changes, and your current and future loan documentation, please do not hesitate to give any of us a call.

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