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LIBOR Phaseout: What Happened and What's Next?

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The Financial Conduct Authority (FCA) of the United Kingdom plans to phase out the London Interbank Offered Rate (LIBOR) by the end of 2021. LIBOR is the benchmark rate that many banks use to set interest rates in loan documents. More than $300 trillion in loans are tied to LIBOR, which is based on submissions from a panel of banks estimating the daily interest rate for each bank to borrow money from another bank. By the end of 2021, the FCA will stop requiring banks to submit the daily rates that are used to calculate LIBOR. Without the panelists' submissions, the future of LIBOR is unclear. Banks could continue to submit rates or LIBOR could stop being published altogether.

The news of LIBOR's demise comes several years after the rate-fixing scandal that revealed to the banking industry that LIBOR was unreliable and unsustainable. The race to implement a replacement rate has begun. The goal is to find new benchmark rates that are less likely to be fixed by competitors in the market.

In the United States, the Federal Reserve set up a committee to find a replacement rate for LIBOR. The Alternative Reference Rates Committee proposed a broad Treasuries repo financing rate, which is linked to the cost of borrowing cash secured against U.S. government debt. Unlike LIBOR, this rate is based on actual transactions. The new rate is scheduled to be published in the first half of 2018.

For transactions based on the pound sterling, the Bank of England is proposing a reformed version of the Sterling Overnight Index Average (SONIA) to replace LIBOR. SONIA is based on the costs of actual transactions in the overnight unsecured market, and the reformed version will be available in April 2018. Because the broad Treasuries repo financing rate and SONIA are both based on actual transactions instead of estimations, they are less open to manipulation. Many other countries have proposed replacement benchmark rates as well.

To prepare for the transition away from LIBOR, existing loans tied to the benchmark should be reviewed to determine if the loan documents include sufficient language to choose a replacement rate in the event that LIBOR ceases to be published. Additionally, these documents should be reviewed to determine if amendments are permitted and needed to account for the end of LIBOR and entry of a new rate.

With uncertainty in the future of LIBOR, new loan documents should be written to include fallback provisions. The fallback provisions should provide a clear alternative for choosing a rate if LIBOR is discontinued altogether. Additionally, the provisions should include language that protects the lender if LIBOR continues to be published with less regulation and becomes an unreliable rate. In this case, lenders would want the option to change the interest rate calculation. When drafting fallback provisions, ensure that the provisions are broad enough to cover all of the possibilities of LIBOR's future.

If you have any questions regarding LIBOR issues or need assistance in updating loan document provisions, please contact any member of Baker Donelson's Corporate Finance Group.