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# LIBOR: What Is It Good For?

**In 2021, LIBOR will be good for almost nothing. LIBOR (London Interbank Offered Rate), originally used as the interest rate for interbank loans, is currently the benchmark for approximately $350 trillion of financial instruments and products. Over the past several years, LIBOR's reliability has been impacted by its own fundamental shortcomings and scandal. The United Kingdom Financial Conduct Authority (FCA) will stop regulating LIBOR in 2021, which, in essence, will end LIBOR's service as a near-universal benchmark.**

### What Went Wrong?

Any mention of LIBOR triggers thoughts in some minds of fast bankers manipulating LIBOR rates for illicit gain. Indeed, several banks have paid billions of dollars in fines to settle accusations of wrongdoing related to LIBOR rate-rigging. LIBOR's poor public relations campaign (or lack thereof) certainly has not helped its popularity. However, its systemic shortcomings are ultimately the source of its demise.

The LIBOR rate is computed by calculating the average interbank short-term unsecured loan rates that a panel of contributing banks submits to the LIBOR administrator (ICE Benchmark Administration). Many banks, however, no longer make these types of loans to one another and do not know the rate for these types of loans. Instead, banks use their "expert judgment" to provide a rate for the LIBOR computation. This leads to an imprecise set of rate samples from which the ultimate LIBOR rate is derived. The LIBOR rate, therefore, is not pegged to an active market.

As Andrew Bailey, the current chief of the FCA said, interbank lending is no longer "sufficiently active" to provide a meaningful LIBOR rate. More pointedly, he asked: "If an active market does not exist, how can even the best run benchmark measure it?" To illustrate the dearth of interbank market activity, only 15 transactions for a single currency were executed among banks in 2016. The ideal benchmark should instead be an index based on active market transactions yielding an accurate rate.

### The Next Step

Global banking officials are now considering alternative benchmarks in anticipation of LIBOR's replacement. In the United States, the Federal Reserve's Alternative Reference Rates Committee (ARRC), comprised of private sector participants, has recommended a rate that most comprehensively reflects the rates used in the Treasury repurchase market (collateralized Treasuries used for short-term loans). The newly published index will be called the Secured Overnight Financing Rate (SOFR).

SOFR is considered a vastly superior benchmark, in that it is based on an active trading market. In fact, 15 banks this past June voted in favor of replacing LIBOR with SOFR. Federal Reserve Board Governor Jerome Powell, who has been nominated by President Donald J. Trump to chair the Federal Reserve, said, "SOFR will be derived from the deepest, most resilient funding market in the United States. As such, it represents a robust rate that will support U.S. financial stability." The New York Fed and Office of Financial Research (an independent body of the U.S. Treasury) will publish the rate, which should help maintain rate integrity.

### Challenges — LIBOR Legacy Contracts

Whichever index the regulators choose, the overarching issue is transitioning to the new benchmark. The transition poses challenges in that many financial products with variable rates that are tied to LIBOR extend beyond 2021 — so-called legacy contracts. These products' interest rates reset periodically and therefore require a benchmark index rate from which they can base their adjustments.

In some legacy contracts tied to LIBOR, an alternative benchmark may not have been considered. Other legacy contracts do however provide a replacement index in the event LIBOR is no longer published. The replacement index, however, is typically not the same across all legacy contracts (some adopt UST + X, others adopt PRIME + X, etc.). This is likely to pose a challenge as contracted parties move off LIBOR to a garden-variety of benchmarks, which could create widespread divergence in spreads beyond the differing LIBOR + X spreads previously negotiated.

If LIBOR continues to exist after 2021, a party to a legacy contract may insist on continuing to use LIBOR if it believes it is in its best interest (LIBOR's inaccuracy notwithstanding), making the argument that LIBOR was the agreed-upon contract benchmark, irrespective of its soundness or administrator. So long as LIBOR's rates are published, the parties should continue to refer to them.

However, public policy interests could afford parties the option of discontinuing the use of LIBOR, which is universally acknowledged as flawed. Parties originally selected LIBOR because of its wide acceptance and presumed accuracy. The contract's negotiated spread over LIBOR represented the lender's borrowing costs and, to an extent, the borrower's risk tolerance. This all rested on the assumption of an accurate baseline. Continuing to use LIBOR, which no longer serves its original purpose, could upend the original deal metrics. Accordingly,

using an index that tracks the deal originally contemplated by the parties at loan origination would seem the most equitable resolution. A judge, jury or, most likely, an arbitrator may ultimately have to decide this issue.

Regardless of which position one takes, the arguments to use an alternative benchmark over using a stale LIBOR benchmark may be moot, because it is likely that LIBOR will not exist after 2021. As it is, banks are uncomfortable submitting their rates to ICE, because ICE asks the banks to provide rate information that the banks do not have. Instead, banks must rely on their "expert judgment" to determine a rate and submit it to ICE. The admitted conjecture involved opens the banks to possible liability — not a new headache in the LIBOR sphere — and banks understandably do not want to participate. They nevertheless do so to cooperate with regulators in order to prop up LIBOR, and because the FCA technically has the authority to compel banks to submit their rates to ICE. (This power is not "indefinite," but the banks have agreed to continue sending in their rates until LIBOR sunsets.) However, now that financial regulators have (i) agreed to quit LIBOR; (ii) agreed to establish a new benchmark to replace LIBOR; (iii) acknowledged that LIBOR is inaccurate; (iv) acknowledged the banks' already uneasiness in submitting rates; (v) all but acknowledged LIBOR is an anachronism; and (vi) waning power and therefore a lessened desire to nudge banks into submitting to LIBOR, it is possible to envision a scenario whereby ICE will no longer have a contributing panel of banks, thus definitively marking the end of LIBOR.

If true, how do we transition to a new benchmark?

**Transition**

The ARRC is currently drafting a transition report that is expected to be published at the end of 2017 (after the writing of this article). Specifically, the report will recommend solutions to incorporate a new benchmark into legacy contracts. Apart from this committee's impending report, there is no consensus or roadmap guiding the markets forward (in how best to integrate a replacement benchmark into legacy contracts).

Recent and current events in the Swiss financial markets are instructive and possibly prescient. In 2013, the CHF TOIS (Switzerland's LIBOR equivalent) encountered problems similar to those LIBOR is currently experiencing — an insufficient trading marketplace to inform CHF TOIS. Much national and regulatory effort was expended to stabilize CHF TOIS, but to no avail. In 2016, Swiss bank officials announced that the CHF TOIS benchmark would end on December 29, 2017. The Swiss National Working Group (the AARC equivalent) favored SARON, the rate on the overnight Swiss Franc repo market (the SOFR Swiss equivalent) as a replacement benchmark. The National Working Group issued the following recommendation with respect to transitioning to the new benchmark:

> For all TOIS with a maturity date beyond the discontinuation date of the TOIS fixing, there are two obvious choices for addressing the situation that adherence to the original agreed-upon floating rate becomes impossible after the discontinuation date. TOIS either need to be terminated early prior to the discontinuation date at the prevailing market value, or they need to be restricken to be linked to an alternative floating rate instead of TOIS. In case of a restrike, the NWG proposes that TOIS be restricken to reference SARON.

While the value and number of financial products relying on LIBOR are much greater than those underpinned by the CHF TOIS, the recommendation's principle applies.

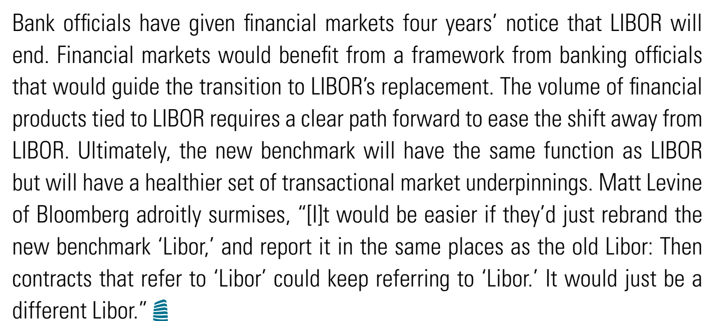
For LIBOR-based products, terminating or negotiating individual contracts on a massive scale would be impractical, cumbersome and likely impossible given the number of securitizations using a LIBOR benchmark that occurred following loan origination. Additionally, an automatic "re-peg" to a replacement benchmark, while relatively more seamless and practical, may be subject to legal challenges in as much as the replacement index was not contemplated as part of the parties' original bargain. But if LIBOR ceases to exist, which seems likely, parties to a contract involving LIBOR may have no other choice but to face a wholesale "re-peg" or some customization thereof, by parties who seek now to change their contracted benchmark.

One alternative but imperfect way to alleviate a possible automatic "re-peg" of LIBOR to the replacement index is to make a one-time adjustment that would equal out LIBOR and the replacement index's value and spreads on a particular date. For example, if on January 1, 2019, the rate was L + 300 basis points with LIBOR at 2.00 percent equaling an all-in rate of 5.00 percent, then after selecting a replacement benchmark, the parties could back into the LIBOR all-in rate, using the new index such that if the replacement index is at 1.75 percent, the spread adjusts to 325 basis points.

Of course, this method exposes flaws and is subject to infinite variables, such as the overall intrinsic volatility of LIBOR compared to its prospective replacement index (to be sure, LIBOR's volatility in the run up to the financial market meltdown greatly surpassed other relatively comparable indexes — allegations of LIBOR fraud aside), and thus the replacement index's movements may not accurately match. To address this, perhaps the ARRC or another committee can add control factors to solve for any marked distortion in the replacement benchmark's movements versus LIBOR by studying these indices' previous performance relative to LIBOR.

Another alternative but imperfect "re-peg" option is for the ARRC or other body to recommend three benchmark rates that parties to a legacy contract can choose from. The ARRC or another body would explain and provide the historical performance of these three benchmarks compared to LIBOR. This will assist the less sophisticated party in understanding and appreciating its replacement benchmark options, and both parties would agree on one of the three options. This solution may be more palatable than an automatic "re-peg" to a predetermined replacement index, as it avoids a situation of an unwanted single replacement benchmark being foisted upon unwitting parties. This solution also eliminates the daunting prospect of choosing from numerous possible exchanges, about which one of the parties may have very little information. One issue with this option is that one party, such as a large financial institution, may inherently have the upper hand over an individual borrower in determining which benchmark is best, inasmuch as financial institutions may have better resources to evaluate the benchmark options, and will select one that benefits itself. Another issue with this option would be implementation may be difficult because of the sheer number of contracts.

**Conclusion**



Bank officials have given financial markets four years' notice that LIBOR will end. Financial markets would benefit from a framework from banking officials that would guide the transition to LIBOR's replacement. The volume of financial products tied to LIBOR requires a clear path forward to ease the shift away from LIBOR. Ultimately, the new benchmark will have the same function as LIBOR but will have a healthier set of transactional market underpinnings. Matt Levine of Bloomberg adroitly surmises, "[I]t would be easier if they'd just rebrand the new benchmark 'Libor,' and report it in the same places as the old Libor: Then contracts that refer to 'Libor' could keep referring to 'Libor.' It would just be a different Libor."