MORRISON | FOERSTER

Client Alert

December 13, 2017

Life After LIBOR

By Geoffrey R. Peck, Peter C. Dopsch, and Gabriel Yomi Dabiri

INTRODUCTION

After a long and at times scandalous life, LIBOR is retiring. Earlier this year, Andrew Bailey, chief executive officer of the United Kingdom's Financial Conduct Authority (FCA), the regulator of the London Interbank Offered Rate (LIBOR), announced that the interest rate benchmark founded in the 1980s would be phased out by the end of 2021. This Client Alert briefly sets out the background that led to this decision, and how this decision has impacted syndicated credit agreements.

WHAT IS LIBOR?

LIBOR (currently known as ICE LIBOR and administered by the Intercontinental Exchange (IE)) is a benchmark for the rate at which major banks in the London interbank market lend to one another. IE administers a panel of 11 to 17 banks for five currencies with seven maturities to produce 35 quoted rates each London business day. IE averages the reported rates, with each average being readily available on Reuters, Bloomberg and similar services. Hundreds of trillions of dollars' worth of financial products around the world reference the benchmark, including corporate loans, swaps, student and other consumer loans and mortgages. Economists and central banks analyse LIBOR fluctuations to project economic health, and some central banks reference LIBOR to determine their own interest rate targets.

SCANDAL

Given the ubiquity of the LIBOR benchmark in financial transactions, its reliability is critical. However, in 2008, during the global financial crisis, that was called into question by allegations that certain LIBOR panel banks were deliberately manipulating their reported rates. Panel banks were allegedly reporting offered rates that were lower than the actual rates to create the appearance of better financial health for banks and submitting fraudulent rates to improve the returns on the banks' trading positions. The resulting years of litigation, arrests of bankers and payments by banks of billions of dollars in fines left LIBOR with a tarnished reputation and calls for a replacement benchmark that was more accurate and less subject to manipulation.

THE DECISION

In his speech, Andrew Bailey cited three primary criticisms of the LIBOR benchmark.

One, LIBOR is based on estimates submitted by panel banks that, in many cases, relate to markets in which these banks are not active. This results, Mr. Bailey argued, in a benchmark that may not reflect the actual cost of borrowing.

Second, Mr. Bailey argued that the activity within the underlying market that LIBOR seeks to measure, the unsecured wholesale term lending market, no longer generates the number of transactions needed to produce an accurate LIBOR benchmark. Mr. Bailey cited as an example a rate generated from submissions from a dozen banks, who among them executed only 15 relevant transactions for the entirety of 2016.

Third, Mr. Bailey asserted that the unverified judgments of banks, which currently underpin LIBOR, are always going to be susceptible to manipulation. The LIBOR scandal only served to underscore this point.

In consultation with LIBOR panel banks, as well as central banks and regulatory authorities around the world, the FCA determined that four to five years would be a sufficient amount of time to transition to a new benchmark. While the LIBOR benchmark may continue in some form beyond 2021, the expectation is that market participants will have settled on a new benchmark by this date, and the FCA will no longer use its legal authority or influence to sustain LIBOR.

IMPACT AND REACTION

Mr. Bailey's announcement did not come as a surprise to close followers of the LIBOR market. The focus since the announcement has been on determining a proper replacement (or replacements) for LIBOR and analyzing the impact this will have on existing and new syndicated credit agreements, as well as on other financial products.

Even prior to the announcement, regulators had been studying possible replacement interest rate benchmarks. The Alternative Reference Rates Committee (ARRC), a group of private-market participants empanelled by U.S. regulators, suggested prior to Mr. Bailey's announcement that a secured overnight U.S. Treasuries repo rate[1] be a LIBOR replacement for derivatives. In the United Kingdom, the Sterling Overnight Index Rate (SONIA) has been proposed, with EONIA (Euro's overnight rate), SARON (Swiss Average Overnight Rate) and TONAR (Tokyo Overnight Average Rate) recommended as possibilities for other currencies.

Central banks and regulators have intensified their analysis of alternative benchmarks. At the end of this past summer, for example, the U.S. Federal Reserve publically issued a "Request for Information Relating to Production of Rates," which is expected to be the basis for a future recommendation from the Fed for a LIBOR replacement. Next summer, the Bank of England is expected to announce new methodology for calculating SONIA.

LIFE AFTER LIBOR IN SYNDICATED CREDIT AGREEMENTS

An immediate consideration for market participants is how best to address existing syndicated credit agreements that use LIBOR and new syndicated credit agreements executed during the period of transition away from LIBOR.

Many existing syndicated credit agreements contain provisions that could apply if LIBOR is no longer available. These provisions, however, may not technically be triggered in this circumstance or, if triggered, may not provide a satisfactory replacement.

Syndicated credit agreements may have two relevant provisions.[2] These provisions were not originally intended to apply long-term, but rather to a temporary disruption in the London interbank market. They may nonetheless be triggered by the termination of LIBOR.

First, the definition of LIBOR may have a provision to determine LIBOR if it is unavailable on the applicable Bloomberg or Reuters screen page. If triggered, the provision requires the administrative agent to solicit rate quotations from banks in the London interbank market at which they offer deposits in the relevant currency for the

1 SOFR (Secured Overnight Funding Rate) is its acronym, changed this past August from its initial acronym of BTRF (Broad Treasuries Financing Rate).

2 For examples of each of these provisions, see the October 19, 2017 "Form of Credit Agreement" prepared by The Loan Syndications and Trading Association®. The first is in the definition of "LIBO Rate" in Section 1.01 and the second is in Section 2.20.

relevant maturity. This provision, however, only works if banks in the London interbank market quote these rates. If LIBOR is terminated entirely, this provision would not be triggered. Even if the provision is triggered because rates are still quoted, the administrative agent may find this provision burdensome and costly to administer on a long-term basis. Further, if only a few banks in the London interbank market quote this rate, the result may not reflect market pricing.

Second, a syndicated credit agreement may have a "LIBOR Market Disruption" provision, which is triggered by the inability to determine LIBOR "by reason of circumstances affecting the London interbank market," deposits in the relevant currency not being offered in the London interbank market or LIBOR not "adequately and fairly reflecting the cost" to the lenders. If the provision is triggered, a syndicated credit agreement may provide that LIBOR loans are converted to loans bearing interest at another specified interest basis (such as prime rate or base rate). If no alternative is specified, which is common in cross-border loans where prime or base rates are not as regularly used, a syndicated credit agreement may provide that the loans bear interest at each lender's cost of funds. Either of the alternatives may not be satisfactory to the borrower or the lenders since interest costs and returns could be different than originally expected. Further, the administrative agent and the lenders may find a "cost of funds" interest rate burdensome and costly to administer.

New syndicated credit agreements are starting to include additional provisions to address LIBOR termination. Some banks have prepared model provisions for their syndicated credit agreements, and The Loan Syndications and Trading Association® has kept its members up-to-date on related issues. Since there is not yet a market consensus on a LIBOR replacement, these provisions provide a process for the parties to designate a future LIBOR replacement. These provisions provide for a variety of ways for parties to agree on the LIBOR replacement. Typically, syndicated credit agreements require all lenders to approve a change in the interest rate. Some LIBOR replacement provisions alter that requirement and give the borrower and the administrative agent the right to approve an alternative, while others also require approval of the majority or a super-majority of lenders.

CONCLUSION

Retiring LIBOR may be disruptive to the syndicated credit markets. For existing syndicated credit agreements that will continue beyond 2021, parties should analyse the existing LIBOR provisions. We expect that, in many cases, these provisions may not provide a satisfactory long-term solution for replacing LIBOR and that amendments ultimately may be needed.

Market participants should consider adding a LIBOR replacement provision to new syndicated credit agreements. Until a clear LIBOR market consensus replacement emerges, however, the provision will need to provide flexibility to designate a replacement. Once the financial markets have coalesced on a replacement, we expect new syndicated credit agreements to expressly reference the replacement benchmark.

Finally, all market participants should closely monitor developments as they occur so they can react quickly to consensus as it develops around a successor benchmark to LIBOR and take action as necessary to address any impact that the new benchmark may have on existing and new syndicated credit agreements.

Contact:

Geoffrey R. Peck
(212) 336-4183
gpeck@mofo.com

Peter C. Dopsch
(212) 506-7263
pdopsch@mofo.com

Gabriel Yomi Dabiri
(212) 336-4040
gdabiri@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for 13 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.