LIBOR – buckle up

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THE LONDON INTERBANK OFFERED RATE (LIBOR) has been underpinning financial contracts and other products for the best part of 40 years. Now its tarnished reputation and changes in the financial markets and banks’ funding regimes since the financial crisis, undermine LIBOR as a representative rate. By the end of 2021, panel banks will no longer be obliged to submit their LIBOR rates.

The banks are getting ready for the end of LIBOR, but are their corporate customers?

TIME TO ACT
As we reach the ‘endgame’ for LIBOR, expected by end-2021, there is increasing risk for corporate borrowers in relation to their legacy LIBOR-referencing debt. The risks associated with the end
of LIBOR have been widely covered in the financial press, but often from the perspective of financial markets and their participants.

In this article we look at the issues and strategies for corporate customers of banks’ LIBOR-referenced business. In particular, what should a corporate borrower with existing debt referencing LIBOR be doing today? We argue that you should be prepared to fight early and fight hard to protect your position.

**TRANSITION**

With millions of contracts and financial products referencing LIBOR, the transition away from LIBOR is a hot topic on every bank and industry body’s lips. But what will this new world look like and what does this mean for those contracts and financial products that currently rely on LIBOR? The scope of financial and non-financial products affected by this change is broad and varied. Product-specific considerations also need to be taken into account.

**COAST ALONG WITH LIBOR UNTIL YOU RUN OUT OF FUEL**

Although there is uncertainty as to what the landscape will look like without LIBOR, opinions on the reliability of legacy contracts referencing and relying on the LIBOR rate after end-2021 are
clear. Regulators have raised concerns that the number of banks on the LIBOR panel will deplete so much that the question will be raised as to whether the rate is representative of the underlying market. On this premise, the Financial Conduct Authority (FCA) has asked for fallback provisions to be considered where LIBOR is referenced, as there is likely to be a scenario where such loss of representativeness would lead to “legal and regulatory restrictions”. On this basis, relying on LIBOR post-2021, and even post-2020, is not an advisable option. Indeed, corporate borrowers should be executing their own transitional plans now, including in relation to existing contracts.

**FALLBACK WHIPLASH**

There is a likelihood that LIBOR will become unavailable as a reference before the end of 2021, leaving legal and commercial uncertainty for the parties to a contract which, on its face, requires payments to be made by reference to a non-existent rate.

Some contracts make no provision for this scenario. Some include so-called ‘fallback’ clauses. Some of those clauses were never designed for the permanent end of LIBOR. Other fallback clauses amount to a procedure for negotiation, while some attempt to fix a
replacement rate-setting mechanism. While fallback clauses have been referred to as the seatbelt in the journey of transition away from LIBOR, they should be used only as a last resort. Although the types of fallback language are varied between different financial products, there is likely to be one similarity between them all: many fallback clauses were drafted based on short-term concerns rather than the complete cessation of the benchmark. Therefore, many fallback clauses are not adequate for purpose.

At best, interpretation of ceased LIBOR rates could lead to substitution of an alternative, possibly more costly or possibly simply inadequate, rate for the corporate borrower. At worst, it may be considered that the cessation of LIBOR was beyond the contemplation of the parties when entering the contract and constitute a frustrating event, amounting to termination of the contract with significant wider consequences to the financial markets. With crowds in search of an adequate alternative in late 2021, buyers may lose control.

Amid this uncertainty, we suggest two near-certainties. First, corporate borrowers will not be prepared to refuse to pay if an argument arises over the appropriate rate for a payment that has become due in a world without LIBOR. Second, the replacement
proposed by the corporate borrower’s counterparty will err on the side of transferring value to the bank, not the borrower. If we are right about these things, that dictates a strategy today, rather than cruising toward the cliff-edge.

**STEERING AWAY FROM A CRASH**

In our view, corporate borrowers with existing LIBOR-referencing debt should now be negotiating an alternative rate with their financial counterparty, sufficiently in advance of the time when LIBOR ceases to exist to avoid an undesirable outcome. There is also the issue of future funding requirements and their structure.

In the UK, the preferred replacement rate is Sterling Overnight Index Average (SONIA), an already well-established rate in the market, published by the Bank of England. An unsecured overnight rate, its advantage lies in the fact that it is calculated using actual transactions and thereby is less susceptible to manipulation. However, key differences between LIBOR and SONIA create difficulties in a seamless transition.

First, LIBOR is forward-looking and published on seven lengths of interest period, whereas SONIA is a backward-looking overnight rate. This has the consequence that SONIA cannot be de-
terminated until after the period, thereby creating uncertainty as to applicable rates on the market. Second, LIBOR includes a liquidity premium and accounts for credit risk. SONIA does not. The lender will require a spread and, with the best will in the world, finding an equivalent to that built into LIBOR will not be straightforward.

Although work has been undertaken by the International Swaps and Derivatives Association (ISDA) to establish a methodology to calculate the relevant spread between SONIA and LIBOR, this has only been based on historical data. This can therefore only be an estimate of what the future difference will be. An alternative option would be to consider another forward-looking rate. However, this may carry the same risks that allowed LIBOR to be manipulated.

**NAVIGATING THE TERRAIN**

The use of SONIA in derivatives markets and bond markets has been increasing since 2018, and regulators are now turning up the heat to continue the introduction of risk-free rates, such as SONIA and to cease trading LIBOR. The Working Group on Sterling Risk-Free Reference Rates has set out a roadmap detailing 2 March 2020 as an appropriate date for the move of new sterling
swaps to SONIA, which has been encouraged by the FCA and a ‘Dear SMF’ letter that threatened supervisory tools to ensure that LIBOR ceases to exist by the end of 2021.

Substantial work has already been undertaken to complete the transition but there is a clear imbalance in the market. Those bigger players in the market, some of whom were referenced in the scandal, are already placing themselves ready for a seamless transition. However, it should be noted that their smaller counterparts may not be as fully prepared.

**TURN OFF CRUISE CONTROL, START DRIVING**

Corporate borrowers do not have the UK protection which consumers enjoy and cannot rid themselves as readily of unfair replacement rates imposed by their lenders. There is a reasonable likelihood that banks will, where they can, impose bank-friendly spreads to reflect the absence of credit risk in the most likely replacement rates. Legal risk is significant, since the courts will face the same difficulties as the markets in judging between competing arguments over the appropriateness of different replacement rates or synthetic structures. Some protection will be afforded by the courts which, following the Braganza case, will adopt restric-
tions on one party’s contractual freedom to abuse a power to make decisions to the detriment of the other.

Notwithstanding this, corporate borrowers should in our view take control now. The way forward is to contact the counterparty and negotiate. Some borrowers might be able to trade out of a strong position. Others may not, but may at least be able to take advantage of the time available in 2020 to avoid the risks which are likely to hit in 2021.

If negotiations do not show promise, then corporate borrowers should take steps to put in place an alternative strategy. Waiting for the market to develop appropriate new benchmarks in time is more passive than may be wise. Derivatives strategies may be available. In our view, a corporate borrower for whom negotiations with the bank have failed should take the legal fight to the banks early. This should be done well before the risk materialises that LIBOR is not available as a reference rate. If not, short of not paying, the cards will all be in the lenders’ hands.

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