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The disappearance of LIBOR

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How companies should assess whether LIBOR's disappearance might impact them?

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What the key risks might be for companies?

As a benchmarking tool, LIBOR is deeply embedded in operating models, contracts and other types of financial arrangements. Moreover, some markets rely on 'forward-looking' interest rates, and reliable benchmarks to replace LIBOR in this regard are still under discussion.

Moving to an alternative benchmark will not only affect how contracts are priced and risk assessed but any change could give rise to legal, regulatory and even litigation challenges, which could create previously unanticipated problems (or possibly benefits). There could clearly be 'winners' and 'losers' in such situations.

In some cases renegotiation of products may not be necessary. Where renegotiation is needed this could lead to increased exposure to financial risks and even early termination of contracts which could eventually lead to claims for redress."

What can companies do in response?

Devote sufficient time and resources to implement the necessary transitional changes. It is paramount that companies agree on their transition roadmap as early as possible after taking stock and advice as to the effects of the cessation of LIBOR on their business and contracts.

The strategy should outline the steps being taken from an operational, legal and regulatory point of view to move from LIBOR to an alternative benchmark. They should also have a clear idea of how they intend to manage the financial risks of transition.

Where a business decides that it is impractical to convert the reason for doing so and the potential implications should be sufficiently communicated to all internal and external stakeholders.

Background

What is LIBOR?

The London Interbank Offered Rate (LIBOR) is a published measure of interest rates (in short, an average rate) at which banks are willing to lend to each other on an unsecured basis over certain periods. The rate is identified through data submitted by certain 'panel banks'.

How has LIBOR been used?

According to a presentation from November 2018 by 'The Working Group on Sterling Risk-Free Reference Rates' (the "WG Nov 18 presentation"), LIBOR "*is a major interest rate benchmark which underpins c.$300tn ($30tn in* [sterling] *markets) of financial contracts*

including, derivatives, bonds and loans."

The UK Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) have in particular identified that, among others, various insurers and real estate lenders and borrowers have referred to LIBOR in respectively designing capital calculation/modelling systems (under 'Solvency II') and drafting contractual terms for loan agreements.

Further use by non-FS firms is indicated in media stories as to the use of derivatives, which could include LIBOR-based interest provisions, by corporates as risk 'hedging' mechanisms (eg as to movements on various financial indices).

In what way is LIBOR 'disappearing'?

In the words of Edwin Schooling Latter of the FCA in a speech from January 2019: "*Thanks to the agreement reached with 20 panel banks to continue submitting until end 2021, LIBOR is not expected to cease before that point*."

In other words, LIBOR can continue, or will cease, to be available subject to the availability of the requisite data from panel banks, but 2021 looks to be a key threshold.

Why is LIBOR 'disappearing'?

In short, LIBOR is decreasingly relevant. It has ceased to be sufficiently representative – both in terms of the methodology for its calculation, and by reference to the aggregate value of the transactions on which such calculation is based – of the interest rates for unsecured loans in the financial markets.

What is replacing it?

In general terms, the Sterling Overnight Indexed Average (SONIA) is the replacement for LIBOR in terms of being a standard measure for interest rates. In broad terms, SONIA is the interest rate for banks to lend money to each other overnight.

SONIA is different from LIBOR in that, in effect, SONIA is a report on rates in respect of transactions that have occurred for a very short period, whereas LIBOR projects rates up to the end of a much longer future period.

According to the WG Nov 18 presentation: "*The average value of transactions underpinning SONIA since April 2018 is c.£45bn per day*"; by contrast: "*During 2017…there was only £187m of* [average daily] *deposits* [in respect of '3m' (3-month period, or 'tenor') sterling loans]...*the most widely used…*[sterling] *tenors".*

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