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Financial Technology (FinTech) and Regulation

Part One in the *LIBOR Uncertainty* Series

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How the Syndicated Loan Market is Dealing with the Potential Replacement of LIBOR

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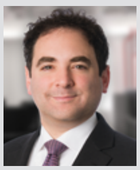

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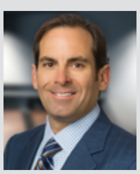

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The May 2008 disclosure of the manipulation of London Inter-Bank Offered Rate (LIBOR), in what has become known as the 'LIBOR Scandal'; resulted in regulators for the United States, the United Kingdom and the European Union fining banks more than $9 billion. LIBOR underpins over $350 trillion worth of transactions each year, of which about $200 trillion consists of derivatives, mortgages and, of particular of concern here, syndicated loans.[1] To get a better sense of the magnitude of LIBOR-based transactions, it is useful to consider that the amount of annual transactions under LIBOR totals about five times the gross domestic product (GDP) of the entire world. In 2017 statements by the chairman of the Bank of England led to increased momentum to replace LIBOR. On April 3, 2018, the Federal Reserve Bank of New York (New York Fed) began publishing a new rate called the Secured Overnight Financing Rate (SOFR) which has the potential to be a replacement for LIBOR. However, as discussed below, it is far from certain that SOFR is the best suited rate to replace LIBOR in the syndicated loan market.

Part One of this series discusses: (i) what is LIBOR? what concerns are currently associated with it? and whether it is likely to be replaced, and (ii) how the loan market is adjusting to the current uncertainty surrounding LIBOR's fate. Part Two, originally published in Risk Magazine on March 29, 2018[2], will discuss possible fintech solutions which have the potential to revolutionize the process of determining LIBOR and/or other reference rates.

What is LIBOR and How Important is it to the Loan Market?

LIBOR, now officially known as ICE LIBOR, is comprised of a series of rates, traditionally issued daily by the former British Bankers Association (BBA). The role of administering LIBOR was

[1] U.S. Libor Exposures Larger than Thought at $200 Trillion: ARRC, (March 5, 2018), REUTERS, https://www.reuters.com/article/us-usa-bonds-libor/u-s-libor-exposures-larger-than-thought-at-200-trillion-arrc-idUSKBN1GH2Z8. *See, also*, Britain to Scrap Libor Rate Benchmark from End of 2021 (July 27, 2017), REUTERS, https://www.reuters.com/article/us-britain-regulator-libor/britain-to-scrap-libor-rate-benchmark-from-end-of-2021-idUSKBN1AC18L.

[2] https://www.risk.net/comment/5464761/how-fintech-could-reboot-libor

transitioned from the BBBA to the Intercontinental Exchange (ICE), an independent UK subsidiary of the private U.S.-based exchange operator, following the LIBOR scandal. These rates are used to determine the interest rate on most variable interest rate products. LIBOR is intended to represent the average cost of unsecured borrowing to banks and is calculated as the interest rate at which a bank would be able to borrow unsecured funds from other banks.

LIBOR is calculated by a representative panel of global banks that provide an estimate of their borrowing costs to the Thomson Reuters data collection service each morning at 11:00 a.m. Thomson Reuters discards the highest and lowest 25 percent of rates submitted and then averages the remaining rates to determine LIBOR. LIBOR is published for five different currencies—the U.S. dollar, the euro, the British pound sterling, the Japanese yen, and the Swiss franc—at seven different maturity lengths from overnight to one year, LIBOR is the most relied upon global benchmark for short-term interest rates. The rate for each currency is set by panels of between eleven and eighteen banks.

One of the 35 available LIBOR rates is generally the starting point for determining the interest rate applicable to a financial product, such that a rate for a high yield transaction commonly is a LIBOR rate plus an additional amount, often referred to as the "spread". The total interest rate of a transaction can thus be seen as the LIBOR rate reflecting the cost of capital in the market generally and the spread reflecting the specific counterparty risk of an entity entering into such transaction. The widespread use of LIBOR is based on the premise that the same underlying rate of the cost of funds can be relevant across a broad range of transactions. The USD 90 day-rate is by far, the most commonly used LIBOR rate, and the rate from which the interest rate for almost all syndicated loans in the United States are calculated.

Over the years, LIBOR's accuracy in representing the cost of borrowing in the economy has lost some credibility. This is primarily because banks generally do not borrow funds from each other in this manner anymore. As such, the request from a bank of for its cost of borrowing is asking a hypothetical question and not a practical one. Mervyn King, former Governor of the Bank of England, has described LIBOR as "the rate at which banks don't lend to each other, and it is not clear that it either should or does have significant operational content."[3] The difficulties in obtaining LIBOR were compounded by a number of reports, starting in around 2008, of banks providing artificially low LIBOR rates in order to inflate the perceived strength of their financial condition. Since LIBOR rates are submitted without any back-up information, there is very little transparency as to how the numbers are obtained.

There were also widespread allegations and reports that individual bankers were colluding to actively manipulate the LIBOR in order to profit on trading and transactions. These allegations led to multiple arrests, fines, lawsuits and settlements, some of which are ongoing. In response to those events and the general uncertainty surrounding LIBOR around 2010, Mervyn King and others called for LIBOR to be replaced with another reference rate that would reflect actual transactions and thus would be more accurate and less prone to manipulation. However, due to its versatility and popularity, many would prefer that LIBOR be reformed and not replaced. As part of its efforts to reform LIBOR, the UK Financial Conduct Authority (FCA), has stated that it is improper for banks to report the wrong rate and requires banks to participate in the LIBOR reporting process. However, these reforms have not fixed the problems underlying LIBOR.

The future of LIBOR returned to the attention of the financial markets when, on July 27, 2017, Andrew Bailey, head of the FCA, stated that he hopes that the situation that banks are required to submit rates for LIBOR will no longer be in effect after 2021[4] and that it is the FCA's position that "it is not only potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them."[5] Although his statement was reported in the media as the death of LIBOR, this is not an accurate representation of Mr. Bailey's message. It appears increasingly likely that the USD 90 day rate will still be available even after 2021, particularly if there is no market consensus on a replacement.

Regardless of the long-term viability of LIBOR, this recent uncertainty raises two questions for the syndicated loan market.

[3] UK Parliament, Examination of Witnesses, (Nov. 25, 2008), available at: https://publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/1210/8112503.htm.

[4] Andrew Bailey, FCA Chief Executive, Speech at Bloomberg London: The Future of LIBOR (July 27, 2017), available at https://www.fca.org.uk/news/speeches/the-future-of-libor.

[5] Id.

First, how can lenders protect themselves under existing loan agreements in a situation where LIBOR is not available, and second, which benchmark rate can be developed to replace LIBOR.

What Happens if LIBOR Is Not Available Under Loan Documents?

Under many credit agreements, if LIBOR were not available, , the interest rate under the loan would be changed to a base rate which is the official borrowing rate set by the Federal Reserve and is generally lower than LIBOR, for the period that LIBOR isn't available. Some credit agreements also provide a mechanism for taking a poll of the market to determine the appropriate interest rate in the event that LIBOR isn't available. . In this way loan agreements generally differ from Collateral Loan Obligation (CLO) documentation under which the last LIBOR rate in effect is often prescribed for situations where LIBOR isn't available. The problem with over-reliance on the existing provisions in credit agreements is that these provisions were drafted to anticipate a temporary disruption (such as natural disaster or war) and as such are not a good solution for a permanent discontinuance of LIBOR.

The Loan Syndications and Trading Association (LSTA), the industry association for the syndicated loan market, established a working group to study what loan market participants are doing with their credit facilities with regard to the potential discontinuance of LIBOR and to recommend an approach to the extent that there is market consensus. Since most loan agreements have a term of three years or less the LSTA does not recommend that existing loan agreements be amended. For new facilities and those subject to amendment, parties are incorporating revised language to deal with a potential long-term discontinuance of LIBOR. The examples of LIBOR replacement language that have been collected to date by the LSTA, show that there continues to be significant variation in drafting approaches.

Probably the single most important concern for lenders in the event that LIBOR is not available is what control they will have over the replacement rate. In light of the uncertainty surrounding the difference between the new rate and the cost of funding for banks such a difference in funding costs could potentially have a very significant economic impact on lenders.

While there is not yet consensus among lenders on a preferred approach for the long-term non-availability of LIBOR, the following five approaches appear to be most popular:

- authorizing the administrative agent to choose the successor rate without consulting the borrower;
- authorizing the administrative agent to select the successor rate in consultation with the borrower;
- authorizing the administrative agent and borrower to jointly select the successor rate;
- requiring lenders and borrowers to jointly approve the successor rate; or
- authorizing the administrative agent and borrower to determine the successor rate and giving lenders negative consent rights (deeming their non-objection within a specified period of time an approval).

Given this lack of consensus on suggested procedures for determining a successor rate and the multitude of proposals, the LSTA decided to not publish guidelines or model language at this time. This decision stems from the LSTA's practice to reflect, not forge, consensus. However, the LSTA noted the benefit of providing lenders the right to object to a proposed successor rate. The LSTA plans on reexamining this position in the next six months, at which time it might publish guidelines or suggested language.

Potential Replacement for LIBOR

Since 2014, the Alternative Reference Rates Committee (ARRC), a group primarily focused on the derivatives market has been working on a replacement for LIBOR. In June 2017, ARRC announced its preferred alternative rate to replace LIBOR to be based on the cost of overnight borrowing of Treasury securities and suggested to call the rate the Broad Treasury Financing Rate (BTFR). This rate has recently been renamed the Secured Overnight Financing Rate (SOFR). Although the syndicated loan market comprises a small percentage of LIBOR based transactions and as such it will likely have limited influence on the permanent replacement of LIBOR, the LSTA has since its inception had representation on both the ARRC subcommittee dealing with business loans and the ARRC CLO working group and recently joined the main ARRC committee to continue advocating for the interests of the loan market.

Currently, SOFR appears to be the most prominent potential LIBOR replacement, especially considering that the New York Fed started to publish the rate in April 2018 following a comment period.[6] On April 3, 2018, the New York Fed set the first SOFR, by calculating the volume-weighted median rate, at 1.80%.[7] Even though ARRC has made clear its preference for SOFR, the New York Fed has not let go of its other two contenders to replace LIBOR, the Broad General Collateral Rate (BGCR) and the Tri-Party General Collateral Rate (TGCR) and, on the same day as SOFR was launched it began publishing these rates as well.

SOFR seeks to deal with the flaws of LIBOR by being "fully transaction-based" and encompassing a robust underlying market. The first SOFR was based on $949 billion in overnight repurchase agreement transactions collateralized by Treasury securities between April 1, 2018 and April 2 2018.[8] However, unlike LIBOR, SOFR is a secured rate. There are reasons to be concerned about the long-term viability of basing the interest rate for loans on a secured rate. That is, at least in part, due to the fact that interest rates are at historic lows and if this were to change, as it eventually will, the delta between secured and unsecured rates could become considerable and SOFR would no longer be an accurate measure for the cost of capital for lenders. Simply stated, like a broken clock tells the correct time twice a day, just because SOFR may be a fairly adequate representation of the cost of borrowing for lenders today, does not mean it will remain so in the future.

[6] Press Release, Federal Reserve, Federal Reserve Board requests public comment on proposal to produce three new reference rates based on overnight repurchase agreement (repo) transactions secured by Treasuries (Aug. 24, 2017), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170824a.htm.

[7] Operating Policy, Federal Reserve Bank of New York, Statement Introducing the Treasury Repo Reference Rates (April 3, 2018), https://www.newyorkfed.org/markets/opolicy/operating_policy_180403.

[8] In March 2018, LIBOR backs about $200 trillion in derivatives and loans, an increase of 25% since previous estimates and, to make the process even more delicate, actual inter-bank borrowing has decreased from about $500 trillion at its peak and just about $68 billion in February 2018. In February 2018, the St. Louis Fed discontinued publishing of LIBOR data. Board of Governors of the Federal Reserve System (US), Interbank Loans, All Commercial Banks (DISCONTINUED), FRED, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/IBLACBW027NBOG.

Conclusion

The manipulation of LIBOR has led some to believe that it is no longer an accurate representation of the cost of borrowing in the economy for the reasons discussed above. It is unclear if LIBOR will be reformed or replaced by a new rate such as SOFR which has already started to be published. The LSTA has officially joined the ARRC demonstrating its continued commitment to ensuring that the syndicated loan market has access to a rate that is based on real transactions and that is designed to achieve the stated goals of LIBOR. Meanwhile, the loan market should prepare for the possibility of LIBOR no longer being available by including appropriate language in new and amended loan agreements.

Part Two of this series will consider various fintech solutions including the use of blockchain technology to reform and/or replace LIBOR through implementing systems that involve: (i) collecting real transaction data that is randomized and encrypted to ensure transparency and accuracy of the resulting rate, (ii) inputting such data on the blockchain to avoid manipulation, and (iii) issuing of a special cryptocurrency to provide incentive to banks to submit relevant and arcuate reference rates.

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