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Interest rate benchmark reform: current issues for the loan market

Almost nine months on from the publication of the Wheatley Review of LIBOR and the practical impact on the loan market of the proposed reforms is stepping up a gear. The discontinuation of screen rate LIBOR for some currencies and maturities is taking full effect, leading to a search for acceptable replacements. There have been unexpected problems for the customary Reference Bank contingency measure which is also under pressure from other aspects of the reform process. All the while US regulators are pushing for a complete replacement of LIBOR.

Key points

- Screen rate LIBOR has been discontinued for a number of currencies and maturities
- The standard contingency fallback to Reference Banks is struggling to supply a replacement LIBOR
- Discontinued maturities are being addressed through the use of interpolation of screen rate LIBORs
- Currently, there is no widely accepted alternative pricing benchmark for discontinued currencies
- The LIBOR reform process and the climate that it creates may present wider problems for the Reference Bank fallback
- There is pressure from the US for wholesale replacement of screen rate LIBOR

Discontinuation of screen rate LIBOR

The BBA has implemented the Wheatley Review's recommendation that screen rate LIBOR be discontinued for certain currencies and maturities, which we shall call "***Discontinued LIBORs***".

These are summarised in the box "*Screen Rate LIBOR – where are we now?*" below.

Screen Rate LIBOR – where are we now?

No Screen Rate LIBOR	
AUD	NZD
CAD	SEK
DKK	

Screen Rate LIBOR continues BUT fewer maturities
CHF
EUR
GBP
JPY
USD

Discontinued maturities
2 weeks
4, 5, 7, 8, 9, 10, 11 months
Continuing maturities
Overnight/spot–next
1 week
1, 2, 3, 6, 12 month(s)

Impact of the shrinking London interbank market

In the absence of a screen rate LIBOR the standard contingency provision in loan documents is the Reference Bank mechanism. This works by Reference Banks submitting quotes to the agent bank for their cost of borrowing the relevant currency for the relevant maturity in the London interbank market. The average is then used as the LIBOR for the loan in question. For a more detailed explanation of rate setting in loans, see the box "*How does LIBOR setting work for loans?*".

Recent experience is that this fallback is not always working for Discontinued LIBORs. This is perhaps unsurprising given that the Wheatley Review concluded that there was insufficient trading data for Discontinued LIBORs. Some Reference Banks are struggling to provide quotes for borrowing in the interbank market in currencies and for maturities for which there are very few (if any) transactions on which to base those quotes. Without the Reference Banks providing quotes there is no Reference Bank rate and the loan is left to be individually priced on a lender-by-lender basis by reference to each lender's cost of funds. This is not palatable practically or commercially.

Solutions?

Using a Reference Bank mechanism was never likely to be a desirable option for regular rate setting given the additional administration involved. However, the difficulties of applying it in practice for Discontinued LIBORs means that the hunt is on in earnest for alternatives.

Discontinued maturities

These can be addressed relatively easily by providing that, if a screen rate LIBOR is unavailable for the maturity in question, a loan's LIBOR should be determined by interpolating between the two nearest available screen rate LIBORs. This approach seems to be gaining traction, assisted no doubt by the publication of both LMA and ISDA wording.

Discontinued currencies

Interpolation is obviously no fix for the more difficult issue of discontinued currencies. There is no avoiding the difficult commercial question: what pricing benchmark is appropriate? The underlying issue is philosophical: should the commercial imperative be to reflect as accurately as possible a syndicate's cost of funds? Or should it be simply to identify a readily accessible and transparent rate off which the loan can be priced? Some potential options that have been discussed are set out below, together with possible advantages and complications.

1. Domestic benchmarks

Domestic benchmarks exist for all the currencies for which screen rate LIBOR has been discontinued (see the box "*Domestic benchmarks for discontinued currencies*" below). Euromarket loans could be priced by using these benchmarks instead of LIBOR.

Advantage
Availability: these rates are published on screens, are easily available and seem to be widely used as a representation of a domestic bank's cost of wholesale funds in the local markets.

Complications
Potential disconnect from funding cost: domestic benchmarks are, by their nature, based on domestic markets

How does LIBOR setting work for loans?

That LIBOR reforms are impacting the syndicated loan market is unsurprising. Ever since their inception around 40 years ago, the interest rate for syndicated loans has typically been expressed as a specified margin over the rate of borrowing in the unsecured London interbank market (LIBOR) reflecting the historic assumption that lenders would fund their lending from that market.

Although the reality for a while has been that most lenders obtain their funds from a variety of sources, LIBOR has remained the most common and accepted benchmark for syndicated lending pricing. Modern loans determine LIBOR primarily by reference to screen rate LIBOR, currently administered by the BBA. They recognise that a screen rate may not always be available and have as their primary contingency measure a fallback for the loan's LIBOR to be the average of quotes of borrowing rates in the interbank market supplied by Reference Banks. Failing that, the loan's LIBOR is determined on a lender-by-lender basis by reference to each lender's self-certified cost of funds – intended to be a short-term emergency measure only.

and are largely intended to reflect a local bank's cost of wholesale funds in the local currency. Lenders which do not have access to those local markets may consider that local benchmarks risk understating their cost of funds to too great an extent for use as a pricing benchmark in euromarket loans. It might, of course, be possible to address such concerns in the loan's pricing, as the market saw recently with pricing premiums attaching to US dollar tranches.

Practical issues: some domestic benchmarks are set on a same day basis. Assuming that euromarket lenders require 2 business days' notice to fund the relevant currencies the rate used will have either to: (i) be fixed (and known) before funding and so will not match exactly the loan's interest period; or (ii) be fixed after funding (and therefore unknown at funding) to match exactly the loan's interest period.

Fallback in case of unavailability: traditionally the aim of a Reference Bank fallback is to replicate contractually the methodology of the chosen screen rate. If this remains the preferred approach then the chosen Reference Banks will have to be institutions which are active in the relevant local market. This is likely to mean different Reference Banks per currency and may also mean that it is impractical to require Reference Banks to be lenders. Depending on the significance of the relevant currency in the relevant loan, it may be considered that it is more pragmatic simply not to include a Reference Bank style fallback to the domestic screen rates and, in the absence of another fallback, to accept that if the domestic screen rate is unavailable then the loan falls to be priced on the basis of individual lenders' cost of funds.

Domestic benchmarks for discontinued currencies

AUD	Bank Bill Swap Reference Rate (**BBSW**). Published by the Australian Financial Markets Association. Based on rates for certain short-term securities issued by specified banks operating in Australia.
CAD	Canadian Dealer Offered Rate (**CDOR**). Overseen by the Investment Industry Regulatory Organization of Canada. Based on bid rates for Canadian bankers' acceptances.
DKK	Copenhagen Interbank Offered Rate (**CIBOR**). Administered by the Danish Bankers Association. An interbank borrowing rate based on interest rates for unsecured interbank borrowing in the Danish interbank market.
NZD	New Zealand Bank Bill Reference Rate (**BKBM**). Published by the New Zealand Financial Markets Association. Based on mid rates for discount securities issued by specified banks registered in New Zealand.
SEK	Stockholm Interbank Offered Rate (**STIBOR**). Administered by the Swedish Bankers' Association. An interbank borrowing rate based on interest rates for unsecured interbank borrowing in the Swedish interbank market.

2. LIBOR plus f/x swap

An alternative would be to base the interest rate on a combination of:
(i) screen rate LIBOR for another currency (e.g. US dollars or euro); and (ii) the cost of swapping that currency into the currency in question.

Advantage
Approximation of funding cost: in the seeming absence of an active London interbank market for the discontinued currencies such a formulation might be the best approximation of the method by which the largest number of euromarket lenders routinely obtain funds in these currencies.

Complications
Availability: although this type of composite rate is well established and recognised for some currencies, this is not necessarily the case for the discontinued currencies. Any such rate would need to be constructed on a bespoke basis using currently available swap rates.

Fallback in case of unavailability: if a Reference Bank mechanic was to be used it would likely need to consist of both a Reference Bank LIBOR and a Reference Bank swap rate.

Complexity: any move to a composite LIBOR/swap rate for some currencies would inevitably complicate a facility agreement's infrastructure.

3. Central bank interest rates

At the other end of the spectrum in terms of complexity would be to base the interest rate on the base rate published by the central bank of the currency concerned. This approach is already used in some markets, such as the US market where some loans are priced off the Federal Funds rate.

Advantage

Availability: central bank rates are obviously widely available and easily ascertainable.

Complication

Potential disconnect from funding cost: there would be a similar issue as already discussed above in the context of domestic benchmarks. It is likely that not all lenders will be able to access funds from the relevant central bank and so the central bank's rate might not be thought to accurately reflect a syndicate's cost of funds. Even banks with ready access to the relevant central bank may regard its rate as too low a benchmark particularly as most headline central bank rates approximate to the cost to banks of borrowing from their central bank on an overnight basis. Again, it is possible that such concerns could be addressed in the loan's pricing.

Documentary aspects

Though clearly secondary to the commercial issues, the documentary aspects of any new benchmark for discontinued currencies should not be overlooked. Of particular significance is that much of the plumbing of euromarket loan documentation (such as business day conventions, market disruption provisions and other provisions) is driven by the assumption that lenders will fund the loan from the interbank markets. If new benchmarks abandon that concept a number of those provisions may need recasting. The extent of this will turn on whether any new benchmark is designed to reflect an assumed funding process.

Implementation

On new transactions the implementation of any solutions becomes part of the documentation and negotiation process. Perhaps more pressing are existing transactions where pricing might well fall to be determined on a lender-by-lender basis if the Reference Banks are unable to provide quotes for Discontinued LIBORs. If it is considered desirable to amend documentation to provide for interpolation and/or some form of alternative benchmark, focus will shift to the amendment provisions in loan documentation.

Any amendment will invariably require the borrower's consent. The important question is whether majority lender consent will be sufficient or whether all lender consent will be required (often very hard to achieve in practice). Although hard to generalise, it is likely that, on the basis of market standard provisions, this question will come down to the extent to which the amendment "*relates to .... a reduction in the amount of .... any payment of .... interest .... payable*". The terms of any intercreditor agreement, which often restrict amendments to yield provisions, would also need to be considered.

Issues for the Reference Bank fallback generally?

The Discontinued LIBORs have highlighted that the Reference Bank mechanic requires an active interbank market for the currency and maturity concerned in order to operate effectively. However, there are concerns that reform of screen rate LIBOR might impact more fundamentally on the Reference Bank concept.

Code of Conduct and confidentiality requirement

One of the Wheatley Review's recommendations was that a Code of Conduct be developed to guide the behaviour of institutions which submit rates for screen rate LIBOR purposes.

Although this is not yet a public document, it seems likely that it will impose an obligation on a submitting institution to keep its screen rate LIBOR submission, and anything related to that submission, confidential. There has been a concern that this could mean any institution which submits rates for screen rate LIBOR would be unable to act as a Reference Bank. Although worrying on its face, this ought not to be insurmountable. Firstly, it is clear that this requirement would have no impact on a submitting institution being a Reference Bank in respect of a currency or maturity for which screen rate LIBOR is not produced or for which that institution does not submit rates for screen rate LIBOR purposes. Secondly, it seems likely that the final Code of Conduct will allow screen rate LIBOR submitters to contribute their screen rate LIBOR submissions to contractual Reference Bank fallbacks provided that suitable confidentiality obligations are in place.

Increased risk aversion

The more fundamental concern for the Reference Bank mechanic is less tangible: that in the current climate, institutions may simply be more reluctant than previously to contribute quotes towards contractual rate-fixing mechanics. This might lead to changes to the Reference Bank mechanic in loan documentation.

Intermediate fallbacks could be used for any temporary unavailability of screen rate LIBOR, with Reference Banks being used only if the screen rate is unavailable for a significant period. Examples that could be considered include temporarily using either the previous interest period's LIBOR or an overnight screen rate LIBOR on a rolling basis.

Additionally, potential Reference Banks might seek higher levels of contractual protection from other syndicate members and borrowers in response to any perception of increased litigation risk.

Distant drums

In case the here and now was not enough, there are also question marks over LIBOR's medium to long-term future.

The Wheatley Review clearly envisages reform rather than replacement of the benchmark. However, in a global village it is hard to ignore the well-publicised views of US regulators that LIBOR is "*unsustainable*" and that replacements are needed – although what those replacements might look like is unclear.

In the medium to long term the loan market might find itself (together with the derivatives market and all other financial markets which reference LIBOR) needing to adjust to a discontinuance and replacement of screen rate LIBOR that goes significantly beyond the dropping of certain currencies and maturities.

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