CLIFFORD CHANCE

LIBOR – A BRIEF HISTORY

– THOUGHT LEADERSHIP

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In July 2017, the Chief Executive of the Financial Conduct Authority (FCA), Andrew Bailey, signalled the beginning of the end for LIBOR as an interest rate benchmark. He said that, in spite of the various reforms introduced from 2012, the underlying market for unsecured wholesale term lending to banks is "no longer sufficiently active" and it is "potentially unsustainable, [and] also undesirable, for market participants to rely indefinitely on reference rates that do not have actual underlying markets to support them." So, how did we get to this point?

Risk-free benchmarks

Regulators have been encouraging market participants to consider alternative "risk free" benchmarks for some time. Mr Bailey's speech heralded a period of transition away from LIBOR and towards benchmarks based on these "risk-free rates" (RFRs) by stating that there would be a voluntary continuation of panel submissions to sustain LIBOR until the end of 2021, but after that time it was no longer intended that the FCA would use its powers to compel banks to submit to LIBOR. Given that it is widely believed that many panel banks currently only submit to LIBOR because they are effectively compelled to do so by regulators, it is likely that this means that LIBOR will cease to be published by the end of 2021 at the latest (possibly earlier if suitable RFR alternatives are in place).

Although participants in the derivatives market had been planning for the introduction of RFR benchmarks for some time, Mr Bailey's speech came as a surprise to the loan markets and other "cash" markets. Indeed, the fact that such alternatives had been largely sponsored by the derivatives markets meant that their suitability for the loan market was questioned by many market participants.

Consultation and transition

The loan markets are in a period of consultation as to how loans can transition from being based on LIBOR, EURIBOR and other IBOR type benchmarks to being based on alternative RFR benchmarks.

Currently, the position with regard to the alternative RFR based rates for each of the five LIBOR currencies is:

Sterling	A Working Group on Sterling RFR has recommended that a reformed version of the Sterling Overnight Index Average (SONIA) should be the alternative benchmark for Sterling LIBOR. This rate is based on unsecured overnight transactions
US Dollars	The Federal Reserve's Alternative Reference Rates Committee (ARRC) has selected the Secured Overnight Financing Rate (SOFR – a broad treasury repo financing rate) as the alternative rate for Dollar LIBOR.
Swiss Franc	The Swiss National Working Group on RFRs has identified SARON, a secured overnight repo rate, as the Swiss Franc alternative.
Japanese Yen	The Japanese Study Group on RFRs has selected TONA (an unsecured overnight rate) as the Japanese Yen alternative.
Euro	A private sector working group selected the Euro Short Term Rate – ESTER – an unsecured overnight rate, as the alternative for EONIA (Euro Overnight Index Average).

A brief history of IBOR and LIBOR

From the outset of the creation of the syndicated loan market, the market worked on the principle that pricing would be based on the interest rate at which interbank deposits were offered by banks to other prime banks (IBOR). In most cases this IBOR was set in the London market (LIBOR) although over time IBOR rates have been set in other markets.

This use of IBOR rates as benchmarks for interest rates arose because in the early days of the syndicated loan market banks actually funded their participations in the loans via the taking of deposits in the interbank deposit market for the relevant currency of the loan. However there was no requirement for lenders to fund themselves in this way and, over the years, banks funded their activities in increasingly diverse and complex ways in order to increase profit margins. Therefore, the idea that loans were being funded in the interbank deposit market became something of a fiction. However, it was a useful fiction as LIBOR (and other IBOR rates) were easily ascertainable and understandable rates which (at least until the global financial crisis) were not questioned either by lenders or borrowers.

In 1986 the British Bankers Association (BBA) took on responsibility for administering LIBOR (collecting the submissions of panels of banks for each LIBOR currency in relation to the rate at which the panel members thought "interbank term deposits will be offered by one prime bank to another prime bank for a reasonable market size today at 11am"). In 1998 the BBA changed the question asked of the panel banks so that it related to the rate at which they could borrow funds were they to do so by asking for and then accepting interbank offers.

1986-2007

However, the biggest development in relation to LIBOR during the period prior to the global financial crisis was that it was used as the basis for huge numbers (and volumes) of derivative contracts so that the aggregate value of LIBOR related derivatives dwarfed the aggregate value of LIBOR related loan transactions. LIBOR was also used in a wide variety of other financial instruments so that it was an integral part of the global financial markets.

The impact of the global financial crisis

The central role played by IBORs (and particularly LIBOR rates) in the financial markets had evolved quietly and almost without being questioned. However, the global financial crisis of 2007 and 2008 revealed a number of flaws in the IBOR benchmarks which had been largely ignored until that point. During the crisis there was a huge focus on IBOR rates as the drying up of liquidity was seen as a sign that banks did not have confidence in the creditworthiness of other banks and that this might lead to a meltdown in global markets.

After the crisis

Following the GFC and the scandals relating to IBORs which emerged from it, international regulators started to look more closely at all the benchmarks which underpin the financial markets. In July 2013, the International Organisation of Securities Commissions produced a set of principles for financial benchmarks which have been the basis for reform and regulation of IBORs and other financial benchmarks ever since. In September 2012, the initial report of the UK regulators, the Wheatley Review of LIBOR, concluded that LIBOR should be retained as a benchmark rate, but that it should be comprehensively reformed. The recommendations of the review included the discontinuance of the publication of LIBOR for certain currencies and tenors where the volumes of trades were particularly low.

In 2014, ICE Benchmark Administration (IBA) took over administration of LIBOR from the BBA. In the period from 2012-2017 regulators around the world encouraged the continued reform of IBOR based benchmark rates with the aim of ensuring that they were determined using actual transactional data rather than the judgement of the submitting banks. IBA has, for example, implemented a number of changes to the determination of LIBOR and similar changes have been implemented and/or considered for other IBOR related benchmarks (including EURIBOR which is the principal benchmark used for Euro interest rates).

The administration of, and submissions to, LIBOR became regulated under the UK Financial Services and Markets Act following the Wheatley Report and the European Benchmarks Regulation brings activity related to a wide variety of benchmarks under regulation on a Europe-wide basis.

RFR alternatives have already been identified and the derivatives markets appear to be well prepared for the transition from LIBOR to these rates. However, the RFRs identified so far are not necessarily all suitable to use in the loans market and there will need to be considerable work done before the loan markets are ready to transition away from LIBOR and other IBORs. Indeed, it could be said that such is the dependence of the loan market on LIBOR/EURIBOR that the transition away from those benchmarks may be the most significant change to the syndicated loan market since its inception.

Aligning RFRs with the loan market

There are a number of significant differences between the RFRs which have been selected as alternatives to LIBOR rates and LIBOR. In order to provide for an orderly transition to the use of interest rates based on those RFRs in the loan markets there will need to be work done either to align the RFR rates with practices in the loan markets or to change loan market practices to bring them into line with the methodology being used for the RFRs.

The regulators have recognised this and are consulting with loan market participants and trade associations like the LMA and the LSTA as to how the transition away from LIBOR can best be managed in the loan market. For example, in the Sterling market the RFR Working Group charged with promoting the transition to SONIA has established a sub-group to consider benchmark transition issues in the syndicated loan markets.

The work on transitioning away from LIBOR in the loan markets still has a long way to go, but there are clearly some key issues which need to be dealt with as follows:

- **Term rates**
  LIBOR is a forward-looking term rate (in other words a rate fixed for its period to maturity) quoted across a range of maturities from overnight to 12 months whereas the RFRs are all backward-looking overnight rates. From a borrower's perspective one advantageous feature of LIBOR is that the borrower can "lock in" the interest rate for the term of the interest period it selects so that it can be certain as to the cash outflow required when interest comes due to be paid at the end of the interest period. If RFRs were simply imported into loan transactions, then this feature would not be available. Either the borrower would have to pay interest on a daily basis or the interest payment could be made on a regular (say monthly, quarterly or six monthly) basis, but without any certainty as to the amounts to be paid because that would depend on the daily fluctuation of the overnight rate. A number of possible ways of dealing with this discrepancy have been considered including:
  - calculating a "term" SONIA by averaging the overnight rates over the interest period (but this would still not provide the certainty of a forward-looking rate);

- fixing the borrower's interest cost for an interest period by way of a basis swap (but this involves added complication and cost for borrowers); and
- establishing a variant of SONIA which replicates the forward-looking term nature of LIBOR (but this may not have a sufficient basis in real transactional data to distinguish it from LIBOR).

The jury is out on what solution the market will select. The same issues apply to all of the RFRs being introduced as alternatives to LIBOR in other currencies.

• Risk Premium

LIBOR is intended to measure the funding costs of banks and, therefore, includes an element to compensate for the credit risk of lending to a bank on a term basis. However, the RFRs are not intended to include any element of compensation for credit risk. As a result, an RFR should typically be a lower rate than the equivalent LIBOR rate. This means that in the transition from LIBOR based rates to RFR based rates in existing financial contracts it is not possible simply to substitute the relevant RFR for LIBOR because this will almost undoubtedly favour one of the parties to the contact. The various working groups looking at transition are considering how best to bridge the gap which this causes – probably by the determination of a "risk premium" element intended to equate to the discrepancy in rates at the time of transition.

• Consistency

One of the attractive features of LIBOR based lending is that a multicurrency facility including all the LIBOR currencies does not have to have a multiplicity of special features relating to drawings in each currency because they are, to a large extent, determined on the same basis (although the day count basis and timetable for Sterling differs from those for other currencies). However, it is likely that many of the features of any RFR based rate will be currency specific. For example, the RFRs are either secured or unsecured depending on currency. This could event result in there being differing margins depending on currency. The working groups on transition will have to look at whether a level of consistency can be achieved across currencies.

• Technology

The technology platforms for syndicated loans are based on the mechanics of LIBOR and thus, the discrepancies noted above mean that significant changes will be needed to those platforms in order to accommodate the transition to RFR based rates (unless the discrepancies can be eliminated).

The Future – the end of the end?

It is likely that by (or perhaps before) the end of 2021 LIBOR and (perhaps) EURIBOR will either cease to be published or will cease to be the preferred rate for use in syndicated loan transactions. The expectation is that the IBOR for each currency will be replaced by rates related to the alternative RFR rates for these currencies identified above.

It may be that the replacement rates will be modified versions of the overnight RFR rates which have been adjusted to include some of the characteristics of LIBOR identified above as being advantageous. During the transition period it is expected that loan documentation will be adjusted in order to be flexible enough to accommodate these new rates. The market will also have to find some way to enable "legacy" transactions (ones which do not contain mechanisms expressly allowing for the transition to the new rates) to be amended to allow for a move from LIBOR based rates to RFR based rates.

It is probably too early to say what solutions will be found to these issues. However, it is safe to conclude that absorbing these changes requires a huge and concerted effort by market participants.

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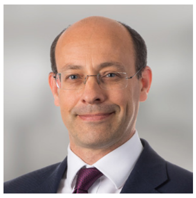

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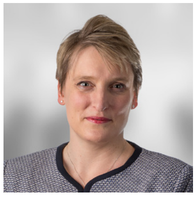

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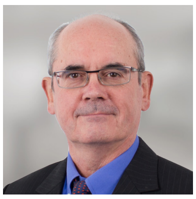

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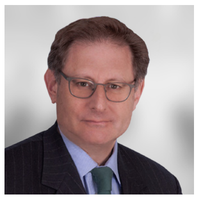

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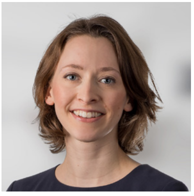

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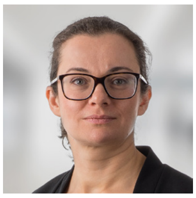

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