Client Alert | Banking and Finance

LIBOR Will Likely End in 2021: What Happens Next?

August 2017

Author: Courtney Kirkman Gücük

The UK's Financial Conduct Authority recently announced that it will not compel panel banks to produce LIBOR (the London Interbank Offered Rate) after the end of 2021. As a result, LIBOR will likely cease to exist after the end of 2021. Market participants and regulators now need to plan a transition to alternative reference rates. There is no single, obvious global replacement for LIBOR. Instead, different markets will likely have different rates.

I. The Background of LIBOR

LIBOR is an interest rate index. It is the average rate at which a group of twenty large, reputable banks that participate in the London interbank money market estimates that they would be able to borrow unsecured funds from each other in five different currencies (the US dollar, the euro, the UK's pound sterling, the Japanese yen, and the Swiss franc) across seven borrowing periods (ranging from overnight to one year). It is a floating or variable rate, and it is "forward looking", meaning it reports what the rate is today for a forward-starting term. The panel of lenders submits the rate every morning. LIBOR is administered by the ICE Benchmark Administration ("**IBA**") and regulated by the UK's Financial Conduct Authority ("**FCA**").

For over thirty years, LIBOR has been used as an international standard benchmark interest rate. LIBOR serves as a fundamental reference rate in many contracts and financial documents. It is currently used as a reference rate for about US$400 trillion worth of financial transactions, including loans, bonds, securitizations, and derivatives. It is also routinely used by tribunals in international arbitration proceedings to calculate damages and pre- and post-award interest accruing on awarded sums. LIBOR is also widely used in Turkish law governed banking and financial transactions because Turkish law recognizes the application of LIBOR under the principle of freedom of contract.

II. The FCA's Decision to Phase Out LIBOR

On 27 July 2017, the FCA's Chief Executive, Andrew Bailey, announced that the FCA will no longer compel the panel banks to contribute LIBOR after the end of 2021 and that market participants should begin a transition away from LIBOR. If the IBA and the panel banks wish to continue contributing to LIBOR after 2021, they are free to do so; however, the FCA will no longer compel participation. In other words, there is no guarantee that LIBOR will exist after the end of 2021. In reality, it is unlikely that the panel banks will continue to produce LIBOR on a voluntary basis after this date.

The FCA made this decision because the underlying market that LIBOR seeks to measure, which is the market for unsecured wholesale term lending to banks, is no longer sufficiently active. This market slowed down significantly following the global financial crisis in 2008; since then, the panel banks' submissions to LIBOR have been based more on their "expert judgment" than on their actual borrowing transactions. As a result, LIBOR has become a largely hypothetical rate. The fact that there is little actual borrowing activity in this market puts into question the sustainability of the LIBOR benchmarks that are based upon these markets. "*If an active market does not exist, how can even the best run benchmark measure it*?"[1]

In his announcement, Mr. Bailey stated that the FCA has spent a lot of time persuading the panel banks to continue submitting to LIBOR. The panel banks' participation until 2021 is necessary to avoid the market disruption that would be caused by an unexpected and unplanned disappearance of LIBOR. The FCA is empowered by UK and European legislation to compel banks to contribute to LIBOR if necessary, but the FCA would much prefer not to have to do so. Mr. Bailey warned, "*I cannot entirely discount the risk of earlier panel degradation, or having to fall back to use of our powers to compel, with all the costs and risks of a messier and more costly transition that this might crystallise*."[2]

Although the FCA has given market participants and regulators a four-and-a-half-year notice of the change, the shift away from LIBOR will be a challenge. Market participants and regulators must start work now on planning a transition to alternative reference rates that are based firmly on transactions.

Although the FCA's announcement came as a surprise to many, market participants and regulators have already been considering possible alternatives to LIBOR.

III. Possible Alternatives to LIBOR

It does not appear that there is any single, clear global successor to LIBOR. Instead, different markets may adopt different reference rates.

Consensus has been reached among derivative market participants on the preferred alternative reference rates, which could be adapted for other purposes. The following rates have been proposed as alternatives to LIBOR:

- **UK**: the Risk Free Rate Working Group selected the reformed SONIA (Sterling Over Night Index Average) in April 2017 as an alternative to GBP LIBOR. The SONIA interest rate benchmark reflects bank and building societies' overnight funding rates in the sterling unsecured market.

- **US**: the ARRC (Alternative Reference Rates Committee) announced in June 2017 that it recommended replacing USD LIBOR with a new, broad Treasury repurchase agreement[3] (or "repo") rate. The Federal Reserve Bank of New York, in cooperation with the Treasury Department's Office of Financial Research, plans to start publishing this new rate daily sometime in the first half of 2018. This is a secured rate, collateralized by Treasuries.

Mr. Bailey noted that both rates above are based on markets that are significantly more active than term LIBOR, and that neither involves the banks' "expert judgment".

- **Europe**: EONIA (Euro Overnight Index Average), which is the weighted average of overnight Euro Interbank Offer Rates for inter-bank loans, to replace EUR LIBOR.

- **Switzerland**: SARON (Swiss Average Rate Overnight), which is based on data from the Swiss franc repo market, to replace CHF LIBOR.

- **Japan**: TONAR (Tokyo Over-Night Average Rate), the uncollateralized overnight call rate, which is calculated and published by the Bank of Japan as the JPY risk-free rate, to replace JPY LIBOR.

---

1 https://www.fca.org.uk/news/speeches/the-future-of-libor

2 https://www.fca.org.uk/news/speeches/the-future-of-libor

3 These are short-term loans that are structured as overnight sales and repurchases of securities that use US government debt as collateral, amounting to around US$660 billion in daily transactions.

Mr. Bailey noted that these rates also benefit from being anchored in overnight markets. In contrast to LIBOR, which is forward looking, all of the above proposed rates are "backward looking", meaning they report what the rate was for past transactions. Market participants will need to consider the applicability of backward looking rates, among other things, as the basis for construction of a new forward looking benchmark.

IV. What Will Happen to Existing Contracts?

The first obvious question is: What will happen to existing contracts that reference LIBOR and that will still be in force after the end of 2021? If the IBA and panel banks maintain LIBOR after 2021, there will not be any problem. On the other hand, if LIBOR disappears after 2021, there will be a problem.

In his announcement, Mr. Bailey questioned "*whether the better approach to transition would be to amend contracts to reference an alternative rate, or amend the definition of LIBOR through the fallback protocol to replace the current methodology with alternative reference rates*."[4] He referred to European Benchmark Regulation, which requires some regulated firms using benchmarks to produce and maintain written contingency plans if a benchmark materially changes or disappears.

Parties to financial contracts and documents that reference LIBOR should:

- Conduct a thorough contract and document review to determine:
    - which contracts and documents reference LIBOR;
    - whether the documentation refers to a fallback position in the event LIBOR cannot be calculated;
        - where fallbacks are specified, whether they are sufficient;
        - where fallbacks are not specified, how best to manage the situation; and
    - whether the documentation needs to be amended.
- Monitor the development of alternative benchmark interest rates and implement any proposed solutions in a timely manner.

V. What About New Contracts?

Until the market participants agree on how to proceed, current transactions and documentation will likely continue to be based on LIBOR. The documentation can then be amended as needed, once the situation develops more clearly. However, documents should be drafted in such a way as to provide flexibility for later amendment if LIBOR is in fact discontinued.

Çakmak Avukatlık Ortaklığı
Piyade Sokak, No. 18
C Blok, Kat:3, 06550
Çankaya, Ankara - Turkey

T +90 312 442 4680

[4] https://www.fca.org.uk/news/speeches/the-future-of-libor