
Planning For the End of LIBOR: Holland & Knight

By 2021, it is likely that LIBOR will no longer exist, and even more likely that it will no longer be the leading global benchmark interest rate. This news comes from the U.K. Financial Conduct Authority's (FCA) announcement that after 2021, it will no longer make the reporting of interbank lending transactions on which LIBOR is based mandatory.1 That change, together with criticism that LIBOR rates are no longer supported by sufficient underlying market data and the rate fixing scandals in recent years suggest LIBOR's days are numbered.

The discontinuance of LIBOR would affect most financial markets, including the aviation finance industry. Many aviation finance transactions incorporate some form of a floating rate based on LIBOR whether it be in the form of a floating rate loan, floating rent rate, or default interest rate pegged to the benchmark. It is prudent to assess existing and future transactions that will remain in place past 2021 to ensure that they contain suitable provisions for selecting a replacement rate.

Lack of Data and Scandal

The London Interbank Offered Rate (LIBOR) was created almost 50 years ago to track the interest rate at which certain large institutional banks lend unsecured funds to each other in multiple currencies and for twelve different tenors on the London interbank market. LIBOR rates are created based on information supplied to the ICE Benchmark Administration by a panel of 20 banks that participate in the London interbank market. The panel is required to submit interest rate data from actual interbank loan transactions, and where no such transactions have taken place, the LIBOR rate is based on the submitting bank's traders' estimates of what the rate of an actual interbank loan on that date would have been. The published rates are the average of all submissions.

A dramatic decrease in interbank lending has left LIBOR as more a representation of expert opinion than a summary of actual market activity.2 According to Andrew Bailey, the head of the FCA, the number of certain interbank loan transactions has dropped down below 20 per year. For a rate that is set daily, this means that on most days the rate is set based on expert opinion alone. This lack of actual data, coupled with the recent LIBOR rate fixing scandals, are likely to spell the end of the benchmark. Since 2012, banks have been fined over USD$ 9 billion for fraud, collusion and manipulation of LIBOR rates.3

Alternatives to LIBOR

Belief that the end of LIBOR is near is strong enough that governments worldwide have started looking at replacement options. A few alternatives are starting to build momentum, but there is no consensus around which rate will replace LIBOR as the market standard benchmark. In fact, there is speculation that no single replacement will emerge and instead LIBOR could be replaced by multiple benchmarks, leading to a more fractured market and greater complexity for negotiating parties.

To address the end of LIBOR, the United States government created a panel of fifteen large U.S. banks called the Alternative Reference Rates Committee (ARRC). In June, the ARRC endorsed the use of what has come to be called the Broad Treasury Financing Rate (BTFR), which will be published by the Federal Reserve Bank of New York as the best practice for U.S. dollar derivatives and financial contracts.4 The intricacies of the BTFR are currently undergoing a public review and comment period, after which it is expected that the rate will be published beginning in the middle of 2018. Generally, the BTFR will represent the interest rate at which banks and others will fund overnight loans secured by U.S. government debt.

In the United Kingdom, the leading alternative appears to be the [Sterling Overnight Index Average (SONIA)](), which reflects the rates for unsecured short-term transactions tied to the pound.5 SONIA's scope is more limited than LIBOR since it only covers sterling while LIBOR covers five different major currencies, and SONIA only measures the overnight rate while LIBOR covers seven maturities from overnight to 12 months.6 These limitations may hinder SONIA's adoption globally.

Existing Documentation

Aviation finance industry participants should review their existing documentation which incorporates LIBOR and may have a term or tenor through 2021 or beyond. LIBOR is used in loan documentation (secured and unsecured), all varieties of leases (with or without floating rent rates), MRO general terms agreements, and even guaranties or other credit support documentation. Even where the principal payment obligation is not a floating rate, documentation can have other types of floating rates that incorporate LIBOR such as default interest rates, or fixed to floating rate conversion options.

Documentation that incorporates LIBOR but lacks a mechanism for selecting a replacement when LIBOR is no longer available should be amended in the coming years if it is expected to remain in place past 2021.

However, documentation that incorporates LIBOR usually includes a mechanism for determining the applicable interest rate if LIBOR becomes unavailable. Here are some thoughts on assessing the adequacy of three of the most common varieties of replacement provisions:

- *Successor Provisions.* These provisions indicate that if another entity takes over the publishing of LIBOR from the ICE Benchmark Administration, or if the LIBOR rates are published in a different way in the future, that such successor publisher or means will be the new rate. These provisions won't be of much use if LIBOR ceases to exist.
- *Interpolation and Alternative Information Source Provisions.* Provisions that empower one party to interpolate between other available LIBOR rates if the LIBOR rate of the selected tenor is no longer available will not be of use if the benchmark itself no longer exists. Similarly, provisions that empower one party to select a different source for the screen rate will not be of use if the underlying benchmark is not available anywhere.
- *Unilateral Selection.* Another type permits the creditor party to unilaterally select a suitable replacement if the LIBOR rate is no longer available or no longer the market standard. Sometimes these provisions require consultation with the borrower, sometimes not. While we are likely to experience a period without a clear market standard alternative to LIBOR, generally speaking this type of a provision will still give the parties sufficient certainty that a suitable replacement will be selected when that time comes. In syndicated loan documentation, borrowers may wish to have the selection of a replacement rate require the approval of a majority of lenders, rather than requiring unanimous approval to expedite the selection of a new rate once a market consensus is reached.
- *Reference Bank.* Finally, so called "Reference Bank" provisions specify that a particular interest rate offer from a specified private bank or the average of rates supplied by a few banks will be the replacement rate if LIBOR is unavailable. This type of provision, which is found in standard LMA and LSTA documentation, is intended to resolve short-term LIBOR interruptions, but leaves considerable uncertainty if utilized indefinitely and should not be viewed as a practical permanent

solution. For example, it is likely to result in a party paying different rates of interest under different deals that are on the same commercial terms but appoint different reference banks.

By the time LIBOR reporting is no longer mandatory, there ought to be greater consensus around the suitability of available replacements. For now, parties should be cautious about incorporating a LIBOR replacement they are not already familiar with. Until consensus grows in the financial sector, parties need to ensure that their existing documentation and new documentation contain adequate provisions for selecting a suitable replacement in the future.

Footnotes

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

2 In 2015, about 70% of the bank submissions were experts guesses. http://www.businessinsider.com/demise-of-libor-part-of-massive-global-trend-many-overlook-2017-9

3 https://www.lexology.com/library/detail.aspx?g=342c165d-5c56-4cb5-a1cb-5a15696e91ca

4 https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Ju--22-2017.pdf

5 https://www.lexology.com/library/detail.aspx?g=342c165d-5c56-4cb5-a1cb-5a15696e91ca

6 https://www.lexology.com/library/detail.aspx?g=342c165d-5c56-4cb5-a1cb-5a15696e91ca

Last Updated: October 17 2017

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