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Filling the LIBOR Vacuum

Legal Update
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This article is the second article published by Fredrikson & Byron relating to the ending of LIBOR.

The likely end of the London Interbank Offered Rate (LIBOR) is coming soon, but many banks have not taken adequate steps to protect themselves and their clients from a seismic shift that some have labeled "the next Y2K."

LIBOR is on the short list of the world's most important numbers. An industry standard since 1986, LIBOR is derived from a periodic survey of banks participating in the London interbank lending market. The survey asks what interest rates banks believe they would be charged to borrow money from other banks in the market. LIBOR is used globally by most financial institutions to set loan interest rates and is crucial in a litany of areas ranging from derivatives pricing to residential mortgage rates.

Despite its prominence, LIBOR may be phased out by the end of 2021 because of concerns relating to the manipulability of the rate and a reputation for scandal earned during the 2008 financial crisis. LIBOR's end could be deeply problematic for the industry. Many loans with maturity dates beyond LIBOR's projected end rely on the index, and the documents governing these loans often do not adequately address the potential end of LIBOR or the adoption of other indices that could result in drastically different rate calculations. In addition, replacing the almost-universally adopted LIBOR index with multiple different published rates (rather than one uniform standard) could lead to far greater market complexity and confusion.

Alternative Standards

While there is no consensus as to which rate might replace LIBOR in the United States, the Secured Overnight Financing Rate (SOFR) is currently the leading option and has been endorsed by the Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation. Created in 2017 by the Alternative Reference Rates Committee (ARRC), SOFR is based on actual overnight secured transactions between banks, making it more difficult to manipulate. However, SOFR may not mirror the actual borrowing costs of some banks due to its focus on secured transactions.

AMERIBOR is a benchmark interest rate that is calculated at the end of each trading day as the transaction volume-weighted arithmetic average interest rate of the unsecured overnight loans transacted on the American Financial Exchange (AFX). AFX has more than 100 bank members, ranging in size from community to large regional banks, plus an additional 1,000+ “downstream” banks that are represented by their correspondent banks who are members of AFX. AMERIBOR addresses the transparency and accountability issues that plagued LIBOR, while offering rates based on unsecured transactions.

Other rates proposed internationally may also present viable options for U.S. lenders, including the Sterling Overnight Index Average (SONIA) in the U.K. and the Swiss Average Rate Overnight (SARON) in Switzerland. Rates such as SONIA and SARON may be useful to U.S. banks in certain transactions or industries.

What Banks Should Do

As the potential expiration date draws closer, banks can take these steps to prepare for the end of LIBOR:

- Create a working group to lead the bank’s transition away from LIBOR. By delegating responsibility to a focused group within the bank, banks can develop a well-informed and cohesive strategy to smooth the transition.
- Review portfolios for transactional documents indexed to LIBOR with maturity dates that may extend past the end of LIBOR. Understanding which loans and transactions are impacted can help banks adequately prepare and evaluate options before the potential risks posed by LIBOR’s expiration become actual losses or headaches.
- Amend transactional documents indexed to LIBOR with maturity or expiration dates beyond the likely end of LIBOR in 2021. Amending such documents before the end of LIBOR can reduce the risk profile of banks and their clients. Amendments based on recommendations by the ARRC, industry experts, regulators such as the Federal Housing Finance Agency (FHFA), and legal counsel can remove or mitigate much of the risk such outstanding documents pose and will likely reduce push-back from borrowers if such amendments become an industry standard.
- Become familiar with the rates that could replace LIBOR, such as SOFR and AMERIBOR. Understanding the strengths and shortcomings of different rates will allow banks to choose the rates that are best suited to meet the needs of the bank and its clients. To ensure the bank is obtaining its anticipated return on capital, banks may need to adjust the margin or other pricing on loan transactions as the replacement rate will not mirror LIBOR exactly.
- Educate staff on the changes mandated by the end of LIBOR and implement institutional processes to handle the transition. Properly trained staff and appropriate procedures will help ensure a smooth transition.
- Implement alternative rates and indices in place of LIBOR in all future transactions.

The transition away from LIBOR in 2021 could be painful for many banks but does not have to be. Keeping informed of developments in the race to fill the impending LIBOR vacuum and beginning to take appropriate steps now are essential to a smooth transition away from LIBOR.