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It's the End of LIBOR as We Know It

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LIBOR (the London Interbank Offered Rate) is a common reference rate that many banks and financial institutions use to set interest rates for loans. For various reasons, the United Kingdom governmental authority that publishes LIBOR may phase out LIBOR by the end of 2021, though it is unclear exactly when LIBOR will stop being published. Once LIBOR is phased out, there will no longer be a published rate for lenders to reference when determining the applicable interest rate to charge borrowers. Lenders who use LIBOR should carefully review their loan documents and, in particular, provisions relating to the establishment of interest rates, to determine what effect the phasing out of LIBOR will have for the lender and its borrowers.

LIBOR is based on certain financial institutions' estimates of the rate for borrowing money from another financial institution. LIBOR is self-reported by these financial institutions. LIBOR became well known a few years ago because of a scandal where several financial institutions were accused of colluding to fix LIBOR at certain rates that would be profitable. This scandal caused the financial industry to realize LIBOR was unreliable, and so began the phaseout and a search for a replacement reference rate.

Various stakeholder groups are engaged in a process to identify and standardize a replacement for LIBOR. In the United States, the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York convened a committee, which has selected an alternative reference rate known as the Secured Overnight Financing Rate or SOFR. SOFR is a rate tied to the cost of borrowing cash overnight secured by U.S. Treasury Securities. Unlike LIBOR, SOFR is based on actual transactions and not estimates submitted by financial institutions, so it is seen as less likely to be manipulated. Other countries are developing their own alternatives to LIBOR, so it may be some time before the global financial system settles on a single LIBOR alternative.

Whatever alternative rate is ultimately selected to replace LIBOR, such rate will likely be higher or lower than LIBOR, so any margins or spreads that are currently in loan documents (for instance, to set an effective interest rate of LIBOR plus or minus some percentage) will need to be adjusted.

Moreover, the provisions and definitions in many loan documents respecting interest rates or LIBOR do not contemplate anything other than LIBOR, which means that there may be no contractual flexibility in the loan documents to use an alternative rate. Lenders should carefully review their loan documents for loans with LIBOR-specific provisions to determine what, if any, amendments need to be made to the loan documents to provide the lender the ability to select an alternative rate. New loan agreements should also contain sufficient language to permit the lender to select an alternative to LIBOR. Given the uncertainty regarding LIBOR’s ultimate replacement, interest rate and LIBOR provisions in loan documents should be sufficiently broad to provide the lender with necessary flexibility to adopt a new reference rate, preferably without the consent of the borrower.