REPLACING LIBOR: DANGEROUS IMPROVISATION

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I. Introduction: What is LIBOR?

The London Interbank Offered Rate ("LIBOR") is an average interest rate computed from commercial debt rates submitted by major banks.[1] Originally, these banks were in London and submitted in unison at "high street close" (5:15 p.m. local time in London), but by the 1980s LIBOR incorporated rates submitted by banks around the world. Between 1984 and 2012, LIBOR was administrated largely without government involvement.[2]

Since the 2012 LIBOR scandal,[3] LIBOR has been more tightly regulated and banks have performed audits on their LIBOR submissions as well as their exposure to LIBOR fluctuations.[4] The Financial Conduct Authority ("FCA") in the United Kingdom has authority over LIBOR and has set rules around the audit, reporting, and communication of LIBOR rates since November 2013, seeking to reassure investors and creators of securities that the LIBOR rate-setting is fair, transparent, and subject to regulatory scrutiny. While the FCA suggested LIBOR improved its transparency and accuracy as a tracking rate since 2013,[5] LIBOR-based rates are still

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1. Kimberly Amadeo, *Libor, How It's Calculated, and Its Impact on You: Role in the 2012 Scandal and 2008 Financial Crisis*, THE BALANCE, https://www.thebalance.com/what-is-libor-how-it-s-determined-and-how-it-affects-you-3305858.

2. LIBOR was brought under U.K. regulatory oversight in the Financial Services Act of 2012. *See, e.g.*, Financial Services Act, 2012 c. 21 (U.K.); s*ee also* Press Release, HM Treasury & the Rt. Hon. Greg Clark, Financial Services Bill Receives Royal Assent (Dec. 19, 2012), *available at* https://www.gov.uk/government/news/financial-services-bill-receives-royal-assent.

3. *See generally* Philip Ashton & Brett Christophers, *On Arbitration, Arbitrage and Arbitrariness in Financial Markets and Their Governance: Unpacking LIBOR and the LIBOR Scandal*, 44 ECON. & SOCIETY 188 (2015); *see also* David Hou & David Skeie, *LIBOR: Origins, Economics, Crisis, Scandal, and Reform*, 667 FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS 1 (2014); *accord* Andrea Monticini & Daniel Thornton, *The Effect of Underreporting on LIBOR Rates*, 37 J. MACROECON. 345 (2013).

4. In Q1/09, Citigroup made public that it had interest rate swaps of over $14T, a substantial percentage of which were LIBOR-linked; today, few banks hold such substantial unhedged exposure to interest rate swaps of any kind.

5. *See* Andrew Bailey, Chief Executive, FCA, The Future of LIBOR (Bloomberg, July 27, 2017), *available at* https://www.fca.org.uk/news/speeches/the-future-of-libor.

insufficiently tied to underlying markets in order to sustainably and accurately reflect lending activity, exacerbated by the fact that LIBOR is driven by a volume of one-half billion U.S. dollars in interbank transactions, leaving it vulnerable to manipulation by larger players. The FCA recently announced plans to phase out use of LIBOR completely by December 31, 2021.[6]

LIBOR has many uses, from the setting of rates in financial assets like syndicated leveraged loans (where a credit spread is added on top of LIBOR to compute borrowing cost), to the manufacture of derivatives (where over trillions in derivatives, from interest rate swaps to futures, make reference to LIBOR), to other lending (where bonds, mortgages, student loans, and so on frequently make reference to LIBOR). It is a central reference rate used around the world and simply wholesale replacing it with another rate is neither an easy nor an equitable solution.

Some instruments do have fallback provisions that can be invoked in the event LIBOR is no longer available. However, most syndicated leveraged loans have credit agreements that do not offer alternative base rate calculation provisions for *permanent* unavailability of LIBOR, making such agreements particularly vulnerable to the absence of a published LIBOR rate after 2021. These agreements, and similar agreements that do not have such alternative reference rate provisions, are the focus of this Article.[7] This Article warns that decisions around the phase-out of LIBOR will have far-reaching effects and notes that in the phase-out of LIBOR some options are preferable to others. Those options are highlighted here as paths that ensure parties are treated equitably during this delicate and unprecedented global process.

II. LIBOR's Use in Agreements

Despite "interbank" in its name, LIBOR, and specifically USDLIBOR,[8] is a commonly-used benchmark even when the counterparties involved are not financial institutions. Examples of cases where LIBOR is commonly used in non-bank-to-bank transactions include those involving secured and unsecured loans. Importantly, the syndicated leveraged loan market is made up of instruments that use LIBOR as the reference rate and trillions of dollars of derivatives held around the world incorporate LIBOR as the reference rate. These debt and derivatives instruments often were drafted with no "fallback" provision for the use of another rate or the demise of LIBOR—something unimaginable until recently.

6. Matt Phillips, *The Most Important Number in Finance Is Going Away. Wall St. Isn't Prepared.*, N.Y. TIMES (July 18, 2018), https://www.nytimes.com/2018/07/19/business/libor-future-2021-phase-out.html.

7. While many loan credit agreements have provisions for the temporary or interim unavailability of LIBOR, this is structurally and meaningfully different from the permanent unavailability of LIBOR.

8. USDLIBOR is a U.S. dollar-denominated version of LIBOR promulgated in 1979 and made officially part of the LIBOR interbank lending database in 1986. Values are available on dates from July 1, 1987 onward but, like GBPLIBOR, are not available on U.K. bank holidays (even if U.S. banks are open on those days). USDLIBOR effectively removes the foreign exchange risk associated with using native LIBOR for U.S. contracts or within banks and financial institutions where accounting occurs in U.S. dollars.

What happens to a LIBOR-referential instrument when LIBOR disappears? Clearly, in the case of syndicated leveraged loans, the credit agreement must be modified when an essential term disappears or is no longer applicable. However, assent to these modifications presents a problem. In most credit agreements, amendments and modifications to the substantive terms require affirmative written approval of a majority or supermajority of the lenders. Modification of rights central to the agreement (such as the principal amount, maturity date, currency, and interest rate) typically requires unanimous lender approval. And, even if unanimous approval could be obtained from the caucus of lenders, the holder of the instrument (who may not be, and often is not, the originating lender) may be "stuck" with an interest rate arrangement that does not suit the lender's portfolio or contradicts the lender's expectations.

This presents a series of problems when another interest rate is substituted for LIBOR. Not only might the holder of the resulting security be presented with a blended or alternative index rate that is far from the lender's initial expectations, but the constituent creditors holding income rights from the original instruments may be subject to sudden unexpected and unfavorable adjustments in their rates. So, in addition to replacing LIBOR with an acceptable surrogate rate, lenders would also need to determine a means to determine whether or not the applicable margin is the same as in a LIBOR world.

III. LIBOR Phase-Out

With a phase-out announced in a series of communications to investors during July 2017 (and foreshadowed as early as the second quarter of 2016), investors and attorneys around the world are left puzzled as to which rate to specify in contracts and what might happen to existing LIBOR-keyed contracts that already incorporated LIBOR as the benchmark rate. Further complicating things, while fallback clauses are common in securities and lending arrangements (for secondary dispute resolution options, backstop credit facilities, and other scenarios), parties reasonably believed they could depend upon LIBOR's essentially indefinite existence; hence, the vast majority of contracts do not consider the possibility that a LIBOR rate would cease to exist or become unascertainable.

While it was appropriate for the FCA to "foreshadow" the phase-out of LIBOR well in advance, this creates an adjustment window during which it is unclear which reference rate to use. Because the FCA has not explicitly endorsed any single replacement rate (and it is, in any case, unclear whether private market actors would honor or adopt the FCA's endorsement), there is heterogeneity in interim solutions to the problem. More troubling, however, is the FCA's failure to describe or facilitate *how* the replacement reference rate would be adopted in new contracts and would replace LIBOR in existing credit agreements.

In the case of bonds and certain debt securities, there are existing "alternative computations" that will likely be central to the new generation of instruments and will be readily-accepted by most market actors. Large firm-specific credit facilities

often contain "backstop rules" that include alternative interest rate computations, but this is not a long-term solution and only affects a large-cap, Fortune 100 corner of the much larger market. In the case of syndicated leveraged loan instruments governed by credit agreements, however, the process is substantially more fraught.

It is tempting to use empirical measurements of prevailing lending rates, but this does not solve the problem. Lending arrangements and rates in use by banks are now directly observable and some theorize this empirical measurement of actual cost of capital can supplement, but not fully replace, LIBOR in many cases. However, the chorus of banks represented by LIBOR (including banks of varying size, financial situation, and customer base) created an interesting and unique index not easily replicated through observations or direct measurement of a smaller subset of banks willing to release actual lending rates. It is possible, but unlikely, direct observation of unsecured rates will replace LIBOR in the near future.

Looking at the various options—including a new blended rate or an arbitrary "peg" rate set by either government or industry—the fairest rate to use is the last-known LIBOR value unless and until LIBOR is replaced in the agreement in question. This accomplishes three distinct, important goals.

- It provides certainty to the market as to the rate to be applied and the mechanism by which that rate will be obtained.
- It avoids a fast-moving disintegration or fragmentation of the market and allows the last-known LIBOR rate to remain an industry standard and source of stability during the transition period.[9]
- It allows contracts in force to function as intended, except now with a fixed rate, not disrupting or affecting the other aspects of a security, derivative, or loan agreement.

Perhaps most importantly, the LIBOR rate is observable and actors can absorb and incorporate market information knowing both the fluctuations in LIBOR as the phase-out approaches and the final value of LIBOR on the last day it is published (although there is a school of thought that as the market gets into 2021, the propensity of banks to quote LIBOR will go down, hence the "last known LIBOR" may not be representative). This allows actors to make decisions with as much information as possible and removes the possibility that another rate the actor has not been observing (or does not trust or does not have robust underwriting models for) will be suddenly swapped into an agreement that has for years made reference to LIBOR. It is important to note that, in any event, the replacement rate would require 100% consent or implementation from origination—both unlikely in the case of an unusual rate that is seen as "off market" by any significant number of lenders.

The challenge with this approach is that there needs to be a time limit set for the rate to be permanently replaced, otherwise floating rate loans turn into fixed rate instruments with no end point, which could cause the market to reprice.

9. A fragmentation of the market wherein many creditors suddenly change LIBOR in agreements to non-standardized rates opportunistically chosen would be disastrous. Creditors frequently swap exposure and unless a successor LIBOR-like rate is chosen nearly-unanimously, these swaps will not line up and will deteriorate over time (as two chosen benchmark rates, even if comparable on "day one," will not be perfectly correlated).

IV. The Nuts and Bolts

Market participants that act as administrators for syndicated loans are often banks with a retail presence and an emphasis on the borrower experience, weighing this (and maintenance of the borrower's banking relationship) against the ease of administering the credit facility. Despite a professed sensitivity to the borrower population, many of these entities favor a "negative consent" framework for replacing LIBOR in agreements, particularly those in the syndicated leveraged loan markets. In a negative consent framework, or opt-out framework, the counterparty is automatically included (banks often use the somewhat-erroneous term "enrolled") in a set of amendments or modifying addenda to existing agreements with new language citing a replacement benchmark rate. While terms for the negative consent regime vary, they are often as short as five days—after which the parties irreversibly become part of a modified credit arrangement. This negative consent mechanism is not optimal for the lender(s) but clearly benefits the borrower.

Two obvious problems without obvious solutions present themselves when one begins to contemplate LIBOR replacement at the level of loan origination and bank operations.

A. Modification with Negative Consent

Generally, certain contract terms are often standardized (and are often identical in the case of fungible securities) in credit agreements for syndicated leveraged loans, such as the parties bound, concepts of performance and nonperformance, obligations of payment and delivery, and so on. The contracting parties are empowered to modify terms, draft rules to protect their interests, punish one another for breaches, offer times and paths to cure, and schedule disbursements or obligations. The benchmark rate is *not* one of the key areas of negotiation, customarily, in these financial arrangements and it is considered a core inalienable right of lenders and borrowers—the provision is considered so standard by all participants that it is rarely controversial. For that reason, any change in this benchmark is considered a substantive change which would require written consent of both parties (or the affirmative consent of the borrower and a majority or supermajority of lenders). The concept that a key provision can be replaced or substantially modified without either party's consent is one alien to, and inequitable within, the established frameworks of contract law.

By taking the mere holding of an instrument that has resulted from careful and calculated negotiations as consent for the alteration of that instrument, the relationship between the parties is fundamentally altered without their blessing and such act attacks the sanctity of contract by introducing a third (or fourth or fifth) party and a new arbitrary rate of return. Many holders will have acquired a security as part of a portfolio and will have, as part of that portfolio's construction, considered the historical fluctuations of LIBOR, the likely future ranges within which LIBOR might vary, and the contract language customarily invoked when considering LIBOR.

B. Wholesale Replacement

One troublingly popular implementation of the LIBOR phase-out that runs parallel to many negative consent schemes that has been proposed (and is peculiarly popular in the United Kingdom) is the concept of a wholesale replacement or "terms list." In this hypothetical scenario, a list of terms would be generated that would replace common LIBOR clauses in contracts and instruments that currently specify LIBOR as the benchmark rate—not in any hierarchy, but in a rigid "this for that" series of replacements.

The problem with wholesale replacement of existing clauses is that, as with the negative consent argument above, the parties who originally reached agreement on terms are now asked to accept new terms to which they did not agree and whose implications they did not have the opportunity to consider. Wholesale replacement (the mass replacement of LIBOR-related terms with new terms in every contract so affected) has further problems, however. It endangers creditors by subjecting them to two unknown risks: (i) the repayment risk associated with rates now calculated against a suddenly-introduced coefficient, and (ii) the merchantability risk that they may now be holding a loan or security that is less marketable to secondary-market buyers than it was when it included a LIBOR term.

While there are other rates that have existed contemporarily with LIBOR (and earlier), there is no other rate that is a ready substitute or that has been used as comprehensively in this context.

It is in this vacuum of alternatives that the Alternative Reference Rates Committee ("ARRC")[10] and the Intercontinental Exchange ("ICE")[11] have proposed waterfall approaches. These waterfall approaches utilize relevant transaction data where it is available, transaction-derived data where empirical data is not available, and, when neither is available, expert judgment, appropriately framed, using procedures permitted by and agreed upon with IBA.[12] ICE (and IBA) conferred with all LIBOR panel banks in late 2016 and into 2017 to build the necessary systems, infrastructure, and mechanisms for LIBOR submissions using the waterfall methodology.[13] IBA completed ninety days of testing between September 15, 2017 and December 15, 2017, during which all twenty LIBOR panel banks submitted

10. ALTERNATIVE REFERENCE RATES COMM., https://www.newyorkfed.org/arrc (last visited July 1, 2019) (the ARRC consists of a "group of private-market participants convened by the Federal Reserve Board and the New York Fed to help ensure a successful transition from U.S. dollar (USD) LIBOR to a more robust reference rate, its recommended alternative, the secured overnight financing rate").

11. INTERCONTINENTAL EXCH., https://www.intercontinentalexchange.com/index (last visited July 1, 2019). ICE operates a dozen regulated exchanges and marketplaces, including the NYSE, and created the ICE Benchmark Administration Limited ("IBA") in February 2014, which administrates LIBOR's twilight period. *See LIBOR Overview*, INTERCONTINENTAL EXCH., https://www.theice.com/iba/libor (last visited July 1, 2019).

12. *LIBOR Overview*, *supra* note 11.

13. *Id.*

LIBOR-like rate data using the waterfall methodology.[14] However, the waterfall methodology does not create a system by which long-lived extant securities, debt instruments, and syndicated loans can be successfully transitioned or renegotiated into a post-LIBOR world.

V. A Better Path

Preferable to a replacement of terms is the concept of a conversion approach, wherein a floating-rate asset is converted into a fixed-rate asset by fixing rates that make reference to LIBOR at LIBOR's final value. In essence, rather than considering LIBOR "to have ended," one instead considers only LIBOR's fluctuation to have ended. LIBOR becomes fixed at its final rate. This permits market participants to observe LIBOR as it approaches its final day and to craft their own solutions, with the final LIBOR value as a stopgap that prevents the need for a hasty or forced replacement.

Some critics may assert that this "fixed LIBOR" conversion approach discourages parties from replacing LIBOR with a rate that realistically reflects the cost of capital in the market; however, this is untrue. As the interest rate environment changes over time—regardless of directionality—it will become harder, not easier, for lenders and borrowers to agree on a fair LIBOR replacement. This mechanism alone should ensure many agreements are revised weeks or months after LIBOR's end date, not years.

Though the "fixed LIBOR" approach is appealing and offers a short-term solution and continuity between 2021 and 2022, the final LIBOR rate will not be an appropriate rate for all existing arrangements to utilize in perpetuity. The "fixed LIBOR" solution would be positioned alongside a mechanism for parties to replace this fixed LIBOR rate with a new floating rate that has characteristics appropriate for the agreement in question. Seeking to avoid wholesale replacement of terms and preferring that parties agree with one another on successor terms, one can imagine a voting governance mechanism through which the parties can advocate for and make public their preferences for replacement terms.

In one imagined approach, an advocacy period leads to a voting period in which a vote of a supermajority of lenders that may include less than 100% of the lenders (a supermajority short of unanimity) may choose either the primary or secondary or tertiary alternative to LIBOR from the "menu" of options with a more-than-five-day but less-than-thirty-day consent period. If the affirmative votes do not total the required supermajority, another advocacy period of not more than seven days occurs, followed by another voting period. In each advocacy period, the parties may communicate with one another and may offer and effectuate payments to one another to induce a party or parties to prefer one option rather than another. If two advocacy periods and two voting periods (with attendant voting) occur and no supermajority

14. *Id.* The test LIBOR rates calculated by IBA using the testing period submissions were published on March 17, 2018, alongside previously published LIBOR calculated using the existing methodology for the same period. These are available for public examination and comparison and are substantively similar. *Id.*

can agree upon a reference rate, then the first of the default rules in the hard-wired hierarchy takes effect in place of all LIBOR terms.

The concept of a "hard-wired" approach is rooted in the idea that three fundamental elements of agreement can be introduced to the credit agreement *ab initio* and that the lenders and borrower unanimously agree to a set of triggers, a replacement rate waterfall that takes effect upon the trigger(s), and a spread adjustment that treats lenders fairly while not adjusting rates suddenly. Once a trigger[15] is tripped, the hard-wired system immediately looks to the aforementioned waterfall methodology to determine which rate to use. Some hard-wired approaches install language that shows preference for certain replacements or certain types of rates.[16] All hard-wired approaches assume the information available at the time the credit agreement is drafted is similar between lenders and borrowers, relatively trustworthy (to the extent that then-available market information enjoys universality and accepted veracity), and unlikely to change in fundamental ways (for instance, in fundamental rate calculation mechanics); this is problematic because some rates referenced by forward-looking agreements or prospective waterfall clauses may not currently exist (for instance, six-month SOFR).

Of course, if the lender/creditor parties come to supermajority agreement, they then contractually affect modifications in accordance with the modification or similar clause of the original agreement. But many agreements are currently in force where proactive, preventative modifications are unlikely.

In many cases, the present value or total anticipated return of the asset in question will be altered materially and, in some cases, the posture of creditors will be weakened relative to the predecessor LIBOR clause; however, this process offers the best route to honor the rights of creditors (particularly minority creditors in terms of pro rata principal representation) and to foster cooperation among lenders, which is in the interest of both creditors and customers. Over time, churn in the market will repatriate these securities to other holders through the secondary market and auction markets for these securities should correct reasonably efficiently for decreases in the effective yields of both individual and combined/securitized instruments. Further, the negotiation process will provide useful market information to subsequent holders as to which terms are market appropriate and which agreements are substantially harmed by LIBOR-related amendments (those agreements then trading at a discount).

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15. Typically, any one of the triggers specified. The typical set of triggers would include five or more, the core five being: (i) LIBOR cessation, (ii) an unannounced termination or truncation of LIBOR rate reporting, (iii) a significant reduction in the number of banks reporting to LIBOR, (iv) the relevant regulator preventing or barring LIBOR's use in these or similar agreements, or (v) legislative intervention replacing or removing the LIBOR benchmark rate. These five triggers are already being installed in some credit agreements today.

16. For instance, language might be installed that explicitly favors rates that have one- and three-month tenor features. Sample language sometimes "waterfalls" from a forward-looking single secured financing rate to a compounded SOFR to an overnight SOFR (which exists and is reported today). One might instead have some other rate as the terminal rate in the waterfall, but it is important that this rate is always determinable empirically (for instance, the absolute value of overnight SOFR minus most recent LIBOR including final LIBOR).

VI. Conclusion

It is in everyone's interest to not introduce violent turbulence into markets unnecessarily or to force lenders or borrowers to accept terms completely alien from the original intent of an agreement. It is also in everyone's interest to have a high degree of standardization among financial agreements and instruments—LIBOR's appeal stemmed in part from its ubiquity and effect as a standardization tool.

Given these concerns and constraints, allowing LIBOR to remain in effect as a fixed rate available for incorporation by reference into existing contracts, derivatives, loan agreements, and securities after the fluctuation of the LIBOR rate ends offers a fair and familiar starting place for any subsequent negotiations between the parties to replace terms along with a stopgap value to be used while negotiations occur. Establishing an equitable and standardized system by which parties (particularly where these parties are plural lenders) to an agreement can advocate for—and express preferences as to—successor terms is important and produces outcomes that incorporate new information while ensuring that terms adverse to lenders or borrowers are not suddenly or haphazardly introduced into existing agreements.

In contrast to an opt-out framework or the wholesale replacement of terms through legislative or regulatory mechanics, this approach assures investors there will be continuity at a reasonable, market-representative rate for a period following LIBOR's phase-out and introduces a default process through which a supermajority (preferably, a unanimous chorus) of lenders can craft, advocate for, and express support for successor terms that replace LIBOR in existing agreements. Further, by extending LIBOR's availability (but not its fluctuation) and proposing a process for lenders to reach successor terms, the resulting agreement is much more likely to follow the spirit and context of the original agreement (and its unique considerations) when compared to boilerplate language manufactured, and forcefully inserted, by parties not familiar with the unique requirements of each agreement.

Of course, it is better for lenders, borrowers, and markets generally to have a successor LIBOR-like rate take hold sooner rather than later. But expecting this transition to occur uniformly and instantaneously is unrealistic. Extending final LIBOR rate validity as a reference rate while this transition occurs in the form of new contracts and not-yet-devised approaches has few drawbacks and provides needed stability during the difficult events that can be easily anticipated, but only imperfectly predicted, to occur during 2022.