New LIBOR new danger?

The Wheatley review of LIBOR, published on 28 September 2012 recommends a number of changes to the administration and calculation of what is currently described as BBA LIBOR. Since the Wheatley Report was published, market participants have been considering the extent to which these changes might necessitate amendments to documentation which references LIBOR.

The recommendations that have been focussed on most closely in this context are (a) the replacement of the BBA as LIBOR administrator, (b) the related possibility that the designated screen rate provider and/or display page may change, (c) any changes that might be made to the calculation methodology and (d) the reduction of the number of currencies and maturities for which LIBOR is produced.

Most LIBOR-based products (including the Loan Market Association (“LMA”) syndicated loan agreements) contain a fallback mechanism for calculating funding costs if BBA LIBOR is unavailable. In relation to products which reference the discontinued rates, the contractual consequences are therefore in general, reasonably clear. The parties must consider whether they are content to rely on the fallback provision (often a rate based on average quotes from designated reference banks) or agree a replacement benchmark or, in the case of the discontinued maturities, a means of interpolation.

The result of a referenced rate being discontinued should normally be a straightforward issue to analyse contractually and should not cause widespread difficulty; the rates being abandoned have been selected because they are relatively little used. More challenging is the question of how existing definitions of LIBOR might operate if “new LIBOR” is run or published by entities other than the BBA and Reuters respectively and/or adopts a significantly altered calculation methodology.

The extent to which LIBOR definitions in the LMA recommended forms could become out of date has been the subject of debate among banking lawyers, not least because the definition of LIBOR in common usage cross-refer to a “Screen Rate”, which in turn makes express reference to the “British Bankers’ Association Interest Settlement Rate” as shown on the “appropriate” Reuters screen.

There have been suggestions that this reference could be deleted in favour of a generic reference to the “London interbank offered rate” as shown on screen or similar. Such an approach may, however, be too simplistic depending on what the parties are seeking to achieve and more specifically, whether the parties intend that “LIBOR” should apply even if the rate is subsequently produced or calculated in a way which is substantially different to the position when the agreement was entered into.

Most loan agreements, including the LMA recommended forms, do not make reference to the basis on which LIBOR is calculated. Accordingly, changes to the manner in which LIBOR is calculated will not automatically result
in disruption to documentation referencing LIBOR (and indeed it would be unduly restrictive if that were the case). The BBA has, from time to time, made changes to the underlying methodology without troubling existing transactions. If, however, fundamental changes were made to the calculation of the rate which resulted in a significant economic difference between the BBA LIBOR and new LIBOR, it is conceivable that disputes might arise as to whether the rate calculated in accordance with the changed methodology is the rate originally contracted for by the parties.

In the present context, BBA LIBOR is intended (in the absence of manipulation at least) as a leading bank rate. Contributor panel banks are (in the BBA’s words) "major" banks with expertise in the relevant currency. BBA LIBOR should represent the rate at which leading banks in the relevant currency are able to access funds in the interbank market.

Against that background, the Wheatley Report’s recommendation that the LIBOR contributor panels are broadened might be a cause for concern. If (as is possible) this is aimed at ensuring that leading banks who are notable by their absence from LIBOR panels are encouraged and/or compelled to take part, that is one thing. If the rate is to cease to be a leading bank rate and is instead to be a market average rate (thus taking into account the rates of smaller/weaker banks), that is potentially another. The worry, were the latter correct, is that "new LIBOR" would be higher than would otherwise have been the case.

Some lenders appear keen to “future-proof” loan documentation by incorporating a more generic definition of LIBOR which acknowledges expressly that the parties intend to transition to the London inter-bank offered rate from time to time, however different that rate may be from the current BBA rate. While borrowers and others may for the reasons outlined above hesitate to agree to a definition of LIBOR which is aimed at ensuring that “LIBOR” applies, whatever LIBOR turns into, they will also be concerned about the consequences of existing definitions proving deficient.

Under LMA terms, if the LIBOR “Screen Rate” is unavailable, the fallback is a Reference Bank average rate, deliberately crafted as a proxy for LIBOR, tracking the current BBA definition. Concerns have been expressed that widespread disruption could give rise to difficulties with regard to the availability of Reference Bank quotes. If the Reference Bank fallback rate is unavailable, the result under an LMA loan agreement is a “Market Disruption Event”, which replaces LIBOR with the actual cost of funds of individual lenders until the parties are able to agree on alternative terms. This outcome may be unattractive to borrowers due to the potential for additional costs.

Based on the above it would seem there are good reasons for both lenders and borrowers to address the upcoming changes to LIBOR in new loan documentation by acknowledging the possibility of a successor administrator or screen rate provider. That does not, however, mean that the definitions need to be crafted such that LIBOR from time to time will apply notwithstanding any changes to the rate, however broad-ranging. It should be possible to adjust LIBOR definitions in a manner which welcomes the Wheatley reforms, but without going so far as to close off entirely any rights which a party might have in the unlikely event that new LIBOR is so different from the existing benchmark that resistance is warranted.

An approach along these lines, which addresses an apparently remote but potentially significant risk, should not cause undue concern. Wheatley has repeatedly emphasised the need to reform LIBOR without disrupting existing transactions. It thus does not currently seem likely that new LIBOR (or its calculation methodology) will in fact prompt disputes regarding whether it remains the contracted rate.

In March the LMA published a revised version of the definition of "Screen Rate" for use in conjunction with its recommended forms of facility agreement to address the proposed changes to LIBOR and also the possibility that
similar changes are made to EURIBOR (as a result of the consultation process initiated by the Commission around the time of the Wheatley Report). The new definition, which continues to provide a link to BBA LIBOR, has been approved by the Association of Corporate Treasurers and should provide a means of addressing the concerns of both lenders and borrowers.

The suggestion that LMA-style LIBOR definitions require alteration in new documentation prompts the question of how existing documentation is to be construed in light of “new LIBOR”. The derivatives market has an established means of achieving changes to existing documentation on ISDA terms via a protocol arrangement. If a party chooses to adhere to the protocol, the amendment takes effect in relation to all transactions where their counterparty has also chosen to do so. A protocol along these lines, however, does not provide a straightforward solution for the syndicated loan market, in particular where participations are traded. The failure of a single lender in the syndicate to adhere to the arrangement would most likely defeat the entire arrangement. At the time of writing there is no public indication as to how any interpretative difficulties under pre-Wheatley documentation will be managed. It also feels premature to reopen and amend such terms purely for this purpose. For now, parties are placing significant trust in the authorities to manage the transition to new LIBOR, as promised, without causing disruption to existing arrangements.

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