

Client Alert

Finance & Restructuring Practice Group

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The End of an Accrual Period? Replacing LIBOR Benchmark Rate

The U.K. Financial Conduct Authority (the “FCA”) announced on July 27, 2017 that it expects to eliminate the London Interbank Offered Rate (commonly known as “LIBOR”) as a benchmark rate by 2021. No hard deadline has been provided as of this writing. The FCA’s announcement comes as no surprise: the news media has reported over the last several years on the replacement of the British Banker’s Association (“BBA”) as administrator of LIBOR with the Intercontinental Exchange Benchmark Administration Limited (“ICE”), allegations of potential market manipulation and, more recently, the impending demise of LIBOR as a benchmark rate for pricing floating-rate loan agreements, interest rate hedges and other derivatives transactions.

LIBOR is a benchmark interest rate derived from daily interest rate submissions from a number of banks of the unsecured cost to borrower from other banks. “Customary” bank-to-bank interest rates range from one, three and six months up to 12 months for multiple currencies, including U.S. Dollars.

Prior to the FCA’s announcement, several derivatives industry working groups, such as the U.S. Federal Reserve-created Alternative Reference Rate Committee (the “ARRC”), and syndicated loan industry working groups, such as the Loan Syndications and Trading Association (the “LSTA”), have already been engaged on identifying a replacement benchmark.

An important part of the process of replacing LIBOR as a benchmark index is the development of legal language for floating-rate LIBOR-based credit agreements, interest rate hedges and other derivatives that will enable a seamless transition over a period of years from a LIBOR reference rate to a replacement benchmark rate (once such a rate is identified). Further afield, accounting guidelines and evaluations of loans and derivative contracts under such guidelines will need to be addressed.

While prior initiatives focused on strengthening LIBOR and developing LIBOR fallbacks, the FCA’s recent announcement and resulting market feedback indicates that the primary focus will be development of a new reference “risk-free” or “bank funding” rate. The ARRC, for example, has focused on an overnight unsecured bank funding rate benchmark (the “OBFR”), but issues will remain as to the observable tenor of such a

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benchmark (i.e., daily determinations), and reference benchmarks for other tenors (if any) will be determined.

As noted above, the markets have a recent example of resolution in the LIBOR markets—shortly after the FCA began regulating LIBOR in 2013, the loan and derivatives markets experienced a minor transition when, in an effort to strengthen LIBOR, responsibility for administration of the LIBOR reference rate passed from the BBA to ICE on February 1, 2014. At the time, regulators and industry groups coalesced on a solution for a seamless transition, and we expect similar collaboration in adopting new benchmarks.

King & Spalding has developed provisions for new loan documentation that contemplates the introduction of a new benchmark into a loan agreement without requiring future amendments. Because of the projected 2021 sunset date, we do not believe that the market will see any urgent rush to amending most existing loan documents and, indeed, there is a great benefit to wait until greater clarity develops as to the ultimate new benchmarks that will become the new industry standard.

Your King & Spalding team is actively engaged with a number of working groups on the foregoing issues, and will keep abreast of developments.

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