LIBOR—The Beginning of the End—A Reason to Raise Derivatives Alarm Bells?

By Karen Stretch & Zachary Benson

What Has Happened?
Talk of the future of “LIBOR” (i.e. the London Interbank Offered Rate and its potential successors) has been hard to miss in recent financial media and although the manipulation scandals mean LIBOR appearing on the front pages is not unusual, this time the reports go to the very existence of the benchmark and were prompted by a significant speech from Andrew Bailey, Chief Executive of the U.K.’s Financial Conduct Authority (the "FCA")¹, a speech which has since received public support from the U.S.²

The absence of relevant underlying markets was noted as a key driver for the FCA position, namely that panel banks would only be required to voluntarily sustain (i.e. contribute to) LIBOR until the end of 2021 (the “Deadline”), in real terms marking the beginning of the end for LIBOR.

Does It Affect Me?
More than likely yes — according to press reports, the value of outstanding derivatives, loans, and mortgages affected by LIBOR amounts to hundreds of trillions. Any discontinuation of LIBOR therefore necessarily creates various potential uncertainties and mismatches across such instruments.

From the Deadline, derivatives market participants reliant on LIBOR, in particular those whose derivative transactions are based on ISDA documentation and which utilise LIBOR as a benchmark to determine floating rate payments, must use an alternative or resort to fall back provisions.

What Does This Mean Now?

 Transactions terminating pre-Deadline. Those existing derivative transactions that terminate or mature before the Deadline and which rely upon LIBOR should be unaffected.

 Transactions with maturities beyond the Deadline. Those transactions referencing LIBOR will be affected; in simple terms, documents will reference a rate that will likely no longer be in existence.

What Can I Do?

 Potential issues or solutions will of course be determined by the exact terms of the relevant derivatives documentation and if and how LIBOR is replaced, but possible options are to:
  – rely on fall back provisions, if any;
– amend documentation to include new fall back provision or successor sources; or
– terminate transactions once LIBOR is discontinued or if a fall back option is no longer available.

For transactions subject to the 2006 ISDA Definitions, “fall back” provisions are provided should a rate no longer appear at the initially specified source. In summary, certain prescribed banks are polled for rates which provide an alternative benchmark rate.

**Next Steps**

"The transition will be less risky and less expensive if it is planned and orderly rather than unexpected and rushed."3

Never intended as a permanent replacement, it is not expected that market participants will rely on the ISDA fall back mechanisms when LIBOR is discontinued but rather that ISDA and other industry bodies will step in to develop a market solution for the discontinuation, likely a combination of developing alternative rates, publishing amendments to the standard ISDA documentation (readers will likely be aware of the existing 2014 ISDA Bilateral Amendment Agreement for Certain Rate Swap and Other Transactions), and, as is increasingly common, an ISDA Protocol. For new transactions, we expect that the focus will shift to the relevant new benchmark and will likely involve updating fall back/replacement mechanisms.

Discussions regarding LIBOR alternatives are already progressing. The FCA has suggested that a reformed SONIA (the Sterling Over Night Index Average) could be considered as an alternative; and in the U.S., an alternative rate, the Broad Treasury Financing Rate, derived from the repo market has been proposed by the Alternative Reference Rates Committee (ARRC).

The “go-live” of the EU Benchmarks Regulation on 1 January 2018 will likely serve to fuel these discussions further — it is very much a case of watch this space.

Please let us know if you would like to discuss any aspects of the above.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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2 “How to Fix Libor Pains,” The Wall Street Journal, 3 August 2017, Mr. Jerome Powell (member of the Board of Governors of the Federal Reserve System) and Mr. J. Christopher Giancarlo (chairman of the U.S. Commodity Futures Trading Commission).

3 See end note 1 above.