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LIBOR Sunset: What It Means and Why It Matters

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If you have a role in the financial aspects of your company you may be aware that LIBOR (London Inter-Bank Offered Rate) is set to be discontinued in the last quarter of 2021. LIBOR has been the base index for most variable-rate loans, notes, interest-rate swaps and other instruments for many years. Despite the trillions of dollars of debt obligations based on LIBOR, there hasn't been as much press as one would expect about its imminent demise.

Here, I've answered some key questions to help summarize what's been happening and what's expected to happen in the debt market as 2021 approaches.

- **Why is LIBOR being discontinued?** LIBOR is calculated based on the average rates large banks reported they would loan each other money during various periods of time. However, there was no real underlying transaction to check against. In other words, the effectiveness of the rate depended, to a large extent, on the honesty of the bankers polled. The rest of the story should come as no surprise, but the short story is that several large banks pled guilty to rigging the LIBOR rate, and that translated into LIBOR's time as a reliable market indicator being seen as over. It was soon announced that LIBOR would cease to be published in the fourth quarter of 2021.
- **Does the end of LIBOR effect your company?** It does, if your company either has an existing LIBOR-based obligation that extends past the fourth quarter of 2021 or you're intending on entering into such an obligation. LIBOR can also be used as the basis of interest-rate swaps, which are often paired with variable rate loans. Although not all variable rate loans are LIBOR-based, you should check to see if LIBOR is used in your debt.
- **Is there a replacement for LIBOR?** Currently, it looks like the replacement index will be the Secured Overnight Financing Rate, known as SOFR, which is a broad index based on actual overnight treasury collateral transactions and repurchase agreements. The Federal Reserve Bank of New York began publishing SOFR in April 2018. SOFR is based on actual treasury transactions versus LIBOR, which is based on bankers' statements of their inter-banking borrowing rate. Therefore, SOFR is anticipated to be much less susceptible to manipulation and abuse.

SOFR is also a shorter term rate than LIBOR and is based on secured transactions (i.e., secured by the treasuries making up each transaction) versus LIBOR, which is based on unsecured credit assumptions. The net result of these differences is that the SOFR rate is expected to be lower than LIBOR. This means banks will have to adjust the rate differential to accommodate the lower SOFR rate. For example, if your company is paying LIBOR plus 100 basis points, the equivalent in SOFR might be something like SOFR plus 110 basis points. For swaps, generally the opposite will be the case. If your company is receiving LIBOR plus 100 basis points in a swap and converts to SOFR, you will need a rate differential to get you to the same place economically (e.g., SOFR plus 110 basis points).

What should you do now? Although there was initially a bit of a Y2K-type scare associated with the phase-out of LIBOR, that appears to have settled down. However, you still have some decisions to make, depending on each of your company's relative debt instruments:

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- If you have a LIBOR-based obligation that will mature or be otherwise paid off prior to the fourth quarter of 2021, there's nothing you need to do because LIBOR will likely be fully operational until then.
- If you have a LIBOR-based obligation that extends beyond the fourth quarter of 2021, review the documents to see what they say about the unavailability of LIBOR. Often the documents have a "fall-back" mechanism if LIBOR becomes unavailable. This language should be reviewed to determine if it's clear and fair to your company (i.e., doesn't leave too much discretion to the bank in choosing a replacement index and the result is as economically neutral to your company as possible). If there is no fallback, or it is unclear, consider raising the issue with the bank and proposing a restructuring of the provision to eliminate uncertainty.
- If you are about to enter into a LIBOR-based obligation, you can do one of the following:
  - Consider a replacement index now. SOFR is currently only being used on a limited basis. However, some banks offer other indexes. One index often discussed is the federal funds effective rate, which is highly correlative to LIBOR, historically.
  - If the bank doesn't offer a workable replacement index from the start, you should review the "fall-back" language to make sure it's clear and fair, as previously discussed.

In summary, at this point, the key is to make sure your company is aware of the situation, particularly if you believe you have LIBOR-based obligations that extend past the end of 2021 or are about to enter into such an obligation.

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