ACREL Notes
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You Can't Always Get What You Want
(Loan Documents need a LIBOR alternate rate mechanism)

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LIBOR is going away (sort of). As there are an estimated $300-$800 trillion in LIBOR-denominated contracts, this is a big deal.

Matt Taibbi summarized the cause of LIBOR's demise in an August Rolling Stone article:

"Years ago, we found out that the world's biggest banks were manipulating LIBOR. That sucked.

> Now, the news is worse: LIBOR is made up.
>
> Actually it's worse even than that. LIBOR is probably both manipulated and made up. The basis for a substantial portion of the world's borrowing is a bent fairy tale."
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> *Taibbi: Is LIBOR, Benchmark for Trillions of Dollars in Transactions, a Lie?* http://www.rollingstone.com/politics/news/taibbi-is-libor-crucial-financial-benchmark-a-lie-w497305

To understand why LIBOR is going away, a short history lesson is in order. In the 1960s, the London interbank offer rate, "LIBOR," represented the aggregated rates at which individual syndicate banks (or referenced banks) could borrow funds. This was not an objective "index," but changed from transaction to transaction depending on which banks formed the syndicate and the referenced rate. In the 1970s, financial institutions began developing derivative tools, such as interest rate swaps, to offset the LIBOR-rate risk. LIBOR-denominated contracts subsequently increased, but the opaque and inconsistent nature of the rate setting components curbed the derivatives market. Attempting to create a more transparent index, financial institutions turned to the industry trade/lobbying group the British Bankers' Association. The BBA set rates by asking a select group of large, "reputable" banks to submit quotes daily in answer to a question: "At what rate do you think interbank term deposits will be offered by one prime bank to another prime bank for a reasonable market size today at 11 am [London time]?" Subsequently, rather than referencing an undefined "prime bank," the BBA changed the question: "At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11 a.m. [London time]?" The LIBOR rate was then determined by calculating the trimmed arithmetic mean of the responses, i.e. the highest and lowest 25 percent of the responses were discarded (trimmed) and the mean of the remaining responses became the rate. This would then be repeated for every currency and maturity so that more than 100 rates were produced every business day. Haubrich, Joseph G., 2001. "*Swaps and the Swaps Yield Curve*," December 1, 2001, Federal Reserve Bank of Cleveland.

https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/economic-commentary-archives/2001-economic-commentaries/ec-20011201-swaps-and-the-swaps-yield-curve.aspx; see also, *Supplementary Memorandum from the British Bankers' Association*- Select Committee on Treasury Written Evidence, House of Commons. May 22, 2008 https://publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/536/536we05.htm.

These submission question changes did not entirely quell market concerns about transparency and possible rate manipulation. During the financial crisis, Barclays' activities with respect to its submissions were particularly suspicious. Subsequent investigations established that: "Barclays based its LIBOR submissions on the requests of Barclays' swaps traders…to benefit Barclays' derivatives trading positions" and "[d]uring the…financial crisis…, Barclays lowered its LIBOR submissions in order to manage what it believed were inaccurate and negative public and media perceptions that Barclays had a liquidity problem." *In the Matter of: Barclays PLC, Barclays Bank PLC and Barclays Capital Inc.*, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, as Amended, Making Findings and Imposing Remedial Sanctions, U.S. Commodity Futures Trading Comm'n (June 27, 2012) http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfbarclaysorder062712.pdf. Additional investigations uncovered industry-wide manipulation, and additional fines were assessed against Barclays, Citi, UBS, the Royal Bank of Scotland, Deutsche Bank, JPMorgan, Lloyds Bank, Rabobank, ICAP, Bank of America and RP Martin. *Libor-rigging fines: a timeline*, The Guardian (April 23, 2015) https://www.theguardian.com/business/2015/apr/23/libor-rigging-fines-a-timeline, *Wall Street gets slammed with $5.8 billion in fines for rate rigging*, The Business Insider (May 20, 2015) http://www.businessinsider.com/libor-rigging-criminal-charges-and-fines-2015-5

In the aftermath of the scandal, Martin Wheatley, managing director of the Financial Services Authority and CEO of the Financial Conduct Authority, was asked to review matters relating to the setting and usage of LIBOR, including whether LIBOR should be eliminated. The Wheatley report rejected the idea of terminating LIBOR, concluding that with many reforms, including those intended to promote independent review and administration and to facilitate the use of transparent LIBOR submission transaction data, "the issues identified with LIBOR, while serious, can be rectified." *The Wheatley Review of LIBOR* (September 2012) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191762/wheatley_review_libor_finalreport_280912.pdf

Following the Wheatley Review, LIBOR is now supervised by the U.K.'s Financial Conduct Authority and is administered by an independent private corporation, the ICE Benchmark Administration. ICE, using a waterfall calculation methodology, has more closely linked LIBOR to actual market transactions. *Roadmap for ICE LIBOR*. (March 18, 2016) https://www.theice.com/publicdocs/ICE_LIBOR_Roadmap0316.pdf. However, even with these and other reforms, the FCA announced in July that, as of the end of 2021, it would no longer be involved in regulating LIBOR. The cause for withdrawal was the decline in unsecured interbank borrowing exemplified by the fact that in "one currency–tenor combination, for which a benchmark reference rate is produced every business day using submissions from around a dozen panel banks, these banks, between them, executed just fifteen [qualifying] transactions…in the whole of 2016." See *The future of LIBOR, July 27, 2017*, Andrew Bailey Chief Executive of the FCA, https://www.fca.org.uk/news/speeches/the-future-of-libor. Bailey stated that, after the FCA's withdrawal in 2021 of its power and authority to persuade or oblige panel banks to submit daily quotes, ICE could continue to produce LIBOR "if they wanted to, and were able to do so", but that the FCA would not guaranty LIBOR's continuance as a dynamic benchmark.

Around the world, regulatory bodies are beginning the development of alternate benchmark rates. The Alternate Reference Rate Committee ("ARRC"), a Federal Reserve sponsored group, is leading this effort in the U.S. In June, the ARRC voted to replace LIBOR with a benchmark based on the "Broad General Collateral Repo Rate" described by the Federal Reserve Bank of New York. This LIBOR alternative is a work in progress and ARRC intends to "refine its proposed transition plans, developing implementation options for its recommended rate in consultation with the members of its Advisory Group as well as through broader outreach efforts." *The ARRC Selects a Broad Repo Rate as its Preferred Alternative Reference Rate*. https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Jun-22-2017.pdf

In the meantime, it is important that even though "you can't always get what you want," your loan documents should contain alternate rate provisions so that "you get what you need." *You Can't Always Get What You Want*, Richards, Keith and Jagger, Mick (1969).