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UK LIBOR: No Longer the World's Most Important Number?

Article By:

Laurel R.S. Blair

The London Interbank offered rate (Libor) was once called “the world’s most important number” by the British Bankers’ Association (BBA). Libor was established in 1986 to assist financial institutions in setting interest rates on large corporate loans. It’s a benchmark, calculated based on bank estimates of the cost of borrowing money from other banks. Over time, Libor became an integral part of global finance, an important benchmark for short term interest rates, and a factor in worldwide financial contracts in the approximate hundreds of trillions of dollars sphere, affecting everything from derivatives to credit cards.

The Libor was not subject to any significant government regulation, although central bankers and government officials were aware of its susceptibility to manipulation. In addition, the Libor calculation was inherently inexact and subjective, since it was based on banks’ estimates of how much it might cost them to borrow from other banks, and they had an interest in the outcome. Loan portfolio profits were dependent on Libor fluctuations. Large-scale derivative holdings such as interest-rate swaps involved billions of dollars riding on miniscule market swings and fractions of percentage points. Since approximately 2008, several well-publicized scandals and government investigations occurred as a result of alleged bank manipulation of Libor. Banks paid more than $10 billion in penalties in connection with alleged Libor fraud. Well-known institutions including Barclays, UBS Group AG, and Royal Bank of Scotland Group were subject to investigations, and lost various traders and executives. The British Bankers’ Association, the powerful lobbyist organization which ran Libor, has reportedly closed its doors.

After examination of Libor, U.K. and U.S. central bankers and regulators appear to have concluded that Libor could not be sufficiently regulated to guarantee its integrity, since it’s an inherently subjective benchmark. The Federal Reserve Board and the Federal Reserve Bank of New York convened an Alternative Reference Rates Committee to identify a reference rate to replace Libor. A U.K. banking regulator recently indicated on July 28, 2017 that Libor will be phased out over the next five years, in favor of other alternatives.

Implications? Financial institutions and law firms will need to promptly address existing documentation references to Libor. There are potential implications for existing floating rate securities pegged to Libor, including corporate loans and preferred stocks. It appears that leveraged loans may be negotiated on an individual basis (most tend to be private transactions without prospectuses). Investors with loan exposure may wish to consider contacting their advisors regarding the Libor phase-out. Post-2008 global recession, regulators took a more critical international view of and more active stance with respect to financial institutions. However, that landscape continues to change (such as the U.S. approach via Dodd-Frank), with developments in the international political and economic sectors. Factors such as Brexit implementation may also impact the use of global financial mechanisms and reference rates.

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