The Banking Law Journal

Established 1889

AN A.S. PRATT & SONS PUBLICATION

FEBRUARY 2013

LIBOR: A Finance Lawyer's Assessment

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The author asserts that LIBOR is largely an invented rate that has little bearing on bank funding costs, and that efforts to "fix" LIBOR might be better directed to develop a better, more meaningful, loan pricing benchmark.

There continues to be much play in the press about various LIBOR scandals perpetrated by traders working for a number of money-center banks. These scandals largely concern the manipulation of LIBOR rates by these traders during the tumultuous period following the collapse of Lehman Brothers in 2007/2008. Barclays plc, a major English financial institution, has paid a fine of more than $450,000,000 to U.S. and U.K. regulatory authorities as a result of such scandal, and numerous other banks remain under investigation by various state, federal and international authorities. Among the wrongdoings ascribed to these banks is having quoted LIBOR rates for the purposes of market-rate setting at rates lower than their actual cost of funds in the London interbank market.[1,2] Among the upshots from these scandals has been a wholesale examination by the British government of the LIBOR rate-setting protocol and process that has culminated recently in *The Wheatley Review of LIBOR: Final Report* (the "Wheatley Report").

With all of this attention being placed on LIBOR, this author thought it worthwhile to spend some time exploring the use of LIBOR-based loan pricing. In this essay, after briefly describing the evolution of LIBOR and its meaning today, we will explore certain curiosities in its usage and paradoxes in its implementation, and then provide our own assessment of what needs to be done. While LIBOR is not only used in pure bank lending transactions —

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Published by A.S. Pratt in the February 2013 issue of *The Banking Law Journal.*

it is used to price home mortgage loans and other financial products — this article focuses on U.S. dollar lending by banks using LIBOR pricing.

Interest based on LIBOR, the London interbank offered rate, is a ubiquitous form of loan pricing for loans originated by banks (and other financiers) world-wide. It is generally reported that LIBOR-indexed transactions cover $300 *trillion* of financings. LIBOR rates are intended to capture the cost to banks of borrowing from one another in the London interbank market. The LIBOR rates commonly used as the benchmark rate for these LIBOR-priced loans are those quoted by the British Bankers Association ("BBA") at 11:00 a.m. (London time) two London business days prior to interest periods of any selected consecutive series of months (or days, weeks or years). LIBOR rates are published by BBA for loans in U.S. dollars, euros, yen, and other major currencies.

Banks using LIBOR as a benchmark lending rate charge their borrowers LIBOR for specified interest periods plus a margin over and above the LIBOR rate for such periods. The theory, then, is that banks borrow from Peter (at LIBOR flat) to lend to Paul (at LIBOR plus the margin). They make their money, then, from the margin over the banks' own borrowing costs, which margin is established by the bank to reflect their borrowers' credit risk and the banks' return (and capital costs) requirements.

Back in the day,[3] LIBOR-priced transactions used rates quoted by the lending (or agent) bank as the rate offered to it by other banks in the London interbank market to borrow for discrete interest periods. As the years progressed, this changed to usage of averages of the rates quoted by certain specified money-center banks (often a "balanced" selection of U.S., European and Japanese banks, but typically including the lender or lenders in a related lending syndicate).[4] Some 10 to15 years ago, the industry norm came to use the BBA quoted rate. The BBA rate, posted daily on Bloomberg, Reuters and other financial posting screens, is an average of the eight London interbank borrowing rates quoted to BBA by the empanelled major money-center banks remaining after BBA has omitted the four highest and four lowest quotes from the total of the 16 quotes received. In other words, this panel of 16 banks quotes London interbank borrowing costs daily and such rates then are averaged on the above-described basis to result in BBA's posted screen rate. In this way, a "market" rate is determined over a wide range of banks from different geographic regions.

Having this blended rate diminishes the impact that peculiarities brought by particular panel banks to the average in respect of credit issues that may affect their respective borrowing costs or regional instabilities.[5]

The LIBOR paradigm has permeated bank loan documentation. Utilized interest periods (and payment dates) employ "modified following business day" methodologies.[6] Mid-interest period repayments bring on potential LIBOR breakage payments.[7] Interest is calculated on the basis of a year of 360 days and actual number of days elapsed.[8] LIBOR rates have to be set two business days in advance of applicable interest periods. Prepayment notices must be irrevocable. And, so on.

The slavish devotion to this paradigm is puzzling, and it points to some larger conceptual issues. The puzzlement derives primarily from the fact that most banks that lend based on LIBOR rates do not, in fact, borrow in the LIBOR markets to fund their loans. While a handful of U.S. dollar-starved European banks may get some of their funding in this market, most banks instead rely on (relatively) cheap deposits, as well as equity, long-term debt, commercial paper and other capital market products. In addition, U.S. banks have access to the Fed window for borrowing at highly advantageous rates. Recent anecdotal evidence has shown us that European (largely French) banks obtain substantial access to U.S. dollars, not in the LIBOR market, but by borrowing these dollars from U.S. money market funds. And many German banks, while flush with Euros, obtain U.S. dollars by employing currency swaps.

Notwithstanding the empirical evidence to the contrary, though, the press and regulators have bought into the idea that LIBOR is a meaningful proxy for bank cost of funds. The Wheatley Report, in fact, in its very first paragraph (1.1),[9] states that LIBOR interest rates serve "… as benchmarks of the average cost to banks of unsecured borrowing for a given currency and time period."

Given the seeming lack of relevancy of LIBOR to bank funding, one may wonder then why LIBOR is deemed to be such a suitable benchmark for bank cost of funds. In fact, the incorporation by banks in loan documentation of "market disruption" clauses expressly points to the fact that LIBOR is not necessarily a good gauge of bank funding costs (and probably overstates what such costs really are).[10] These clauses afford bank lenders the opportunity to charge more interest to their borrowers if the quoted LIBOR rate does

not adequately cover the affected banks' cost of funds. This ability to look at the individual banks' situation seems to turn on its head the notion of taking out bank peculiarities from LIBOR loan BBA pricing.

These market disruption provisions take on different forms.

In loan transactions documented in Europe (primarily documentation governed by English law), there exists an industry standard for market disruption provisions as adopted by the London-based Loan Market Association (LMA) that provides, in part, that a bank may charge its cost of funds if "the cost to it of obtaining matching deposits in the Relevant Interbank Market would be in excess of Libor." In U.S.-based money-center bank transactions, the failure of the LIBOR screen rate to cover adequately bank cost of funds would kick over the interest rate basis to "base rate" loans — the highest of the announced "prime rate" by a New York money-center bank, one month LIBOR plus one-half of one percent or federal funds plus one-quarter of one percent.

The LMA approach is deficient insofar as it presumes availability of matching deposits in the London interbank market; as noted above, many banks do not access deposits in the interbank market basis. As well, during the most difficult days of the liquidity crisis in the fall of 2008, many banks were largely unable to access funds in the London interbank market other than on an overnight basis; that is, rather than borrowing for prescribed interest periods in the interbank market, banks were extending credit to each other in the interbank market on a day-to-day basis only. Apparently, lending banks were extremely wary of borrower banks' credit risks and not willing to grant other than overnight loans. Some banks were even finding that overnight funds were not available altogether or, even if available, they were unwilling to place themselves at risk of a failed overnight rollover or constantly shifting interest rates, which may move adversely relative to a screen rate for a contractually prescribed interest period.

The U.S.-based approach is deficient for most European-based lenders as neither U.S. "prime rate" nor federal funds rates have any operational meanings for them insofar as they have no ability to access funds at those rates.

An alternate approach to both the LMA and U.S. money-center bank approach on market disruption matters that some banks have adapted and that seems to work (at least from the bank perspective) is an ability for those banks finding themselves subject to a funding mismatch to assert that (and claim ad-

ditional interest based on) their incremental Treasury — assessed cost of funds is higher than the LIBOR screen rate for any applicable interest period.

The cost of funds indemnity provision itself is replete with uncertainties. Typically, some minimum percentage of the bank loan-holders must be affected by the market disruption in order to make a claim. The industry norm seems to have settled on a range of 40-60 percent of the loan-holders (based on principal amount of the outstanding loans held by them). In case of widely syndicated facilities, this minimum percentage is useful to weed out a singly affected institution(s) falling on hard times; but what happens if the loan is not widely syndicated? In that case, the lending banks can pass on their personal costs to the borrower if those banks (or a bank) had run into credit trouble or a regional instability. What is more, with a market disruption clause, might a bank whose normal funding costs at the time a deal is entered is, say, 20 basis points over LIBOR and which spread is baked into its credit margin assessed to a particular borrower, later renege on its margin commitment to claim the extra spread? While we have not seen any banks abuse this privilege, it is susceptible to manipulation.[11]

The problems of LIBOR go beyond these cost of funds and documentation issues, of course. Besides the market manipulation problem, LIBOR rate quoting on the BBA basis is plagued with an insufficient volume of trades to generate meaningful numbers. In fact, as reported in *The Wall Street Journal*,[12] numerous BBA-quoting banks have kept their quoted rates unchanged for weeks at a time; either they are not trading in the LIBOR interbank market (so their quotes are based on their most recent trades of the (distant?) past) or their quotes are (gasp!) manufactured or best guesses.[13]

This author would assert that LIBOR is largely a made-up rate that has little bearing to bank funding costs. The Wheatley Report's stated goal of "… strengthen[ing] LIBOR sufficiently that credibility, integrity and confidence in it are restored…"[14] seems entirely off the mark. "Restoring" this pricing indicia, then, with the proposals set forth in the Wheatley Report would only serve to create more bureaucracy, costs and government intrusion in the process. Thus, all the efforts of commissions, investigations and advisory panels to "fix" LIBOR might be better directed to develop a superior, more meaningful, loan pricing benchmark.[15, 16]

The model is broken. Let's move on.

NOTES

[1] Why would a bank intentionally underquote? One likely reason is to provide market signals that such bank is not being forced to pay higher interest rates due to its perceived weakening financial stability and credit.

[2] In light of this general manipulation of rates *downward*, one wonders why the "Occupy Wall Street" folks and consumer advocates did not throw a parade to thank the banks for this magnanimous act of kindness.

[3] For example, when the author started practicing banking law in the mid-1980s.

[4] Commonly called "reference banks."

[5] In the early 1990s, there was a 20-100 basis point "Japanese premium," for example, applicable to Japanese banks.

[6] If interest is due on a day that is not a business day the interest is payable on the next day that is a business day *unless* it falls in the next month, in which case it is payable on the preceding business day. Who came up with that one?

[7] If LIBOR rates have gone down since the beginning of any applicable interest period and the loan has been repaid before the end of the interest period, the bank theoretically has lost the benefit of its bargain for the balance of that interest period (since the money that it has received can only be reinvested at the lower interest rate). The market standard for the reinvestment rate for the purpose of calculating the breakage is the LIBID rate, which rate is usually an eighth less than the comparable LIBOR rate.

[8] Whose great idea was that? A banker, one supposes.

[9] Wheatley Report, p. 5.

[10] I make this assertion based on the fact that banks so seldom resort to the market disruption provisions discussed below, which would protect them if otherwise.

[11] In instances where there are is a single, or only a handful, of banks in a particular facility, we have seen borrowers try to mitigate these risks by (i) asking banks to cap the amount of extra interest they can charge, (ii) asking banks to eat the first "x" number of basis points of a market disruption event before they can start charging the extra costs and (iii) requiring a systemic (general market) event to be a trigger for any extra costs, as compared to bank-specific matters.

[12] *The Wall Street Journal*, September 28, 2012, p. C1.

[13] Given the high volatility of market interest rates and bank credit matters, one would certainly expect these rates to be changing regularly.

[14] Wheatley Report, p. 48.

[15] To be sure, this author is not a finance expert, so the following proposal is largely undeveloped and exploratory. But what would seem to make sense is a more scientific approach to developing a cost-of-funds benchmark. One could start at a baseline at

the "risk-free" cost of funds enjoyed by U.S. government borrowing for applicable interest periods. Add to that an average of short-term screen quoted (and third party developed) credit default swap rates of a panel of banks and perhaps a modest industry-agreed premium for regulatory compliance. This should be a better gauge of funding costs for banks. While flight-to-quality times would normally depress the government rates, the CDS rates would be expected to move in an opposite direction. [16] There is no intention to gloss over the difficulties that would arise in adopting a new basis for LIBOR in light of the trillions of dollars of financial contracts that are based on the current formulation. There certainly would be transition issues, but these can be overcome with long phase-in lead times.