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LIBOR: An Endangered Species?

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The London interbank offered rate, commonly referred to as “LIBOR,” has been under attack. LIBOR is a common reference rate for determining the interest rate to accrue on floating rate debt. Given LIBOR’s widespread use in promissory notes and other financial instruments, is there reason for concern if the rate should disappear? Is it likely the rate will disappear? Will the rate be fundamentally changed?

What Is LIBOR?

Common reference rates for floating rate notes include the prime rate, keyed either to a particular U.S. bank rate, or a blended rate compiled and published by the *Wall Street Journal*, or LIBOR. The classic definition of “prime rate” is “the most favorable interest rates charged by a commercial bank on short-term loans to its best (i.e. most credit worthy) customers." *Black’s Law Dictionary* (West 2009). According to Bankrate.com, “The *Journal* surveys the 30 largest banks, and when three-quarters of them (23) change, the *Journal* changes its rate, effective on the day the Journal publishes the new rate.”

In contrast, LIBOR has historically been calculated by industry lobby group British Bankers’ Association (“BBA”) based on multiple averages of member banks’ reports of rates at which the reporting bank represents it could arrange unsecured loans from peer banks. The LIBOR is actually calculated by BBA for multiple loan durations and multiple currencies, and given the permutations, the BBA published 150 rates in all. Need a reference rate keyed to the New Zealand dollar with an eleven week maturity? BBA can accomodate.

Why Was LIBOR Attacked By British Regulators?

In June of this year,[1] following an on-going investigation commenced in 2009, Britain’s Financial Services Authority (“FSA”) and the U.S. Commodities Futures Trading Commission accused Barclay’s Bank traders of manipulating or attempting to manipulate LIBOR by reporting artificially low rates. Since then, dozens of international banks have come under investigation in the U.S. and abroad, including money center banks Bank of America and JP Morgan Chase Bank. The allegedly bogus rates could be employed in a number of contexts to the bank’s financial benefit, most fundamentally, to profit in the derivatives market or misrepresent the financial standing of banks to counterparties. Barclay’s ultimately settled U.K. and U.S. civil charges with aggregate penalties of £290,000,000 ($469,000,000).

One ripple effect of the proceedings, however, was to trigger a re-examination of the inner workings of the BBA in calculating LIBOR, culminating in the publication of the so-called “Wheatley Review.”[2] Amid press accusations of lax regulation, the author of the report recognized that the elimination of LIBOR altogether might have profound commercial repercussions: “LIBOR is used in a vast number of financial transactions; it is estimated that contracts with an outstanding value of at least $300 trillion reference the benchmark. A move to replace LIBOR could only be justified by clear evidence that the benchmark is severely damaged, and that a transition to a new, suitable benchmark or benchmarks could be quickly managed to ensure limited disruption to financial markets.... A transition to a new benchmark or benchmarks would pose an unacceptably high risk of significant financial instability, and risk large-scale litigation between parties holding contracts that reference LIBOR” *Wheatley Review* at 7.
The *Wheatley Review* instead recommended that the rate mechanism be cleansed and simplified by significantly reducing the number of durations and currencies in which the rate has historically been calculated, to instead be based transparently on “actual transactions.” The rationale was that the markets for interbank lending in many of the historical currencies were either so thin, or non-existent, that reported rates did not and could not truly reflect arm’s length, negotiated pricing of interbank credit. The author emphasizes that “[a] number of the [*Wheatley Review’s*] recommendations are intended to establish strict and detailed processes for verifying submissions against transaction data and limiting the publication of LIBOR to those currencies and tenors that are supported by sufficient transaction data.” *Wheatley Review* at 7. Mr. Wheatley additionally recommended that BBA be stripped of its sponsorship role. *Wheatley Review* at 22. The BBA directors have reportedly conceded defeat.[3]

The FSA is currently engaged in wholesale implementation of the *Wheatley Review*, including governmental regulation of rate-setting.

What Will A Modified LIBOR Mean?

Financial instruments like promissory notes or "swap" contracts may or may not spell out the consequences of the elimination or fundamental change of a designated reference rate. If the *Wheatley Review* is accurate, one may question whether LIBOR reference rates based on US bank reports of the most common interbank loan durations, denominated in U.S. Dollars, are radically changed under the *Wheatley Review* recommendations. Nevertheless, the failure of an instrument incorporating a LIBOR reference rate to specify a "plan of succession" (a replacement rate or institution to succeed the BBA) might conceivably provide some basis for a party to argue that interest ceases to accrue with abolition or succession, if LIBOR is supplanted by a new or materially modified reference rate. How would courts likely address a "zero accrual rate" argument?

Decisions from the modern era of bank failures in the late 1980s suggest that even the complete failure of an instrument to specify a replacement rate for a superseded reference rate would not result in applying a 0% interest rate under the instrument. In the aftermath of "bad bank" after "bad bank," "disappearing rate" issues were extensively litigated in collection actions brought by the Federal Deposit Insurance Corporation ("FDIC"), or successors to the FDIC, against borrowers of defunct banks. Where the note sued on incorporated the defunct lender's prime rate as the reference rate, the question presented in these cases was what evidence of interest accrual was sufficient to meet the plaintiff's burden of proof, given the defunct rate?

In *Bailey, Vaught, Robertson and Company v. Remington Investments, Inc.*[5] an FDIC successor acquired a note signed by Bailey, Vaught, Robertson ("BVR") which for its prematurity rate referred to "lender's prime rate." The "lender" was Forestwood National Bank, which failed in 1989, months before the note's maturity date. The note went into default at maturity and Remington ultimately bought the paper. In its collection action, Remington moved for summary judgment supported in part by an affidavit which included an aggregate dollar figure for pre- and post-maturity accrued interest, without specifying the basis for its prematurity interest calculation. Summary judgment was granted and the borrower appealed. After a discussion of potentially applicable replacement rates, the appellate court held: "in order to calculate the amount due on a promissory note where the prematurity interest rate is based on the no-longer-published prime rate of a defunct financial institution, the trier of fact should apply a 'reasonable' rate of interest, considering the facts of each case."[6] In arriving at this conclusion, the Court rejected a number of alternative rates proposed by both the plaintiff and defendant, including various statutory rates and one percent (as the prematurity rate was set at the Forestwood National Bank prime rate plus one percent).

The failed bank cases instruct us. It is unlikely that British regulatory authorities will abolish LIBOR without strenuous efforts to avoid market unease.[7] Even if LIBOR were to be phased out, or the *Wheatley* version of LIBOR recognized as a materially modified rate, a "reasonable rate" is still proveable through expert testimony, based on such factors as an explicitly identified replacement rate promulgated by FSA or a successor agency, or wholesale interest rates which mimic LIBOR, economically speaking. Checking your specific reference rates may nevertheless provide a measure of comfort to borrower and lender alike.

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1. An instructive timeline of scandal-related events may be found in British Broadcasting Corporation, *Timeline: LIBOR fixing scanda*l, BBC (September 26, 2012), http://www.bbc.co.uk/news/business-18671255.

2. M. Wheatley, *The Wheatley Review of LIBOR: Final Report* (September 2012). Mr. Martin Wheatley ws appointed by the Chancellor of the Exchequer.

3. G. Finch and L.Vaughan, *BBA Poised to Give Up LIBOR Oversight on Rigging Scandal*, BLOOMBERG (September 25, 2012), http://www.bloomberg.com/news/2012-08-13/libor-failures-neuter-bba-as-lobby-may-lose-oversight-of-rate.html

4. G. Vina, *U.K. Will Implement Wheatley Plan for Libor Overhaul in Full*, BLOOMBERG (October 19, 2012), http://www.bloomberg.com/news/2012-10-17/u-k-will-implement-wheatley-plan-for-libor-overhaul-in-full-1-.html (hereafter cited as "Implementation of Wheatley").

5. 888 S.W.2d 860, 1994 Tex. App. LEXIS 3083 (Tex. App. – Dallas 1994), hereafter cited as "*Bailey Vaught*."

6. *Bailey Vaugh*t at 866, citing *FDIC v. Blanton*, 918 F.2d 524 (5th Cir.1990), the 5th Circuit is the Federal appellate circuit court to which Texas appeals are made.

7. Implementation of *Wheatley Review* recommendations is planned by British authorities to be executed over a one year period. See Implementation of Wheatley. Implementation is expected to require new legislation.