EXPERT BANKING

THREE FOR THE PRICE OF ONE

MICHAŁ KULIG, SENIOR ASSOCIATE AT **WOLF THEISS**, EXPLAINS WHY THE INTERBANK EXHCHAGE INDEX LIBOR IS GONE, WHAT HAS REPLACED IT, AND WHAT IT MEANS FOR FINANCIAL TRANSACTIONS.

Ten years have passed since the height of the scandal related to the manipulation of the London Inter-Bank Offered Rate rate (LIBOR) by employees of some financial institutions. LIBOR was the most important indicator for five currencies—the pound, the dollar, the euro, the yen, and the Swiss franc. Apart from the fact that the LIBOR index was the reference rate for mortgage loans, it also played a very significant role in the debt market, and the related financial instruments had a value running into billions of US dollars.

A London court, which in 2015 sentenced a former trader to 14 years in prison for his role in the LIBOR manipulation, determined that the LIBOR market manipulation had been in progress since at least 2006. In connection with this verdict, some of the biggest financial institutions on the international market were also fined, one of them for the amount of over USD 1.5 billion. The total amount of fines exceeded USD 10 billion. It has taken all this time to prepare for the conversion of the most important benchmarks in the world, which finally took place on January 1, 2022.

As LIBOR had become an important tool in financial markets, there was a growing temptation to influence the value of the ratio on which the results of financial institutions depended. The weakness of this ratio stemmed from the fact that it was calculated on the basis of the declarations of the largest banks concerning the interest rate at which they are willing to lend money to each other. It led to accusations of the lack of monitoring of whether the data actually reflected the cost of capital. In order to address these concerns, the EU Benchmark Regulation (BMR Regulation) was adopted in June 2016, with the intention to improve governance and controls over the benchmark process, particularly in relation to conflicts of interest, and to improve the quality of input data and methodologies.

NEW BENCHMARKS

The BMR Regulation defines the principles on which benchmarks are developed and the rules for supervision over institutions that develop these benchmarks and make them available to financial market participants, including banks.

As a result, since the beginning of 2022, LIBOR has permanently disappeared from the financial market and was replaced by indicators based on market data and real, concluded transactions. The new indicator is called the risk-free reference rate (RFR).

The sterling market has introduced the SONIA interest rate benchmark. It takes into account all transactions in the unsecured overnight market from which the average is calculated. In turn, the exchange rate for the dollar market is indexed with the Secured Overnight Financing Rate Data (SOFR), while the benchmark for the Swiss franc is SARON. It is calculated based on the re-purchase market average, but unlike the SONIA ratio, it applies to secured transactions.

The undoubted advantage of the new benchmarks is a transparent method of their calculation and resistance to manipulation, supported by the BMR Regulation, which specifies that the output data on which the index is calculated refers to "transactions, if available and adequate". At the same time, if transaction data does not reflect the market or economic reality with sufficient accuracy and reliability, the regulator allows the use of estimates.

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Higher complexity: Instead of one LIBOR, banks now deal with different methodologies for calculating the rates.

NEW CHALLENGES

The reform results in a number of challenges faced by the entire financial sector. But there are complexities. For instance, instead of one LIBOR, banks now deal with different methodologies for calculating the rates.

In the case of the Polish market, there has been some discussion regarding the compliance of the WIBOR index with the BMR regulation. The position of GPW Benchmark company, which administers the index, is that WIBOR is in line with the BMR Regulation regulating the benchmark market, and compliance is ensured from the management side. The ongoing public debate on this subject and the risk of finding abusive clauses relating to benchmarks may, however, induce market participants to start work on the benchmark reform also in Poland.

There is certainly a need for an economic analysis of contracts that have already been concluded. Changing the indicators on which individual settlements are based may affect the profitability of individual products and the terms of financing agreements entered into prior to LIBOR's transition to RFR, including in particular the syndicated loans market. The benchmarks based on overnight transactions may not reflect the attitude of financial institutions to the debt market in the longer term, as they do not necessarily take into account several risks that arise with longer loan periods.

Additionally, the loan agreements on the syndicated market typically provide for interest periods of one or three months and the calculation of RFR overnight rates needs to be adjusted accordingly. The Loan Market Association (LMA) has published an extensive set of guidelines and documentation on the transition from LIBOR to RFR for the syndicated loans market, including recommended forms of RFR facility documentation. The standard approach is to use a compounded in-arrears RFR with a lookback period of five business days, meaning that the interest for a particular interest period is calculated based on a period ending five business days before the actual interest payment date, so the amount of interest due is known sufficiently in advance.

Other approaches are also possible, such as one based on forward swap transactions, which is why parties to a loan agreement or other financial contract should carefully consider which method to use, bearing in mind its commercial and legal implications.