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The End of LIBOR – What Next?

LIBOR (London Inter-Bank Offered Rate), as the reference interest rate, will be discontinued as per the end of 2021 and subsequently replaced by SARON (Swiss Average Rate Overnight). Nevertheless, LIBOR is still widely used in many financing agreements as the basis for calculating interest rates. This article provides an overview of the reasons for the replacement and highlights the cases where action is required.

1. Reasons for the replacement of LIBOR

LIBOR was introduced in 1969 and has been an important indicator in the financial market ever since. It is published for five currencies and seven maturities. LIBOR shows the average interest rate at which selected banks (so-called panel banks) have granted or would be willing to grant unsecured loans to one another.

LIBOR is used as the base or reference interest rate in various financial contracts. Homeowners in particular are probably familiar with the «LIBOR mortgage»: Here, the interest rate is composed of LIBOR as the base interest rate, which is usually adjusted every three months, and a fixed margin on top.

The big "Libor scandal" broke in 2011. It became evident that LIBOR had been manipulated for years. These manipulations and the fact that LIBOR is now primarily based on estimates rather than on actual transactions between banks led to the discontinuation of the publication of LIBOR as of 2022. Alternative reference interest rates have been developed at a national level as a replacement.

2. SARON as new standard reference rate in Switzerland

In Switzerland, LIBOR is to be replaced by SARON (Swiss Average Rate Overnight) from January 1, 2022. SARON is calculated and published by the Swiss exchange operator SIX Swiss Exchange. However, there are important differences between LIBOR and SARON:

i. Basis: Today, LIBOR is primarily based on estimates by panel banks, whereas SARON is based on actual transactions on the Swiss money market.
ii. Maturity: While LIBOR is published for various maturities, SARON is only available for one single maturity, namely for one day («overnight»).
iii. Collateralisation: LIBOR reflects the average interest rate at which banks lend unsecured funds to one another. In contrast, SARON is based on collateralised transactions. LIBOR always includes a risk premium to compensate for the fact that no collateral is provided. Consequently, SARON is typically lower than LIBOR.

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As the SARON is only calculated for one day, it cannot be used directly as a reference interest rate for maturities of several months. Term rates are therefore calculated from the daily SARON interest rates as a basis for financial contracts. In this context, one speaks of the so-called "compounded SARON", which is a sequence of one-day SARON interest rates.

3. Potential risks in connection with the replacement

LIBOR is frequently used as the base interest rate in loan agreements (incl. mortgage loans) and derivative contracts. Unless a fall-back clause has already been implemented in existing contracts, it is unclear on what basis interest is to be calculated in the future with the discontinuation of LIBOR. Therefore, from 2022 onwards, there will be considerable uncertainty with regard to the interest rate and thus an increased risk for legal disputes.

4. Need for action

4.1. Analysis of existing contracts

To avoid such uncertainties, all existing financial contracts should be analysed. In doing so, the following questions will help:

1. Do you have contracts in place where interest calculation is based on LIBOR?
2. Do these contracts have a term that extends beyond 2021?
3. Do these contracts lack a fall-back provision in the event that the publication of LIBOR is discontinued, or do such provisions not lead to the desired result?

There is a need for action if these questions are all answered with "yes".

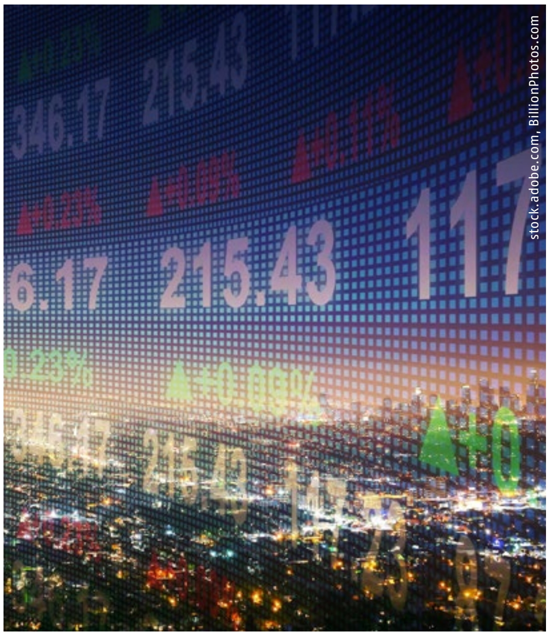
4.2. Amendment of contracts

Amendments of existing contracts must be made on a case-by-case basis and depend on the nature of the contract.

Derivative contracts are generally based on standardised model contracts. For these, the ISDA (International Swaps and Derivatives Association) has published protocols that regulate the replacement of LIBOR and integrate it into existing derivative contracts. Individual renegotiation of contracts is not necessary in that case, provided that the counterparty has also joined the protocol. A similar procedure is also recommended for contracts based on the Swiss Master Agreement (SMA).

Compared to derivatives, loan agreements are much less standardised. Existing loan agreements referencing to LIBOR have to be renegotiated and adjusted with regard to the interest rate.

If new loan agreements are concluded and reference is made therein to LIBOR, it must be ensured that these agreements contain fall-back clauses. Fall-back clauses provide when and how the LIBOR is replaced. It is important that fall-back clauses are drafted specifically enough. It must be specified when and how the replacement of LIBOR will take place, and the calculation method of the new reference interest rate is to be fixed.



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5. Summary and next steps

As of January 1, 2022, LIBOR for Swiss francs will cease to exist. When entering into new financial contracts with terms of more than one year, it should be ensured that LIBOR is no longer referenced or that corresponding fall-back clauses are incorporated in the contract. Many banks now also offer SARON-based products.

Existing financial contracts must be reviewed. Contracts that refer to LIBOR and have a term beyond 2021 must be adjusted accordingly. We recommend not to wait until the end of 2021, but to start the process of renegotiating and adjusting the contracts now. When replacing LIBOR, special attention must be drawn to the fact that SARON is conceptually different from LIBOR. LIBOR can therefore not just simply be replaced by SARON without a respective adjustment of the margin.