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How to prepare for the LIBOR transition

*The commencement of 2022 marks the staged phasing out of LIBOR. Senior Associate **Amy Lindemann** explains what steps shipowners should be taking now to prepare for the LIBOR transition.*

What is LIBOR?

LIBOR stands for the London Inter-Bank Offered Rate. It is the rate used to determine the interest rate on all manner of financial transactions including commercial loans, residential mortgages, derivative transactions and ship finance facilities. The interest rate on a ship finance loan would usually be stated as LIBOR plus margin (being the profit of the lender(s)).

How was LIBOR determined?

Around 18 international banks would provide a quote of what it would cost them to lend money to another bank and then an average rate would be available to the market based on the quotes collected from these banks.

A LIBOR could be obtained for the cost of funding in US Dollars, Sterling, Euros, Japanese Yen and Swiss Francs. Of course, most ship financing is denominated in US Dollars.

Why is it being phased out?

- The quotes given were based on what the banks thought would be the cost of lending funds not on what the bank would actually pay to borrow funds, so it became possible to submit lower rates and manipulate LIBOR. The so-called LIBOR scandals partly contributed to the financial crisis of 2008.

- LIBOR operates on the assumption that there is a robust unsecured interbank market. It is unrepresentative because banks have moved away from funding their activities via the interbank market in the same way they used to, following the financial crisis. Therefore, it is not considered a reliable benchmark for determining interest rates and costs of funds.

When will it be phased out?

LIBOR for Sterling, Euros, Japanese Yen and Swiss Francs, and LIBOR for the borrowing period of 1 week and 2 months will no longer be available after 31 December 2021.

USD LIBOR for the borrowing periods of overnight, 1, 3, 6 and 12 month(s) will no longer be available after 30 June 2023.

What are the alternatives?

The market is shifting to referring to what are known as Risk Free Rates (RFRs). Each currency will have its own risk-free rates which will be determined by looking back to what the actual cost of overnight funding was (rather than the forward-looking method of LIBOR):

Currency	Risk Free Rate	Abbreviation
USD	Secured Overnight Finance Rate	SOFR
GBP	Sterling Overnight Index Average	SONIA
EURO	Euro Short-Term Rate	ESTR
Swiss Franc	Swiss Average Rate Overnight	SARON
Japanese Yen	Tokyo Overnight Average Rate	TONA

These overnight rates are based on actual market activity and a large pool of underlying transactions rather than an estimated rate.

SOFR represents the cost of borrowing cash overnight in the interbank market, with collateral offered in US (government) treasury securities which is deemed to be more reliable.

SONIA is an interest rate that is already used in certain markets, including retail banking. Sonia is published and administered by the Bank of England and is considered a reliable market standard.

What does this mean for new loan agreements to be entered into going forward?

New loans entered into from now should only be based on the relevant RFR or include contractual provisions to facilitate a replacement of LIBOR at the appropriate time. The Loan Market Association which publishes template documentation widely used in the European shipping loan market, has published proposed wording[1] to cover various scenarios. These include simply providing for the parties to enter into good faith negotiations to agree an alternative basis for calculating the loan's interest rate once LIBOR is no longer available.

What does this mean for existing loan agreements where the loan matures beyond June 2023?

Each loan agreement will have to be amended to refer to an alternative rate for the purpose of calculating the interest rate. Many banks are working now to determine which loans in their portfolio will be affected by this and producing generic amendment documentation for this purpose.

The idea will be to limit negotiation with every borrower by applying a one size fits all approach to the extent possible. Where a bank and borrower are unable to reach agreement on the basis for determining the interest rate going forward and required amendments, a borrower may have the option to prepay the loan but that requires having funds or suitable refinancing options available.

What does this mean more specifically for ship finance loans?

The answer to this depends on where the financed ships are registered. The mortgage registered over the ship in favour of the lender will be governed by the laws of the flag state. The form of mortgage used in certain flag states, for example, Liberia and Marshall Islands make reference to the interest rate on the secured loan. Therefore, any amendment to this requires an amendment to the mortgage. The shorter "account current" statutory form of mortgage (for example as used in the UK, Cyprus, Malta) does not require any amendment. The position, particularly for less commonly used flags, would need to be checked.

CJC has been working with and continues to support both lender and borrower clients to prepare for this transition, preparing documentation and identifying flag state requirements.

What disputes might arise?

While preparations are underway to ensure that existing contracts are updated or contain a fallback provision, we expect disputes to arise (i) from contractual terms which reference LIBOR where such provisions become "outdated" once LIBOR rates are no longer published (e.g. in general terms and conditions where such provisions might go undetected) and (ii) where parties are unable to reach

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[1] See https://www.lma.eu.com/documents-guidelines/documents

agreement over an update to an existing contract, for instance because the alternative has the effect of disadvantaging one of the parties.

Such disputes may be resolved (i) via contractual implication to infer the application of an alternative valuation mechanism[2] or (ii) by implying a contractual term if it can be shown that the new term reflects the parties' intentions at the time the contract was entered into. If this is not possible, the courts might consider whether the invalidation of the LIBOR term might trigger a contractual force majeure provision or could amount to frustration of the contract (although given its narrow scope under English law and the preference of the courts to preserve contractual relations, this doctrine will only be applicable in the most extreme of circumstances).

Parties should ensure they take action in time to prepare for the LIBOR transition to avoid the uncertainties of litigation.

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[2] *Sudbrook Trading Estate Ltd v Eggleton* [1983] 1 AC 444.