

LIBOR Replacement Update

January 22, 2020

General background

As most market participants are aware, in 2017, the Financial Conduct Authority (FCA), a financial regulatory body in the UK, announced that LIBOR would be phased out. The announcement was made, in part, in recognition of the decreasing number of underlying interbank transactions on which LIBOR is based (and in the wake of certain widely publicized LIBOR "rigging" scandals).

Since that time, regulators (the New York Fed's Alternative Reference Rate Committee (ARRC)) and market participants (including through the Loan Syndication and Trading Association (LSTA)) have focused their efforts on identifying a replacement reference rate for the countless securities, loans and other financial instruments that currently rely on LIBOR. The result of those efforts, for the swaps market and now the syndicated and private loan markets, has been the selection of the Secured Overnight Financing Rate (SOFR) as a possible replacement for LIBOR — a selection described in detail in this update.

The relevant regulators have made clear their expectations remain that LIBOR will likely be phased out at the end of 2021. On that basis, nearly every new loan incurred today (that is not repaid early) will be outstanding at the time of the LIBOR transition. Though a precise replacement has not yet been identified, private credit providers should understand the primary alternatives and the documentation options currently under review in the market.

A note on SOFR

SOFR is a "repo" rate representing the interest rate which banks impose on each other in making secured loans — specifically, loans secured by US treasuries. SOFR is a daily, overnight rate, released by the Fed every morning — it is not currently available as a forward-looking rate (e.g., 1 month, 3 month, etc.). It is also worth noting that while LIBOR was, at least theoretically, meant to represent a bank's cost of capital, SOFR does not necessarily represent the cost of capital to a bank. SOFR just measures one source of short-term financing. Nevertheless, primarily because there is a large and well established repo market, SOFR is the most likely replacement for LIBOR. The question then becomes which variant of SOFR will replace LIBOR.

Two options: Forward-Looking SOFR and SOFR in Arrears

1. *Forward-Looking SOFR*. One variant of SOFR under consideration by the market is Forward-Looking SOFR. A forward-looking variant would represent a projection of what daily SOFR would be on a certain date in the future. LIBOR is forward-looking as well, so a Forward-Looking SOFR variant would operate similarly to LIBOR.

However, a Forward-Looking SOFR would be dependent upon an active and robust swaps market for daily SOFR. To date, the swaps markets have not produced a Forward-Looking SOFR that is compliant with the relevant regulatory regime (promulgated by the International Organization of Securities Commissions (IOSCO)). The relevant regulators believe there is a material possibility that no IOSCO-compliant forward-looking rate will be available by the time of the LIBOR transition.

2. *SOFR in Arrears*. As an alternative, market participants could calculate SOFR on a backward-looking basis (i.e., SOFR in Arrears). This calculation would be made on the basis of daily SOFR rates that have occurred prior to the relevant interest payment date.

Calculation of SOFR in Arrears would take place with a "lookback" period of several days. In other words, several days prior to the payment date, the agent would identify the daily SOFR rate for each day over the preceding period (i.e., one month, three months, or some other time period selected by the borrower). The agent would then take an average of those daily rates, either via a simple mathematical average or via a compounding average. Such average would yield a reference rate that would form the basis of the borrower's payment.

Needless to say, SOFR in Arrears would operate fundamentally differently from LIBOR: borrowers and lenders would not know the exact amount of an interest payment until a few days prior to that payment becoming due. Banks are reporting that accommodating SOFR in Arrears will require significant retooling of their operations functions, with attendant checks and testing. Private credit providers should discuss this issue internally with their own agency and operations functions.

It's important to note, however, that the International Swaps and Derivatives Association (ISDA) has identified SOFR in arrears, using a compounding method, as its preferred replacement rate for LIBOR.

Takeaway. At the time of this update, market participants and regulators are continuing to discuss the advantages and disadvantages of these two SOFR variants. The situation remains in flux, with at least some indications that an increasingly robust swaps market to support Forward-Looking SOFR may develop — although, as noted, this is by no means assured to occur in time for the cessation of LIBOR. Private credit providers should continue to closely monitor the issue.

Documentation

Two options from ARRC. In May of last year, the ARRC released proposed LIBOR transition language in two variations:

The first option provides for an "amendment" approach similar to the language seen in most credit agreements over the last several years: the agent is given some authority to amend the document to replace LIBOR when appropriate, generally with a borrower consultation right (sometimes a consent right) and generally with some input from "Required Lenders".

The second option provides for a "hardwired" approach whereby the agent is given discretion to replace LIBOR with a variant of SOFR when appropriate; a menu of SOFR options (*i.e.*, first a forward-looking rate and, if one does not exist, then a rate in arrears) could be included. Borrower and Required Lender consents would be more limited.

To date, we have seen little traction in the market for the "hardwired" approach. Nearly every credit agreement entered into last year reflected a form of "amendment" approach.

LSTA Model Agreement: Compounded SOFR in Arrears. Towards the end of last year, the LSTA released a model credit agreement featuring language that would permit a calculation of Compounded SOFR in Arrears. We have reviewed this language, which was released primarily for indicative purposes. As of this update, we do not believe the language released by the LSTA is likely to appear in credit agreements without modification.

Spread adjustment. The potential for a "spread adjustment" — *i.e.*, a rate to accommodate the difference between LIBOR before the transition and SOFR following it — remains under consideration in the market.

Key takeaways

Regulators and market participants — primarily financial institutions with deep footprints in the syndicated loan space — are continuing to grapple with the LIBOR transition, potential replacements, and documentation challenges.

Private credit providers should:

- consider a portfolio review to understand the LIBOR transition language in existing credit documents;
- initiate conversations with internal operations and agency functions regarding the feasibility of providing SOFR in arrears (whether compound or simple); and
- continue to monitor the issue closely, including as it unfolds in the syndicated markets.

We are following this issue closely and discussing actively with relevant regulatory and industry-side groups; additional updates will be forthcoming.

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