LIBOR Transition: Preparing for the End of LIBOR

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For the past several years, loan market participants have been well aware of the anticipated phase-out of the London Interbank Offered Rate (“LIBOR”) as a benchmark for floating rate instruments. Based on current regulatory guidance, the official end of LIBOR may not occur until after the end of 2021, when banks that have participated in the determination of LIBOR will no longer be required to make LIBOR submissions. However, loan market participants are strongly advised to take action now, to ensure their loan documentation permits the efficient replacement of LIBOR with another suitable benchmark rate at the appropriate time.

Why is LIBOR likely going away?

For decades, LIBOR has been the standard floating rate benchmark for debt instruments of all kinds around the world, calculated every banking day by polling major banks on their estimated borrowing costs for various currencies and tenors. However, during and after the last financial crisis of 2008-2009, the imperfections and weaknesses of LIBOR became increasingly clear, most noticeably through the exposure of numerous examples of LIBOR market manipulation. Though attempts at reform were made, including shifting the administration of LIBOR from the British Bankers’ Association to the ICE Benchmark Administration, the U.K.’s Financial Conduct Authority (the “FCA”), the regulatory body charged with regulating the rate, announced in 2017 that the twenty LIBOR panel banks will not be compelled to make LIBOR submissions beyond December 31, 2021. The FCA commented that, in addition to greater vulnerability to manipulation when rates are based on judgments rather than the real price of term funding, “it is not only potentially unsustainable, but also undesirable for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them.”

LIBOR has widely been criticized due to the declining amount of unsecured, wholesale borrowings by banks since the financial crisis. The declining volume has been further highlighted during the COVID-19 pandemic, as over half of the 35 published LIBOR rates across all currencies contained no transaction-based submissions at all during the week of March 16, 2020, but instead relied on estimations from the panel banks. LIBOR rates, and costs for borrowers, spiked upwards during this period. Since banks will no longer be compelled to make LIBOR submissions, it is unlikely that the rate will remain sustainable past 2021.

What is the ARRC, and What is SOFR?

The Alternative Reference Rates Committee (the “ARRC”) is a group of private-market participants convened by the Federal Reserve Board and Federal Reserve Bank of New York in cooperation with the Consumer Financial Protection Bureau, the Securities Exchange Commission, the U.S. Treasury Department and other governmental bodies. It was originated in 2014 to identify risk-free alternative reference rates for LIBOR and to create an implementation plan with metrics of success and a timeline to support an orderly adoption of an alternative reference rate.

On June 22, 2017, the ARRC identified the Secured Overnight Financing Rate (“SOFR”) as its recommended alternative to USD LIBOR. SOFR is a broad measure of the cost of borrowing cash overnight, collateralized by U.S. treasury securities in the repurchase agreement (“repo”) market. SOFR uses data from overnight repo activity to calculate a rate published each business day at approximately 8:00 a.m. Eastern time. SOFR will reflect an economic cost of lending and borrowing relevant to the wide array of market participants, and a key difference compared to LIBOR is that SOFR is based on observable transactions rather than on estimated borrowing rates.

The ARRC Recommended Transition Dates

On July 13, 2020, John Williams, the president of the New York Federal Reserve, and Andrew Bailey, the governor of the Bank of England, reaffirmed that despite the COVID-19 pandemic, the end of 2021 deadline for dropping LIBOR would not be extended and lenders and borrowers should continue their transition plans. The ARRC has recommended steps that all syndicated and bilateral loan parties should take by specific dates to prepare for a post-LIBOR world. First, to the extent not already utilized, all new business loans should include the ARRC Benchmark Replacement Language (described in further detail below) as soon as possible, but in any event no later than **September 30, 2020**. Second, third-party technology and operations vendors affected by the end of LIBOR are strongly encouraged to complete all necessary enhancements to support SOFR by **September 30, 2020**. Third, the ARRC recommends that after **June 30, 2021**, no new business loans using LIBOR and maturing after December 31, 2021 should be originated. Fourth, for contracts specifying that a party will select a replacement rate at their discretion following a LIBOR transition event, the determining party should disclose its planned selection at least **six months prior** to the date that a replacement rate would become effective.

Benchmark Replacement Language

One major practical hurdle that the ARRC has attempted to address is that historically most contracts referencing LIBOR do not envision the replacement of LIBOR with another acceptable benchmark. Syndicated and bilateral floating rate loans are commonly structured so that, if LIBOR becomes unavailable, the benchmark rate would revert to an alternate base rate (ABR) determined as the higher of the Federal funds rate plus a spread (typically 50 basis points) or the lead lender or administrative agent's "prime" rate. However, ABR has historically been higher than LIBOR, and is therefore an unattractive fallback for borrowers. As an alternative to simply reverting to ABR, and to instill a uniform response that will make the transition away from LIBOR smoother, in 2019 the ARRC released fallback replacement language to provide a mechanism for supplanting LIBOR in various types of loan agreements and other debt instruments. For syndicated loans, there were two separate alternative fallback approaches recommended by the ARRC: the "Hardwired Approach" and the "Amendment Approach." Over time, the Amendment Approach saw widespread adoption in the broadly syndicated loan market, but the Hardwired Approach was generally not used. However, the ARRC's updated guidance clearly favors the Hardwired Approach.

The Hardwired Approach, updated as of June 30, 2020, applies a waterfall for selecting a replacement benchmark and spread adjustment upon the earliest date LIBOR is no longer usable, providing certainty upfront. The Hardwired Approach solidifies SOFR as the most likely replacement for USD LIBOR while preserving optionality for a different benchmark replacement further down in the waterfall. The updated language includes a set of contractual provisions that identify clear and objective triggers, a successor rate waterfall and a spread adjustment waterfall, and includes the use of daily simple SOFR in arrears, which is the version of SOFR that will be easiest to implement operationally while a forward-looking term rate based on SOFR (“Term SOFR”) is still being developed. The ARRC language also includes a more permissive early opt-in trigger, which allows parties to switch over to an alternative rate like SOFR before LIBOR is officially discontinued, furthering the ARRC’s goal to add fallback language to all new loan agreements by September 30, 2020.

The Amendment Approach, on the other hand, is a shorter and simpler alternative that provides a streamlined amendment mechanism for the borrower and the agent to negotiate the benchmark replacement and corresponding spread adjustment closer to the time of actual LIBOR cessation. Such proposed amendment negotiated and agreed between the borrower and the agent will become effective unless objected to by the “required lenders” (typically lenders holding a majority of loans and commitments) under the credit facility. Because the Amendment Approach could result in parties taking advantage of then-current market conditions at the expense of other parties during the amendment negotiations, and because thousands of these amendments at LIBOR cessation would burden the syndicated loan market, the ARRC elected not to update its Amendment Approach language and instead endorsed the revised Hardwired Approach language. However, the application of replacement language is up to the contracting parties to embrace, and therefore it remains to be seen whether and how quickly the market will shift away from the widely utilized Amendment Approach language.

The LSTA Concept Credit Agreement

The Loan Syndications and Trading Association (LSTA) has announced that it is preparing a concept credit agreement that supports the use of hardwired fallback language, to ease the transition to new originations of SOFR-referenced loans. When finalized, it will likely be a useful reference tool to familiarize the market with replacement benchmark alternatives and further assist loan market participants in planning for the impending transition.

Additional Considerations for Multicurrency Facilities

As SOFR is the expected successor rate only for USD LIBOR, borrowers with credit facilities that allow loans in other currencies should also become familiar with the expected successor rates for non-USD loans; for example, Sterling Overnight Index Average ("SONIA") for GBP LIBOR and Euro Short-Term Rate ("€STR") for EUR LIBOR.

Best Practices Moving Forward

Proskauer's market-leading international corporate and fund finance practice has the necessary experience to prepare clients for the end of LIBOR, both in the US and in Europe. We recommend taking a proactive approach when it comes to updating existing credit agreements or implementing the appropriate fallback language for new facilities. Working together with the firm's corporate, tax and other practice groups, our finance practice is available to help our clients structure and implement such credit facilities to fit their needs. Please contact us with any questions.

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