Proskauer

Libor Replacement Update

January 26, 2021

This update to our previous LIBOR succession bulletin reflects recent developments, including guidance from the Alternative Reference Rates Committee, market consensus around SOFR and the latest on "spread adjustments." We also note that some private credit loan documents executed in recent weeks have included hardwired LIBOR replacement mechanics. We are actively monitoring LIBOR succession developments and will continue to provide pertinent updates.

November 2020 Announcement; Regulatory Guidance and Scrutiny; Market Developments

Updating previous guidance regarding LIBOR succession, on November 30, 2020, the Ice Benchmark Administration ("ICE") and the Financial Conduct Authority (the "FCA") announced that most tenors of US Dollar LIBOR would continue to be published through **June 30, 2023**.

This new deadline constitutes a considerable extension beyond the previously announced date of December 2021. The extension relieves pressure on lenders with exposure to existing loans that were drafted without LIBOR replacement mechanics; the additional time will allow a considerable number of such loans to mature before ICE ceases to publish LIBOR.

However, the Alternative Reference Rates Committee (the "ARRC"), including its members from the Federal Reserve Board and New York Federal Reserve, has subsequently emphasized that the extension to June 2023 does not alter the regulatory perspective on new loan issuances: that market participants should already be using language that provides for an automatic switch from LIBOR to a replacement ("hardwired language," discussed below) in new loan agreements (or should start immediately) and that **June 30, 2021** should be the target for the cessation of new loans based on LIBOR.

Recent regulatory developments include detailed inquiries by the Securities and Exchange Commission (the “SEC”) of asset managers, including credit investors, into their plans for managing the transition, as well as an announcement by the Federal Financial Institutions Examination Council (the “FFIEC”), an interagency body representing bank regulators like the Federal Reserve and the Office of the Comptroller of the Currency, highlighting the risks of LIBOR cessation and encouraging banks to address the transition.

Although hardwired language remains, for the moment at least, unusual in the private credit market, the Proskauer Private Credit Group has seen some documents executed recently that included these mechanics. In the syndicated markets, some agent banks have either built hardwired language into their forms or are considering doing so. However, acceptance of proposed ARRC fallback language by borrowers (and private equity sponsors) is still developing.

Private credit providers should continue to monitor this issue closely – we anticipate an increasing number of private credit loan documents with hardwired language will be executed in 2021.

LIBOR’s Replacement: SOFR

As of this update, Secured Overnight Financing Rate (“SOFR”) is the presumptive replacement for LIBOR. SOFR is a “repo” rate representing the interest rate that 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.*, one month, three months, etc.). Note 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. SOFR will be available in various forms, including:

1. *Forward-Looking SOFR (also referred to as “Term SOFR”)*

A forward-looking variant of SOFR would represent a projection of what daily SOFR would be on a certain date in the future. LIBOR is forward-looking, so a Forward-Looking SOFR variant would operate similarly to LIBOR.

However, 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")), primarily because the underlying volume of SOFR-linked issuances has not grown sufficiently to bolster a robust market in SOFR swaps. However, recent market developments, including increased SOFR-linked issuances by financial institutions, may lead to the necessary increase in volume. Thus, although relevant regulators continue to believe there is a material possibility that no IOSCO-compliant forward-looking rate will be available by the time of the LIBOR transition, there now appears to be some likelihood that Forward-Looking, or Term, SOFR will be available at such time.

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. 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) and then take an average of those daily rates, which 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. In the ARRC's parlance, this short period prior to an interest payment date is called a "lookback."

A “lookback” allows the borrower, lenders and administrative agent to ascertain the amount of interest at least several days prior to the interest payment date by offsetting the observation period of SOFR from the day on which an interest payment is actually due. Consider the ARRC’s example of a SOFR loan with a tenor of 30 days, commencing on April 1 and maturing on April 30, and with a five business day lookback. The first SOFR rate applicable to the loan would be SOFR for Wednesday, March 25 (five business days before the start of the interest period). Daily SOFR rates are then observed for the next twenty-nine days, with the last observation day on Thursday, April 23 (five business days before the end of the interest period on April 30). On that date, an average of the preceding thirty days’ rates is taken, which (together with the margin on the loan) yields the amount of the interest payment due at the end of the interest period (which, in the case of this example, is also the maturity date).

Fallback Language

In April 2019, the ARRC published recommendations for LIBOR transition language. One option was the “amendment approach” which gives the agent authority to amend the document to replace LIBOR when appropriate, subject to negotiable borrower consent or consultation rights, and required lender negative consent rights.

In June 2020, the ARRC published final form hardwired language (what ARRC refers to as the “hardwired approach”) which provides for the automatic replacement of LIBOR with SOFR upon certain triggering events.

To date, the amendment approach, or some variation of it, has been widely used and is standard in the private credit market. However and as noted, the ARRC has recommended that new business loans start incorporating hardwired language immediately. The following are salient features of the recommended hardwired language.

Benchmark Replacement Waterfall

The hardwired language sets forth a waterfall with three steps to determine which rate should be used to replace LIBOR. Once a trigger event occurs, the administrative agent under the credit agreement will replace LIBOR according to each available SOFR variant in the following waterfall:

Step 1: Term SOFR + Adjustment. The first step of the waterfall is the sum of (a) Term SOFR and (b) the related spread adjustment (discussed below). As discussed above, Term SOFR, which is a forward-looking SOFR, is not currently available, although it may become available before the cessation of LIBOR.

Step 2: Daily Simple SOFR + Adjustment. If Term SOFR is not available, the next step of the waterfall will be the sum of (a) "Daily Simple SOFR" and (b) the related spread adjustment. Daily Simple SOFR is a SOFR in Arrears approach (described above). A Daily Simple SOFR loan would accrue interest based on SOFR for each day of the interest period with a lookback, the length of which would be established by the administrative agent, on the basis of an average of the daily SOFR for each such day. (Note that the International Swaps and Derivatives Association (ISDA) has opted for a slightly different methodology of calculating a SOFR in Arrears reference rate – rather than taking a simple average, the ISDA fallback uses a compounded average. As a result, some agent banks may prefer to use a compounded average at this step in the waterfall; the economic difference between a simple average and a compounded average of SOFR should be negligible, although there are some methodological differences on which operations/agency teams should sign off before the compounded approach is accepted).

Step 3: Borrower and Administrative Agent Selected Rate + Adjustment. If neither Term SOFR or Daily Simple SOFR is the successor rate, then the borrower and the administrative agent select a replacement. This last step is effectively the "amendment approach," which is currently the standard in the majority of credit agreements.

"Climbing the Waterfall"

Certain market participants, including one agent bank with deep roots in the syndicated market, have augmented the waterfall to provide that if, as an initial matter, Term SOFR is unavailable at the time of LIBOR's cessation, and the agreement therefore defaults to Daily Simple SOFR in arrears, the agreement would subsequently "climb" back to Term SOFR if it became available.

Spread Adjustment

Historically, LIBOR has generally traded at a slight spread above SOFR, in part because SOFR is an overnight, secured, risk-free rate and LIBOR is an unsecured rate. (There have been some exceptions to this pattern, particularly in times of crisis, when the spread has spiked (as in October 2008) and also gone negative (in March 2020)). In order to account for the historical spread when transitioning from LIBOR to SOFR, the ARRC recommends the use of a spread adjustment. The ARRC recommended spread adjustment will be a five-year historical median between LIBOR and SOFR.

Triggers

The hardwired language includes a number of triggers which would automatically activate the switch from LIBOR to SOFR pursuant to the waterfall described above. These triggers are generally set to announcements by relevant regulatory agencies and industry bodies that LIBOR will no longer be published. However, the hardwired language also provides for an "early opt in," whereby parties can choose to switch to SOFR when, for example, a set number of syndicated credit facilities are at that time calculated based on SOFR.

Key Takeaways

Regulators and market participants are continuing to grapple with the LIBOR transition, potential replacements, and documentation challenges.

Private credit providers should:

- prepare for loan documents that include hardwired language by discussing the language and implications with counsel;
- continue a portfolio review to understand the transition language in existing credit documents;
- confirm internal operations and agency functions are prepared for the possibility of providing SOFR in arrears;
- consider whether to update form language to include a hardwired approach; 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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