Proskauer

LIBOR Transition Update

December 30, 2021

This LIBOR transition update, directed primarily at private credit lenders, provides a recap of recent trends and reflects new developments on the eve of LIBOR transition for banks, including new SOFR issuance by private credit lenders and context around "spread adjustments." We are actively monitoring LIBOR transition developments and will continue to provide pertinent updates.

December 31, 2021 deadline; Relevant regulation

As readers will no doubt be aware, relevant federal bank regulatory agencies, in consultation with the administrator of LIBOR and various state agencies, have made clear that the banks they regulate are to cease making new extensions of credit based on LIBOR by December 31, 2021.

In anticipation of this deadline, several investment banks have, in recent weeks and months, arranged new syndicated credit facilities based on alternative reference rates (principally, SOFR). As we enter the new year, we expect that the vast majority of syndicated credit facilities will be based on alternative reference rates like SOFR.

Direct lenders are, generally, not subject to bank regulation and do not fall under the purview of the agencies that set the December 31 deadline. As a result, in discussing LIBOR succession with many of our clients throughout the year, we do not anticipate an immediate transition to SOFR (or any other alternative reference rate) by private credit lenders in 2022. However, many direct lenders may be subject to other regulatory schema, including, for example, regulation by the SEC, an agency which has made its concerns about LIBOR clear. For this reason and for some of the reasons we outline below, we anticipate that direct lenders will likely provide an increasing number of loans based on SOFR in the coming months.

LIBOR replacement documentation

While direct lenders continue to prepare to issue new loans based on alternative reference rates, we have continued to see a general trend toward including “hardwired” LIBOR replacement “fallback” language in credit documentation. As a refresher, there are generally two options for addressing LIBOR succession in credit agreements: the “hardwired approach,” which provides for the automatic replacement of LIBOR with SOFR upon certain triggering events, and the “amendment approach,” which is effectively an “agreement to agree” giving the agent authority to amend the document to replace LIBOR when appropriate, subject to borrower consent, and often with required lender negative consent rights. A considerable number of private credit lenders now favor the hardwired approach in LIBOR credit facilities (but see our notes below concerning “spread adjustments” in hardwired documents).

SOFR issuance by private credit lenders

With the advent of new SOFR-based syndicated credit facilities, SOFR term sheets, financing grids, commitment letters and credit agreements are working their way into the private markets as well. (To be clear, as noted in previous bulletins, the trend towards SOFR as opposed to other alternative references rates is at this point a strong one, and we are aware of very few, if any, credit facilities based on non-SOFR alternatives in the private markets). We have seen a noticeable (though still modest) uptick of SOFR issuance (or proposed SOFR issuance) in recent weeks. We expect this trend to continue and likely to increase in 2022, for several reasons.

First, any private credit lender considering participation in a junior tranche of capital (a second lien, for example) in a structure in which the senior tranche is syndicated or otherwise provided by a bank will likely come under some pressure to provide a SOFR-based loan, since the senior tranche will almost certainly be based on SOFR. Although it is possible to bifurcate reference rates (and, indeed, we are aware of at least one credit facility in which revolving commitments were based on SOFR and the term loan was based on LIBOR) we expect that most borrowers will insist on a single rate across tranches for ease of administration.

Second, many direct lenders incur leverage or subscription-based debt facilities of their own as part of their overall strategy. Any such facility that is provided or arranged by a regulated bank (which is to say, the vast majority of them) and is entered into after December 31 will be based on SOFR. A lender with a leverage facility based on SOFR but a portfolio of loans based primarily on LIBOR may be subject to risk management challenges brought on by this mismatch between liabilities and assets, and those challenges might lead to greater SOFR issuance.

Third, to the extent interest rates increase over time, borrowers may become more likely to enter into interest rate swaps and hedges, which (given the derivative market's own transition from LIBOR) may further incentivize loan market participants to move to SOFR.

Finally, direct lenders will be subject to the same macro trends that led to the shift from LIBOR in the first place. As noted above, regulatory pressure may continue to increase, and lenders may have concerns (or their investors may have concerns) about the shrinking LIBOR market and the inherent instability of LIBOR that initially brought on the push for a successor rate.

Of course, ultimately the question of the private credit market's transition away from LIBOR is one of timing. As readers know, the ultimate deadline for LIBOR is June 30, 2023, after which it will no longer be published, and all new and existing credit facilities will need to transition to an alternative reference rate prior to that date.

A few words on spread adjustments

Spread adjustments, the precise mechanics of which we covered in our previous bulletin, are designed to compensate lenders for the difference between LIBOR (an unsecured, "credit sensitive" rate) and SOFR (a secured rate which has historically traded at a discount to LIBOR).

For new SOFR-based loans, the syndicated market has seen several different approaches taken on spread adjustments. One approach has been to apply a 10 basis point spread adjustment for one-month SOFR, 15 basis points for three-month SOFR and 25 basis points for six-month SOFR. Another approach has been to price with no spread adjustment at all, but to instead include the economics of the spread adjustment directly into the margin. We expect to see additional options tested in the market as the transition commences in earnest. As issuance of SOFR loans in the private market increases, we expect to see the same price exploration there as well.

For new LIBOR-based loans with hardwired fallback language, the standard form of language published by the Alternative Reference Rates Committee contemplates spread adjustments of approximately 11, 26 and 42 basis points for one-, three- and six-month tenors, respectively. (This is the same spread adjustment recommended by ISDA). Recent months have shown some negotiation around these spread adjustments as well, although the ARRC recommendations remain common in the market.

Key takeaways

As the transition from LIBOR continues, private credit lenders should:

- complete a portfolio review to understand the transition and/or fallback language in existing credit documents (keeping in mind the ultimate deadline for amending existing LIBOR transactions in June of 2023);
- consider formulating a policy on fallback language for new LIBOR-based transactions (including on spread adjustments);
- prepare business, legal, operational and agency functions for new SOFR issuance; and
- continue to monitor the issue closely, including as it unfolds in the syndicated markets.

We continue to follow this issue closely and will provide additional updates as relevant.

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