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Client Alert

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The Beginning of the End of the End: Transitioning Loans and Derivatives from USD LIBOR in 2021

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Since at least 2017, lending institutions around the world have wrestled with how to devise – and transition financial products to – new benchmark rates that would replace numerous interbank offering rates. In the U.S., where USD LIBOR has been the primary benchmark of business loans for decades, market participants have been preparing for the transition by considering how existing "legacy" agreements and future transactions address or should address LIBOR transition.

This article compares model USD LIBOR fallback approaches that have been promulgated by policymakers and industry leaders in the U.S. syndicated loan market, on the one hand, and the over-the-counter (OTC) derivatives market, on the other. Though the approaches parallel each other in many respects, market participants who wish to align their positions in cash loans and related derivatives should be aware of several important distinctions.   We discuss these distinctions, together with two alternative strategies for those seeking to minimize basis risk arising from different fallback approaches, in detail below.

"[P]reparation should include reviewing cash and derivatives instruments to assess potential basis risk arising from differences in LIBOR fallback mechanisms, calculations, timing and other terms."

THE END OF THE END HAS BEGUN

On March 5, the UK's Financial Conduct Authority (FCA) announced the dates on which USD and other LIBOR settings will cease to be published, officially marking the long-anticipated beginning of the end of a multi-year process to terminate LIBOR and transition markets to new benchmark rates.

According to the FCA's March 5 announcement:

- Publication of 1-week and 2-month USD LIBOR settings (and other foreign settings) will permanently cease immediately after December 31, 2021; and
- Publication of all other USD LIBOR settings will permanently cease immediately after June 30, 2023.

Although most USD LIBOR settings will be available until 2023, U.S. banking regulators have stated that, for new originations, U.S. banks should cease solely relying on USD LIBOR "as soon as practicable" and in any event by the end of 2021 (subject to limited exceptions for certain derivatives products). To that end, the Alternative Reference

Rates Committee (ARRC), which oversees U.S. transition efforts, currently recommends that:

- All *new* syndicated loans maturing after 2021 should use its "Hardwired Approach" by using a designated replacement reference rate (discussed below);
- Legacy derivatives referencing USD LIBOR should incorporate the International Swaps and Derivatives Association (ISDA) fallback provisions by adherence to its related protocol. No new trades maturing after 2021 should reference USD LIBOR (except for risk management of certain legacy LIBOR positions).

USD LIBOR REPLACEMENT & TRANSITION APPROACHES

The Secured Overnight Financing Rate (SOFR) is the reference rate identified by U.S. banking regulators as the preferred successor to USD LIBOR. The Federal Reserve Bank of New York (FRBNY) publishes SOFR daily based on financial participants' actual daily transactions in the U.S. Treasury overnight repo market. SOFR is distinct from USD LIBOR in several structural respects, as outlined in Appendix A. These differences mean that SOFR cannot simply be "dropped into" contracts in substitution for USD LIBOR without addressing complex economic and operational issues related to switching rates midstream. Below, we examine three leading transition approaches[1]:

- **ARRC's "Amendment Approach"** for **syndicated loans,** which relies upon the borrower and administrative agent to select a successor rate, subject to prevailing regulatory guidance, market practice and lender consent provisions. This approach is often found in existing facilities and, at least for a time, frequently used in new originations, though is not currently ARRC's most favored approach.
- **ARRC's "Hardwired Approach"** for **syndicated loans**, which mechanically identifies a successor rate in accordance with an express "waterfall" of alternative rates ranked in order of parties' preference. This is ARRC's recommended approach and has gained popularity with new originations of syndicated loans.
- **ISDA's IBOR Fallbacks Protocol and Supplement No. 70 to 2006 Definitions**, which amend existing **OTC derivatives** and refresh commonly-incorporated ISDA standard definitions for use in new contracts to include highly mechanical provisions for replacing various benchmark rates facing obsolescence, including USD LIBOR. The protocol launched on January 25, 2021. Supplement No. 70 applies to new trades from that date, and legacy trades to the extent both parties adhere to the protocol.

COMPARISON OF APPROACHES

Both ARRC recommends, and ISDA adopts, a transition approach using a SOFR-based rate plus a spread adjustment for replacing USD LIBOR, although the details of the replacement methodologies vary slightly. Market participants with derivatives designed to hedge their exposure under cash instruments, or vice versa, should evaluate their contracts to determine whether such methodological differences may introduce unacceptable basis risk. In particular, market participants should consider the following key questions:

1. Which Type of Successor Rate Will Be Used?
There are a number of SOFR-based successor rate possibilities, and different approaches have selected their favorites:

a. Term SOFR: a *forward*-looking term rate based on SOFR that is not yet available. Nonetheless, if and when Term SOFR becomes available, the **ARRC Hardwired Approach** prioritizes using the type of rate over other SOFR-based rates.

b. Daily Simple SOFR: a *backward*-looking overnight rate based on SOFR averaged over the duration of the applicable tenor, with no compounding. This is selected under the **ARRC Hardwired Approach** (while Term SOFR

[1] The approaches for debt products were promulgated by ARRC with backing from the Federal Reserve Board and the FRBNY. ISDA led on OTC derivatives. It should be noted, however, these are merely model approaches. Many market participants will have idiosyncratic internal policy or contract-specific reasons for using modified or wholly bespoke approaches to resolve LIBOR phase-out issues. This is especially true for parties in the loan market, which does not use standardized form language to the same extent as the OTC derivatives market.

remains unavailable) as the second (or present) preferred rate in its fallback waterfall.

c. Daily Compounded SOFR: a *backward*-looking overnight rate based on SOFR, subject to compounding accrued unpaid interest over the applicable calculation period. Compounding methodology could be either:

- Compounding of the rate, which is embodied in the ISDA Approach and is how the FRBNY compiles its SOFR index; or
- Compounding of the balance, a complex technique that more accurately reflects economic costs of funding where principal amounts vary during the calculation period.

If the ARRC Amendment Approach is adopted for a credit agreement, the borrower and administrative agent may select any alternate benchmark rate and related conventions, subject to ratification by *negative* consent (*i.e.,* failure to object) of the facility's "Required Lenders" – though, in the U.S. syndicated loan market, the varieties of SOFR-based rates above are expected to be most popular.

2. What Rate Conventions Govern the Accrued Interest Calculations?

In addition to prioritizing different types of SOFR-based rates, the fallback approaches vary as to which, and how, technical conventions are adopted for calculating interest using such successor rate. These conventions range from the mundane (*e.g.,* business day, rounding and implied rates for holidays) to those with significant economic and operational impact, such as "lookback" periods for calculating accrued interest payable at the end of a particular calculation period.

Under the ISDA Approach, rate conventions are prescribed in detail in Bloomberg's IBOR Fallback Rate Adjustment Rule Book. The rules require, for instance, compounding interest over a lookback period that is "backward shifted" such that the accrual period begins two business days prior to a relevant floating rate payment period and ends two business days prior to the payment date. This helps give the parties enough time to calculate and process payments.

By contrast, the ARRC Approaches grant the administrative agent broad authority to determine a facility's rate conventions (after considering ARRC recommendations and market practices, to the extent administratively feasible). Although ARRC has published recommended conventions, it may be difficult to predict with certainty whether a facility's future conventions will match those of its hedge.

3. How Are Spread Adjustments Calculated?

Final spread adjustments under the ISDA Approach were fixed on March 5 as a result of the FCA's announcement, which constituted an "Index Cessation Event". For each relevant tenor, Bloomberg (ISDA's official vendor) determined the final spread by calculating the median of the historical differences between LIBOR (for such relevant tenor) and SOFR compounded in arrears (over a corresponding duration of time) over the five years preceding March 5, 2021.

In order to promote consistency of rates across the cash and derivatives markets, ARRC previously has stated that it intends to match ISDA's spreads for purposes of the Hardwired Approach.

Under the ARRC Amendment Approach, a borrower and the administrative agent select a spread adjustment (or calculation method) after considering recommendations of relevant government authorities or prevailing syndicated market conventions.

4. When Will the Fallback Rate Apply?

Although the March 5 FCA announcement constitutes an "Index Cessation Event" (under ISDA terms) and a "Benchmark Transition Event" (for facilities using ARRC terminology), this event itself does not trigger the replacement of LIBOR. Instead, the replacement date varies by approach and by possible elections of credit facility parties.

Under the ARRC Hardwired Approach, the "Benchmark Replacement Date" occurs only once all rate options under a facility are no longer available. For syndicated facilities referencing the most commonly used USD LIBOR tenors, this will be immediately after June 30, 2023. However, if a facility also permits borrowings under one-week or two-month USD LIBOR, the agent may simply "turn off" such tenors as available options beginning after 2021 so long as the facility offers borrowings under other tenors.

Under the ARRC Amendment Approach, the March 5 FCA announcement permits the borrower and the agent to begin the rate amendment and lender ratification procedures discussed above. Any decision to amend a facility's rate, however, will not become effective until a pre-negotiated time (*e.g.*, 90 days) prior to official cessation of LIBOR.

The ISDA Approach provides that the successor rate will begin to apply upon the cessation of all tenors of USD LIBOR – *i.e.*, just after June 30, 2023. If a tenor (*e.g.*, one-week USD LIBOR) referenced in an ISDA transaction becomes unavailable before then, such unavailable tenor is determined by linear interpolation (much like the fallback mechanism for unavailable rate settings already existing under the 2006 ISDA Definitions prior to Supplement No. 70).

MITIGATING BASIS RISK

The differences among LIBOR fallback approaches for cash and derivatives transactions may introduce basis risk for some market participants. For example, a corporate borrower who has entered into an interest rate swap to hedge floating rate exposure under a LIBOR-based facility may not be precisely hedged if the instruments' successor rates mismatch in type or convention. Similarly, a loan total return swap may see changes in its returns if the methodologies for calculating its floating rate amount under the swaps and the underlying loan interest diverge after LIBOR replacement.

Two alternatives may be used to eliminate these basis risk. The Hedged Loan Approach, originally promulgated by ARRC for bilateral loans with perfect hedges, may be suitable in circumstances in which a market participant has substantial control over a credit facility's documentation. Under this approach, the facility fallback language specifically refers to and applies the successor rate and spread adjustments applicable for derivatives referencing the 2006 ISDA Definitions (including Supplement No. 70).

The second alternative, substantially more complex, is available to swap parties even if they do not control the terms of a referenced credit agreement. In short, parties can enter into bilateral agreements so that benchmark provisions under relevant swaps mirror the credit facility. ISDA has published templates to enable parties to bilaterally modify the scope and terms of the ISDA Protocol or Supplement No. 70 as it applies to their transactions. Of particular relevance here are templates that exclude existing or new agreements from the ISDA Approach and:

- apply separate trigger events and fallback rates to those agreements; or
- provide that the triggers and fallbacks match those under a related hedged product.

CONCLUSION

Market participants have already begun preparing for LIBOR replacement in earnest. For many, that preparation should include reviewing cash and derivatives instruments to assess potential basis risk arising from differences in LIBOR fallback mechanisms, calculations, timing and other terms. If bespoke adjustments are worthwhile, participants should determine whether and how to amend or replace loan documentation to match the supplemented ISDA definitions. Alternatively, they may consider bilateral agreements to refine the standard ISDA Approach so that their swaps match loan documents. Market participants concerned about basis risk should begin taking immediate steps in what may be a time-consuming review and negotiation process so that they are well-positioned for the end of the end of LIBOR.

Appendix A

	LIBOR	SOFR
Tenor	LIBOR is a _forward_-looking term rate, quoted for _multiple tenor lengths_.	SOFR is _backward_-looking, published each day based on a single prior evening's _overnight_ rate. *Why this matters*: Because SOFR is only an overnight rate, conversions of daily SOFR are necessary to synthesize longer-term rates of the type typically employed in loan and derivative contracts (*e.g.*, 30-day, 90-day, one-month and three-month tenors).
Credit risk	LIBOR quotes include the perceived _credit risk_ of lending to banks on an unsecured basis and will vary among tenors to reflect liquidity premiums for longer-dated obligations.	SOFR approximates a "_risk-free rate_" because it is based on overnight obligations secured by U.S. Treasury notes. *Why this matters*: A fallback rate based on SOFR (or any other risk-free rate) must include spread adjustments in order to more closely track LIBOR rates used in preexisting agreements. Absent appropriate adjustments, significant transfers of value could occur between debtor and creditor parties due to switching from a risk-based to risk-free benchmark rate.
Currencies	In addition to USD, ICE Benchmark Administration currently publishes LIBOR quotes for _various currencies_.	SOFR is intended for _USD-denominated obligations only_. Government authorities in foreign jurisdictions have identified their own preferred risk-free rates for replacing local-currency LIBOR rates.
Availability	Publication of USD LIBOR rates based on bank surveys is being phased out over the next two years.	Daily SOFR and certain compounded SOFR figures are now available from the FRBNY. Adjusted SOFR-based fallback rates are currently available on an indicative basis from Bloomberg.

QUESTIONS

If you have any questions, please call your usual contact at Kibbe & Orbe LLP or one of the persons listed below.

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