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Transitioning from LIBOR to a Replacement Rate Index: What Steps Should Lenders Take Now?

By Andrew Kalgreen

Lenders and borrowers alike are wondering when and how they will adapt to a market in which LIBOR is no longer the preferred interest rate benchmark, a development likely to occur at year-end 2021. Clearly lenders must consider the many effects of replacing LIBOR with another floating rate index. This article discusses the steps lenders should take now, and why.

Financing Robotics: Scoping the Opportunity

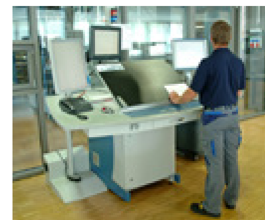
By Paul Bent, Shawn Halladay and Andrew G. Mesches

Will the growth of robotics increase financing volume? The jury is out, but niche players with asset management skills will likely discover opportunities. As this article points out, most risks are no different from those faced in any technology-driven asset class: managing residual risk and associated soft costs in a fluid environment.

Analyzing U.S. Cannabis Laws and Their Impact on Financial Services

By Gregory D. Omer

As state cannabis laws become more commonplace, indirect connections to cannabis-related businesses are increasingly harder to avoid. Significant legal risk surrounds deposit services, loans, and commercial finance leases. Here is an overview of the complicated web of state and federal cannabis statutes, rules, and government policies.



A Valentine's Day Massacre of Liquidated Damages: *In re Republic Airways Holdings Inc.*

By Arlene N. Gelman and Edward K. Gross

A bankruptcy court ruling in New York this year could be problematic for lessors when enforcing certain typical acceleration and collection remedies against defaulting customers. Specifically, *In re Republic Airways Holdings Inc.* may impair the reliability of SLV-based liquidated damages provisions even in hell-or-high-water leases and guaranties of those obligations under unconditional and absolute guaranties. The authors will explain why they believe that the court erred, and discuss the enforcement and transactional implications to lessors.

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Transitioning from LIBOR to a Replacement Rate Index: What Steps Should Lenders Take Now?

By Andrew Kalgreen

Lenders and borrowers alike are wondering when and how they will adapt to a market in which LIBOR is no longer the preferred interest rate benchmark, a development likely to occur at year-end 2021. Clearly lenders must consider the many effects of replacing LIBOR with another floating rate index. This article discusses the steps lenders should take now, and why.

The drumbeat of articles in the financial press about the end of the London Interbank Offered Rate (or LIBOR) is rising, almost on a daily basis. LIBOR has been used for decades to price everything from home mortgages to commercial loans to derivatives. So lenders and borrowers alike are wondering when and how they will adapt to a market in which LIBOR is no longer the preferred interest rate benchmark.

Some background on LIBOR, its importance, and the reasons for its downfall will help frame the discussion of the next steps that banks, equipment finance companies, and other lenders should take to manage this transition. These next steps will include (1) inventorying the LIBOR indexed loans in a lender's portfolio, (2) analyzing existing loan documents regarding the alternatives (if any) to the LIBOR benchmark already in the contracts, (3) developing or improving the standard set of loan terms and conditions to pivot from LIBOR as an interest rate option when needed, and (4) monitoring the market's preferences for a replacement floating rate index.

WHAT IS LIBOR?

LIBOR is essentially the result of a survey of certain large global banks that are operating in London financial markets. (As used in this article, the term LIBOR will refer to U.S. dollar- denominated LIBOR. However, LIBOR is also calculated for the euro, the British pound, the Japanese yen, and the Swiss franc).

The survey is conducted each business day by the Intercontinental Exchange (ICE), a U.S. company that owns exchanges for financial and commodity markets. ICE submits the survey to 18 panel banks for the U.S. dollar LIBOR. In essence, the survey asks this question: At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11 a.m.?

ICE discards the highest four rates and the lowest four rates (so as to eliminate outliers that could skew the results) and averages the remaining middle 10 rates. The results of the daily LIBOR survey are reported at 11:30 a.m. London time in seven different maturities, ranging from one day to one year, and are published by Thomson Reuters.

Thus, the LIBOR benchmark is meant to reflect the cost at which large, globally active banks can borrow on an unsecured basis in wholesale markets.

WHY IS LIBOR IMPORTANT?

LIBOR is very widely used in financial markets. In March 2018, the Alternative Reference Rates Committee (ARRC) convened by the Federal Reserve Board and the Federal Reserve Bank of New York (New York Fed) stated that LIBOR underpins *$200 trillion* of derivatives, loans, and other financial products.

Many banks, leasing companies, mortgage lenders, and credit card companies set their own interest rates for extensions of credit using LIBOR. It is estimated that LIBOR is the principal reference rate for *$10 trillion* of U.S. dollar loans held by U.S. financial institutions in their portfolios.

During the 2008 financial crisis, private investigations raised the question of whether or not LIBOR had been manipulated by the panel banks or been affected by false submissions.

WHY IS LIBOR BEING ELIMINATED?

The short answer to this question is that the Financial Conduct Authority (the government agency that is responsible for regulating the financial services industry in the United Kingdom and that is specifically tasked with overseeing LIBOR) announced in July 2017 that, as of year-end 2021, it will no longer compel the panel banks to provide LIBOR quotes.

Although this announcement does not mandate the end of LIBOR, it has awakened market participants to the limitations of LIBOR — and to the need to find a replacement index. The longer answer is twofold.

First, according to the frequently asked questions published by the ARRC (www.newyorkfed.org/arrc/faq), LIBOR is increasingly based on the expert judgment of the panel banks due to the declining amount of unsecured, wholesale borrowings by banks since the 2008 financial crisis. Therefore, LIBOR is less and less a robust, transactions-based market interest rate as envisioned by international standards for benchmarks. Again, as noted in the FAQs, the scarcity of underlying transactions also makes LIBOR potentially unsustainable, as many banks have grown uncomfortable in providing submissions based on expert judgment.

Second, during the 2008 financial crisis, private investigations (such as *The Wall Street Journal*) and government investigations (including the U.S. Department of Justice and the U.K. Financial Services Authority, or FSA) raised the question of whether or not LIBOR had been manipulated by the panel banks or been affected by false submissions.

In June 2012, Barclays Bank was fined $200 million by the U.S. Commodity Futures Trading Commission, $160 million by the U.S. Department of Justice, and £59.5 million by the FSA for attempted manipulation of the LIBOR and other interbank rates. This manipulation or erroneous-submission issue arises because LIBOR is survey driven and not the result of actual financial transactions.

In light of the potential risk that LIBOR could be manipulated or subject to erroneous or even biased expert judgments, and of the real 2021 deadline set by the Financial Conduct Authority, the value of LIBOR as a sustainable predictive interest rate tool has been cast into doubt and the financial services industry is searching for its replacement.

WHAT WILL REPLACE LIBOR?

Again, we have a short answer: we don't know yet. But there is no lack of interest in developing an alternative to LIBOR and the one most actively being considered is the Secured Overnight Financing Rate (or SOFR). There are excellent sources of information about SOFR available at the websites for ARRC and for the Loan Syndications and Trading Association (LSTA).

One example is the *ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for New Originations of LIBOR Bilateral Business Loans*, issued December 7, 2018 (Bilateral Loan Consultation) (www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Bilateral-Business-Loans-Consultation.pdf). Much of the information presented about SOFR in the balance of this article is derived from reports and consultations published by LSTA and ARRC.

The Bilateral Loan Consultation describes SOFR as follows:

> SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities. SOFR is determined based on transaction data composed of: (i) tri-party repo, (ii) General Collateral Finance (GCF) repo, and (iii) bilateral Treasury repo transactions cleared through Fixed Income Clearing Corporation (FICC).

In recognition of the importance of LIBOR and the impact of its cessation on financial markets, the New York Fed began publishing SOFR on a daily basis in April 2018.

However, SOFR was originally developed to manage the transition from LIBOR for the derivatives market, not for term-loan products. Adapted from an LSTA consultation (www.lsta.org/uploads/DocumentModel/3523/file/libor-in-the-loan-market_042418.pdf), Table 1 compares features of LIBOR and SOFR.

Table 1. LIBOR Versus SOFR: A Comparison of Features

LIBOR	SOFR
Term structure	Overnight (for now)
Unsecured	Secured (by U.S. Treasury securities)
Reflects bank cost of funds (sort of)	Risk-free (nearly) rate
LIBOR should be a higher rate	SOFR should be a lower rate
Under $1 billion of daily trading (3-month LIBOR)	Nearly $800 billion of daily trading
Easily manipulated	Not easily manipulated

There has also been some concern that SOFR, as an overnight rate, could be fairly volatile day to day. However, as shown in the FAQs, during the September 2018 to January 2019 time frame, compounded average SOFR was far less volatile as compared to daily SOFR. Furthermore, the FAQs also reveal that from 2015 through 2018, the three-month compounded average SOFR has been less volatile than three-month LIBOR.

Despite the differences between SOFR and LIBOR, the development of SOFR and its publication are important steps in establishing an alternative reference rate, and momentum is building via ARRC and other industry sources to accept SOFR as a replacement index for LIBOR. With time, it is expected that the market will arrive at a consensus toward using an index such as SOFR as LIBOR's replacement in loan products.

Some market participants have asked why other interest rate indexes are not being studied as replacements for LIBOR. Syndicated loan facilities and large bilateral corporate loans have long been structured with multiple floating rate options, including LIBOR, the prime rate (the interest rate publicly announced from time to time by the applicable bank as its prime rate or base rate) and the federal funds rate (the rate calculated by the New York Fed based on any given day's federal funds transactions by depositary institutions).

However, these two standard contract alternatives to LIBOR are not considered suitable replacements for LIBOR. The prime rate is not transaction based (rather, it is what the applicable bank says it is), and it is a fairly static rate that does not move in concert with general market trends. The federal funds rate is based on less than $80 billion of trading, it has fewer counterparties, and it is highly reliant on government-sponsored enterprises (such as Fannie Mae, Ginnie Mae, and Freddie Mac).

WHAT ARE FALLBACK PROPOSALS?

The Bilateral Loan Consultation includes an excellent description of the philosophical foundations of the two "fallback proposals," whereby loan parties contractually agree on when and how a commercial loan will be modified to replace LIBOR. This foundation language is provided verbatim below:

> The first is an "amendment approach," which would provide a streamlined amendment mechanism for negotiating a replacement benchmark in the future and could serve as an initial step towards adopting a hardwired approach (see Appendix I). Second is a "hardwired approach," which would provide market participants with more clarity as to a how a potential replacement rate will be identified and implemented (see Appendix II).
>
> The amendment approach and the hardwired approach each have their pros and cons, and they may behave differently in different market environments. The amendment approach uses loans' flexibility to create a simpler, streamlined amendment process. It is similar to the "LIBOR replacement" language that has developed in the syndicated loan market in the past year, it maximizes flexibility and it also does not rely on a rate (term SOFR) and spread adjustment methodology that does not yet exist. However, it may simply not be feasible to use the amendment approach if thousands of loans must be amended simultaneously due to an unexpected LIBOR cessation. This could create the very real possibility of disruption in the loan market. Additionally, the amendment approach is likely to create winners and losers in different market cycles. In a borrower-friendly market, a borrower may be able to extract value from the lenders by refusing to include a compensatory spread adjustment when transitioning to SOFR. Non-consenting lenders still would be subject to the lower rate. In a lender-friendly market, lenders might block a new proposed rate, forcing the borrower to pay a higher interest rate, such as the alternate base rate for a period of time. For these reasons, working group members who are proponents of use of the amendment approach at the current time generally believe that eventually some version of a hardwired approach will be more appropriate. Market participants who choose to adopt the proposed amendment approach should therefore expect that future amendments to those provisions, if possible, may be desirable prior to any LIBOR cessation.
>
> In contrast, the hardwired approach provides clarity upfront. Lenders and borrowers know that they will receive a version of SOFR plus a Replacement Benchmark Spread upon LIBOR discontinuance. Upon a LIBOR cessation event, neither borrowers nor lenders will be able to take advantage of the then-current market environment to capture economic value. However, term SOFR and the replacement benchmark spread do not yet exist, so it may be hard to determine today what the ultimate replacement rate would look like. That said, other products may determine that this is an acceptable risk, for instance, the hardwired approach proposal is closely aligned with the ARRC's fallback proposal for floating rate notes currently under consultation.

HOW DO THE ARRC FALLBACK PROPOSALS WORK?

In appendixes I and II to the Bilateral Loan Consultation are the proposed contacts terms

> **The prime rate is not transaction based and it is a fairly static rate that does not move in concert with general market trends.**

In appendixes I and II to the Bilateral Loan Consultation are the proposed contacts terms and conditions for amending loan documents to account for the cessation of LIBOR as the primary interest rate index.

and conditions for amending loan documents to account for the cessation of LIBOR as the primary interest rate index and to select its replacement. Appendixes I and II can found at pages 17 to 27 of this website: www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Bilateral-Business-Loans-Consultation.pdf. Appendix I adopts the "amendment approach" and Appendix II adopts the "hardwired approach."

Both appendixes have the same four basic components:

1. Identification of the triggering events that precipitate the switch from LIBOR to a new reference rate. Examples of triggering events include LIBOR cessation (or statement of LIBOR cessation), LIBOR not being published for a period of time, or the announcement that LIBOR is no longer representative. The Bilateral Loan Consultation also considers "pre-cessation" triggers and "opt-in" triggers, whereby parties can initiate a transition to a new reference rate, even if LIBOR continues to exist and be representative.
2. Selection of a replacement reference rate. For this article, it is assumed that the new rate will be SOFR.
3. Determination of the spread over SOFR. This spread should compensate for the difference between LIBOR and SOFR.
4. Modification process. This will either be the amendment approach or the hardwired approach.

As noted above, the hardwired approach depends on future development of several innovations related to SOFR. Among these innovations are the following two concepts taken from Appendix V to the Bilateral Loan Consultation:

> "Term SOFR" means the forward-looking term SOFR rate, for a term equal to the applicable Interest Period, that is selected, endorsed or recommended as the replacement for such LIBO Rate by the Relevant Governmental Body. Term SOFR does not currently exist, but is scheduled to be implemented no later than 2021, and there is the potential that it will exist much earlier.
>
> "Compounded SOFR" means, for the applicable interest period, a compounded average of daily SOFR as published by the Federal Reserve Bank of New York or any entity that assumes responsibility for publishing such rate. Compounded SOFR may be either: (i) calculated at the start of the interest period using the historical Compounded SOFR rate for the period that ends immediately prior to that date (this payment structure is often termed "in advance" since the payment obligation is determined in advance) or (ii) calculated over the relevant interest period with a lock up period prior to the end of the interest period, in which case the rate will not be known at the start of the interest period (this structure is often termed "in arrears").

SAMPLE CONTRACT TERMS

Appendix I to the Bilateral Loan Consultation provides the contract language for the amendment approach to handle the discontinuance of LIBOR and the selection of a replacement index and spread. This appendix runs 3-1/2 pages, most of which consists of 12 new definitions. Below is just the first clause of this Appendix I, which sets the table for the loan modification:

> Notwithstanding anything to the contrary in this Agreement or any other Loan Document, at or promptly after a Benchmark Transition Determination, the Lender pursuant to clause (b) of this Section titled "Effect of Benchmark Discontinuance Event" may amend this Agreement to replace LIBOR with an alternate benchmark rate (which may include Term SOFR, to the extent publicly available quotes of Term SOFR exist at the relevant time), including any Replacement Benchmark Spread, in each case giving due consideration to [any evolving or then existing convention for similar U.S. dollar denominated credit facilities for such alternative benchmarks and adjustments or] any selection, endorsement or recommendation by the Relevant Governmental Body with respect to such facilities (any such proposed rate, together with the Replacement Benchmark Spread, a "Replacement Benchmark"). Such Replacement Benchmark shall be applied in a manner consistent with market practice or, to the extent such market practice is not administratively feasible for the Lender, in a manner as otherwise reasonably determined by the Lender; provided that in no event shall such Replacement Benchmark be less than zero for purposes of this Agreement.

Appendix II of the Bilateral Loan Consultation sets forth the contract language for the hardwired approach to deal with the discontinuance of LIBOR and to select a replacement index and spread. This appendix is almost seven pages long, the vast majority of which are 25 newly defined terms.

ARRC has published three other consultations similar to the Bilateral Loan Consultation — one for syndicated loan facilities, one for floating rate notes and one for securitized credit facilities – and each of them has appendixes with sample contract language to revise loan documents using either the amendment approach or the hardwired approach.

Lenders should begin by identifying all current credit facilities (held in portfolio or administered) that include LIBOR as a floating rate option and a maturity date after December 31, 2021.

WHAT STEPS SHOULD LENDERS TAKE NOW?

First, do not panic. Second, get busy now to position your company to manage the process of making a successful change from LIBOR-based loans to loans with a replacement floating rate index.

Lenders should begin by identifying all current credit facilities (held in portfolio or administered) that include LIBOR as a floating rate option and a maturity date after December 31, 2021. Actually, any LIBOR-based loan with a maturity date in 2021 should also be identified since it is possible that a triggering event as described above in the ARRC fallback proposals could occur before year-end 2021.

Lenders will then need to analyze whether these loans include one of the following (each an "index replacement mechanism"): (1) the bank's right to select a reasonable replacement index rate and spread (this would be similar to the ARRC's amendment approach) or (2) a specific, viable and enforceable replacement index rate plus spread (this will be similar to the ARRC's hardwired approach).

Those lenders with existing LIBOR-based loan facilities that do not include an index replacement mechanism should take advantage of any time when borrowers request renewals, extensions, modifications, waivers, or concessions for any reason. Such borrower requests will present lenders with opportunities to amend their credit documents to add an index replacement mechanism.

If no such opportunity presents itself prior to 2021, lenders on their own initiative should approach their borrowers to negotiate an index replacement mechanism for credit facilities maturing after 2021.

For all new credit facilities being negotiated now that will include a LIBOR floating rate index (especially those that will mature in 2022 or later), lenders and their legal counsel should develop standard terms and conditions for an index replacement mechanism in their loan documents, based on either the amendment approach or the hardwired approach.

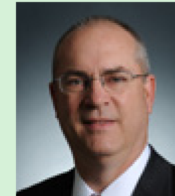
If market participants accept a successor index rate to LIBOR (such as term SOFR or compound SOFR), then at some point prior to 2022, lenders that have included the amendment approach in their credit documents should consider further amending their documents to replace the LIBOR provisions with the applicable SOFR provisions.

Regardless of whether lenders adopt the amendment approach or hardwired approach in their loan documents, lenders should monitor developments related to LIBOR's cessation, the market's acceptance of SOFR as an alternative reference rate index, the New York Fed's creation and publication of term SOFR and compound SOFR, and when available, the performance characteristics of term SOFR and compound SOFR as compared to LIBOR and other floating interest rate indexes.

CONCLUSION

It is beyond the scope of this article (and the author's skill set) to consider other operational issues that lenders will need to address in connection with replacing LIBOR with another floating rate index. Just to name a few: determining how government regulators will view the impact of the transition (such as stress testing); modifying or acquiring software and adjusting internal systems to capture published data about the new index and to price loans with the new index; developing customer communications to alert them to the end of LIBOR and to the replacement index; training bankers, documentation staff, and loan administration personnel on the use of the new index; and updating billing and collection systems.

Year-end 2021 may seem like it is a long way off, but given the importance and complexity of transitioning from LIBOR, its arrival is accelerating. To paraphrase C.S. Lewis on managing change: you cannot go back and undo the demise of LIBOR, but you can start where you are today to change the ending.



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