What to do about the Libor Time Bomb? ARRC Adopts Recommended Fall-Back Language for Libor Based Credit Facilities

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As has been widely published in the financial services sector, the Financial Conduct Authority in the United Kingdom (FCA) has determined that banks will no longer be compelled to support the London Interbank Offered Rate (Libor) beyond 2021.

Libor has been (and continues to be) a key index in commercial financing transactions. Libor is determined each banking day at 11 a.m., London time, for five major currencies (the US dollar, the Swiss franc, the euro, the British pound sterling and Japanese yen) with different maturities, based on responses that the ICE Benchmark Administration receives from a panel of participating banks to the following 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 11:00 a.m. London time?” Based on those responses, the ICE Benchmark Administration calculates Libor for each currency and maturity by throwing out responses in the highest and lowest quartiles and averaging those in the middle two quartiles.

Notwithstanding Libor’s use in the vast majority of financing transactions (currently, there are over $200 trillion of Libor-based contracts outstanding), the Libor market itself is rapidly contracting, in the aftermath of the Libor rigging scandals that rocked markets after the 2008 financial crisis, with less than $1 billion of U.S. Libor daily interbank trading. This imbalance, as well as the FCA’s pronouncement that it will no longer compel banks to submit Libor after 2021, creates systemic issues to the general financing market. This is a problem not only for credit facilities initiated after 2021, but also for existing and new credit facilities that use Libor as the basis for interest charged. While most loan documentation using Libor-based pricing has historically and typically contained provisions for alternative rates (most normally using either a prime based rate or a Fed funds based rate or combination) in the event that Libor is no longer available or in the event that it is illegal to charge interest at a Libor-based rate, such language is generally inadequate, particularly from a borrower’s stand-point, since such rates are not comparable to Libor, do not represent a lender’s cost of funds, and are generally higher than Libor. For instance the prime rate is currently about 300 basis points in excess of current 30-day U.S. dollar Libor. Unfortunately, the market has been slow to adopt a consensus replacement for Libor and banks and other lenders continue to make loans at Libor-based interest rates with maturities beyond the 2021 Libor phase-out and without providing for adequate fallback language to address a Libor replacement.

The Alternative Reference Rates Committee of the Federal Reserve Board and the New York Federal Reserve Bank (ARRC) has previously determined to publish a new reference rate, based on a combination of three rates for overnight repurchase (repo) transactions secured by U.S. Treasury Securities called the “Secured Overnight Financing Rate” (SOFR), which includes actual market data from the Bank of New York Mellon and the Depository Trust & Clearing Corporation. SOFR is a broad measure of the cost of borrowing cash overnight, collateralized by U.S. Treasury Securities. According to ARRC, SOFR has certain advantages to Libor including that it is a rate produced by the New York Fed for the public good, as opposed to a rate subject to price-rigging as was Libor, it is derived from an active, well-defined market of sufficient depth, it is produced in a transparent manner rather than being dependent on estimates, and it is based on the largest rates market (the U.S. Treasury repo market) at a given maturity in the world.[1] ARRC anticipates that once a sufficient SOFR derivatives market develops, there will be forward-looking SOFR terms rates that will be used as a fallback to the current use of Libor.

On April 25, 2019, ARRC published, in two separate reports, recommendations to lenders and market participants for fallback language to use in lieu of Libor in both syndicated financing and variable rate note financings.[2] This Client Alert focuses on the report with respect to syndicated financings, which also has implications for the bilateral loan market, given that loan documentation in the latter is often derived from loan documentation used in the syndications market.[3] As noted above, most existing commercial loan documentation provides for fallback language in the event of the illegality or unavailability (but not generally cessation, as is likely to occur upon Libor phase-out after 2021) of Libor, but such language typically defaults to the use of alternate indexes that are not comparable to Libor. ARRC has recommended two (2) different approaches to providing fallback language. The first is a "hardwired" approach which provides for trigger events and the replacement of Libor with a SOFR-based rate, with all terms for the implementation of the SOFR-based rate included within the proposed language. The second is an amendment approach which uses the same triggers but provides that the parties to the transaction will negotiate amendments to the credit documentation identifying and implementing a new rate, which may include SOFR.

The triggering events are as follows:

- Permanent cessation triggers:
    - A public statement or publication of information by or behalf of the ICE Benchmark Administration that it has ceased or will cease, permanently or indefinitely, to provide Libor and there is no successor administrator that will continue to provide Libor;
    - A public statement or publication of information by FCA, the central bank for currency for Libor (in the case of U.S. Libor, the Federal Reserve System), an insolvency or resolution official or court with jurisdiction over the ICE Benchmark Administration which states that the ICE Benchmark Administration has ceased or will cease, permanently or indefinitely, to provide Libor and there is no successor administrator that will continue to provide Libor.

- Pre-cessation trigger that Libor is no longer representative as announced by a public statement or publication of information by FCA.

- Early "Opt-in" triggers:
    - In the case of the amendment approach, a determination by the administrative agent and the required lenders that U.S. dollar-denominated syndicated credit facilities being executed at such time are being executed or amended to incorporate a replacement benchmark rate for Libor and the election of either (a) the administrative agent or (b) the required lenders to declare that an Early Opt-in Election has occurred and the provision under (a) of written notice from the administrative agent to both the borrower and the lenders or under (b) of written notice from the required lenders to the administrative agent;
    - In the case of the "hardwired" approach, notice from administrative agent (the request by the borrower to the administrative agent) to notify the other parties that a minimum number[4] currently outstanding U.S. dollar-denominated syndicated credit facilities (whether new deals or as amended) then use a SOFR-based rate as the benchmark interest rate in lieu of a Libor-based rate and the joint election of the administrative agent, the borrower and the required lenders to declare that an Early Opt-in election has occurred.

Under the ARRC's amendment approach, once a trigger has occurred, the administrative agent and the borrower may amend the contract to replace Libor with a replacement benchmark which will become effective after a five (5) day negative consent period for the required lenders (i.e., the amendment will become effective five (5) days after the administrative agent has posted the amendment unless the administrative agent has received written notice of objection from the required lenders). Many lenders in both the syndicated and bilateral loan markets have, with increasing frequency over the last year or so, begun using an amendment approach similar to what ARRC has proposed in its amendment language. However, any "hardwired" approach providing for a specific replacement index has not been often used, given the uncertainty of what the replacement index should be and whether the general loan markets would adopt a particular index as a consensus replacement index. ARRC's hardwired approach provides for a waterfall of replacement benchmark successor rates as follows: first, a term SOFR plus a margin; or, second, if a term SOFR does not exist, a compounded average of daily SOFRs plus a margin; or, third, if neither of the foregoing exist, then the hardwired ap-proach reverts to the amendment approach.

There are both pros and cons to using either of ARRC's proposed approaches. On the plus side for the amendment approach are the following:

- Similar to what many lenders and borrowers are currently doing;
- Does not rely on an interest rate structure which is not currently used or is unknown today;
- Nothing is being crammed down on the borrower;
- Allows the parties flexibility in seeking a solution.

On the minus side for the amendment approach are the following:

- May lead to excessive negotiation depending on financing markets at time of trigger event;
- Difficulties in putting into effect from an operational standpoint an unknown replacement rate;

- Lenders and borrowers will likely be overwhelmed with the sheer number of marketplace amendments that would have to be undertaken, negotiated and documented with a very short period of time upon a trigger event, which would affect the market as a whole.

On the plus side for the hardwired approach are the following:

- Since terms are agreed to upfront, and there is at least some basis for support (the ARRC proposal itself), there is less likelihood of over-negotiation;
- Lenders can begin to build into their systems now, since there is certainty;
- So long as a SOFR is available, and the amendatory third level of the waterfall referenced above does not go into effect, the language is self-operative and will need not rely on an amendment being undertaken, which allows lenders to trigger all of their loans with hardwire language at once upon a trigger event;
- The approach is the same as being taken with respect to swaps, other derivatives and other cash products.

On the minus side are the following:

- The language has not been tested;
- The concept relies on a rate which is not published or known today.

Unfortunately, lenders and the commercial loan market in general have failed to date to adequately address impending issues that could result in real disruptions in just over thirty months' time. The "solutions" to date, even in new credit facilities, have been to either rely on fallback language that was never really intended to cover a situation in which publication of Libor ceases entirely or provide for a substitute rate either negotiated with, or imposed upon, the borrower, with appropriate positive or negative margins to be determined based on market conditions at the time. Most market participants have taken a wait and see attitude and "kicked the can down the road" to see where the "market" ends up. To date, except for the proposals advanced by ARRC, little has been put forth to address the situation. However, the clock is ticking, time is fast slipping away, and it is critical that lenders begin to address this issue for both new and existing credit facilities. Lenders need to understand Libor exposure in their portfolios, develop appropriate fallback solutions, incorporate those solutions into their loan systems and documentation, and develop a consistent plan for both new loans and modifications and amendments to existing credit facilities.

If you would like more information or if we can provide assistance in advising as to modification of loan document forms or amendments to existing credit facilities, please contact a member of our Financial Services team.

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[1] *See, A User's Guide to SOFR*, The Alternative Reference Rates Committee, April, 2019.
[2] *See, ARRC Recommendations Regarding More Robust Fallback Language for New Originations of Libor Syndicated Loans*, April 25, 2019, and *ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of Libor Floating Rate Loans*, April 25, 2019.
[3] It is anticipated that the ARRC will publish recommended language for bilateral business loans and securitizations which rely on Libor in the near future.
[4] The ARRC's report as to syndicated loans uses at least five such transactions as the base number.