LIBOR's Ending: A Long Goodbye

Amundsen Davis Financial Services Alert
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In our October 2019 alert, we advised that LIBOR (London Interbank Offered Rate) will not be available for use as an interest rate index after December 31, 2021 (the LIBOR Cessation). As the end of 2021 approaches, here is our update. LIBOR is sticking around for a while (sort of, in a synthetic form explained below). The Secured Overnight Funding Rate (SOFR) appears to be leading the pack to become the standard alternative reference rate to replace LIBOR in bilateral business loans. On the other hand, American Interbank Offered Rate (Ameribor) and Bloomberg Short Term Bank Yield Index (BSBY) are also being used as replacement rate indexes for LIBOR. Our discussion today centers on SOFR. Ameribor and BDBY will be reviewed in a subsequent alert.

The ICE Benchmark Administration (ICE), the source for LIBOR tenors in US Dollars, will not publish "representative" LIBOR rates after December 31, 2021. Don't panic. To facilitate the on-going transition to an alternative reference rate for LIBOR, ICE will publish "synthetic" LIBOR tenors through at least June 2023 for existing LIBOR loans. What is the difference? Representative LIBOR is derived from market interest rates that certain global banks (Panel Banks) have been required to submit to ICE. This requirement ends on December 31, 2021. Accordingly, ICE will lack the data needed to publish the Representative LIBOR tenors. ICE will employ a methodology to come up with Synthetic LIBOR tenors intended to be a fair approximation of what LIBOR would have been if the "representative" method was still in place. (Note: "Synthetic" LIBOR cannot be used as a rate index for loans made after December 31, 2021.) The ICE Synthetic LIBOR tenors will initially be overnight, one (1) month, three (3) months, six (6) months and twelve (12) months. The overnight and twelve (12) months Synthetic LIBOR tenors will not be published after June 30, 2023. ICE has not set a cessation date for the other synthetic LIBOR tenors.

As we discussed in our October 2019 Alert, the Federal Reserve Board created the Alternative Reference Rates Committee (ARRC) to identify an alternative reference rate ("ARR") for U.S. Dollar LIBOR and to set forth a plan to implement the ARR upon LIBOR Cessation. Since 2018, ARRC has consulted with the financial markets and issued recommendations regarding loan documentation provisions to effect the switch from LIBOR to the ARR. Early recommendations were that lenders could follow an "Amendment Approach" or a "Hardwired Approach" in their loan documentation for the change over. The Amendment Approach documentation acknowledged the coming LIBOR Cessation and provided that

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once the ARR was established, the lender and borrower would amend the interest rate provisions of the deal accordingly. The Hardwire Approach was for the documentation to have contractual language which (1) determined the triggering event for the ARR to replace LIBOR, (2) provided the ARR would be the "Benchmark Replacement" set by the Federal Reserve Board; and (3) set out the method by which the lender would determine any interest rate spread adjustment needed for the switch from LIBOR to the ARR.

On August 27, 2020, ARRC published its final recommendations, which are: (1) that SOFR will replace LIBOR; (2) that SOFR will be published by the Federal Reserve Bank of New York as the "SOFR Administrator"; (3) that lenders should use the Hardwired Approach in existing LIBOR priced loans to provide that SOFR will automatically replace LIBOR upon the LIBOR Cessation; and (4) that lenders use the "Benchmark Rate Adjustment" selected or recommended by the Federal Reserve Board for the SOFR indexed rates.

<u>What About that Benchmark Rate Adjustment</u>? LIBOR tenors are based on unsecured loans between banks and therefore some basis points are built in for the credit risk. SOFR tenors are "Risk Free Rates" (as if the underlying loan is fully collateralized) and therefore they are priced lower. Accordingly, once the rate index is switched from LIBOR to SOFR, the interest rate spread may need to be adjusted upward to maintain the same interest rate yield for the lender as it had with the LIBOR index.

<u>What about SOFR Term Tenors</u>? SOFR is an overnight rate. For tenor periods that equate to the familiar LIBOR tenor periods, ARRC recommended on July 29, 2021 that the forward looking SOFR Term Rates published by the CME Group (CME) be used. CME now publishes SOFR term tenors for one (1) month, three (3) months, six (6) months and twelve (12) months.

<u>What about that Amendment Approach</u>? In its August 27, 2020 final recommendations, ARRC stated that the Amendment Approach should not be used going forward. ARRC concluded that it would not be feasible for the "thousands" of loans to be amended upon the LIBOR cessation.

<u>What about the loans documented with the Amendment Approach provisions</u>? Bilateral amendments may be necessary to clean up the interest rate provisions in these loan documents upon the LIBOR Cessation. Depending on the specific amendment provisions used before ARRC chose the Hardwire Approach as the winner, lenders may be able to effect the switch to SOFR by giving notice of the new rate structure to borrowers. <u>Caution is advised in this approach</u>. Certain rate provisions, such as a LIBOR floor, may need to be reset for SOFR tenors with bilateral amendments. Good business practice may be to do bilateral amendments so that the lender and borrower are clearly on the same page on the operation of the SOFR index rates going forward.

Through the extensive efforts of the "powers-at-be" in the interest rate world to develop the Hardwire Approach, come January 1, 2022, the transition to the SOFR tenor indexes in the hardwire loan documents should proceed smoothly. The Amendment Approach loan documentation may need some amending to transition into SOFR tenor indexes. There is time to assess what amendments may be needed, but December 31, 2021 is around the corner.

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