Preparing for the Transition Away From LIBOR

By Danielle Katz

Background on LIBOR and Its Impending Phase-Out

On July 27, 2017, Andrew Bailey of the Financial Conduct Committee put the global financial industry on notice that the London Interbank Offered Rate (LIBOR) would be phased out by the end of 2021.[1] In the wake of that announcement, committees were formed all over the world to analyze, develop, and determine what the future of interest rate benchmarks will look like. While LIBOR was once the premier benchmark used across various currencies and terms, its potential for abuse and lack of liquidity in its underlying market has caused it to go from a front runner to being voted off the island.

LIBOR underpins trillions of dollars in financial products globally, including bonds, securities products, certain floating rate loans, financial derivatives, and adjustable rate mortgages.[2] LIBOR "refers to . . . unsecured whole-sale market rates for jumbo deposits between major banks that are of varying durations and are denominated in certain designated currencies."[3] LIBOR encompasses five currencies and seven distinct term periods. There is a unique LIBOR for each currency and term combination. In 2014, ICE Benchmark Administration Limited (IBA) was given the responsibility of administering and maintaining LIBOR. The daily rate is determined through submissions of a reference panel comprised of 11 to 18 banks for each currency calculated. "Each bank submits the rates at which it could obtain unsecured funding in each maturity for the relevant currency"[4] and then, after excluding the highest and lowest 25% of the rates submitted, the IBA takes an average of the rest to use as the daily rate.[5]

Shortly after the July 27 announcement, the Federal Reserve tasked the Alternative Reference Rate Committee (ARRC) with the responsibility of the transition from the U.S. dollar LIBOR to a new benchmark replacement. SOFR, the Secured Overnight Financing Rate, quickly became the front runner and first began being published in 2018. In order to ensure a smooth and successful transition, SOFR and LIBOR needed to run side by side for "several years in order to help determine a far compensating credit spread between LIBOR and [SOFR] for those financial assets that will need to change their reference interest rate to the new index."[6]

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How the Transition Is Progressing

The COVID-19 pandemic has shed a light on the lack of readiness of the financial industry to move away from LIBOR. On April 9, 2020, the Federal Reserve and the Treasury jointly announced a program aimed at offering mid-sized companies financial relief. This program is called the Main Street Lending Program (MSLP). The original term sheets provided for, among other things, SOFR as the interest rate benchmark for this program. However, after receiving thousands of comments on the proposed program, revised term sheets were published on April 30, 2020. One of the most notable changes? The interest of the loans is now tied to LIBOR, despite the terms of the loans extending past the impending phase-out date. As a result of the urging of banks, which generally argued they did not have the resources to focus on both the transition to SOFR and help companies receive the resources they desperately needed, the Fed conceded, and LIBOR was once again back on top. Although this change helped achieve the short-term goal of stimulating the economy and getting liquidity into the hands of distraught businesses, these same businesses now need to turn their attention to how their loan will be affected when LIBOR is no longer available.

The MSLP shift from SOFR to LIBOR demonstrates that, despite having years to plan and adjust, U.S. financial institutions are reluctant to make the change. This causes concern, not only because of the massive volume of financial products underpinned by LIBOR, but also because the time that the banks have to ensure a smooth transition for themselves and their borrowers is quickly shortening. It begs the inevitable questions, what will the future of lending look like, and what can be done in the meantime? The first question requires patience and is resulting in a lot of sleepless nights for those likely to be affected. The second, however, has much clearer answers.

Contractual Provisions To Consider in Anticipation of the Phase-Out

When reviewing loan documents, practitioners should consider if a business currently has or is taking out LIBOR-based loans that have terms that extend past the end of 2021, when LIBOR is expected to cease being reported. First, look to the loan documents to see if there is a market disruption provision. Grounded in lender's fear of "the possibility that 'disaster' could occur in the LIBOR market that would result in lenders being unable to obtain LIBOR quotes at the beginning of an interest period, or

that the quotes obtained would not adequately reflect the cost to the lenders of making the loan,"[7] most, if not all, LIBOR-based loans have a provision that allows the lender to temporarily use an alternative rate. However, these provisions are not meant to be long-term solutions. This provision is intended to cover situations lasting a day or so and related to things such as technical difficulties, not the cessation of reporting. It is important that there is additional transition language that lends itself to a more permanent disruption.

Confirming there is comprehensive language that deals with various situations is essential to safeguarding borrowers against several possibilities. New provisions, commonly referred to as "unavailability provisions," are addressing situations such as (i) LIBOR no longer accurately reflecting the lender's cost of funds, (ii) LIBOR ceasing to exist or becoming unavailable during the term of the loan, (iii) a public statement or publication of information by the regulatory supervisor for the administrator of LIBOR announcing that LIBOR is no longer a representative interest rate index, and (iv) the determination that it is no longer commercially reasonable or lawful for the lender to use LIBOR as an index. These provisions should also go on to provide for what will happen once LIBOR is deemed unavailable. Consider whether the lender has the ability to determine a replacement rate in its sole discretion or if the borrower's preference should be taken into consideration. Additionally, it is crucial to analyze the provisions to ensure that a comparable rate will be used to replace LIBOR in order to minimize any unintended consequences such as additional interest being paid by the borrower or additional income tax liability.[8]

It is important to note that LIBOR is not turning into a pumpkin in 2022, but that the intention of the phase out and its long transition period is to no longer have to persuade or compel banks to submit to the rate.[9] This leaves open the possibility that LIBOR will continue to be reported but no longer be accurate. This possibility should drive practitioners to think of all possibilities and ensure their loan documents reflect what could happen. Additionally, practitioners should be aware that LIBOR and SOFR are structurally different, and loan documents may need to be adjusted to reflect that.

This switch in rates and consequentially the culture and customs surrounding interest rate benchmarks is ripe for litigation as the situation continues to progress. If not executed mindfully, lenders are opening themselves up to potential breach-of-contract claims, claims for breach of the implied covenant of good faith and fair dealing, and arguments that they have not acted in a commercially reasonable manner in selecting a replacement rate. Making sure that any new or revised provisions are carefully reviewed will be crucial to ensuring borrowers preserve their rights for potential litigation and, arguably more important, end up in the substantially the same position they initially negotiated under the LIBOR loan agreement.

Finally, it is important to note that while LIBOR is one benchmark with various currencies under its umbrella, since the announcement of the phase out countries and regions with their currencies tied to LIBOR have all gone their separate ways and are implementing separate benchmarks. If international companies have multiple loan facilities tied to various LIBOR currencies, practitioners need to be mindful of how the other regions that have their currencies tied to LIBOR, namely Japan, the United Kingdom, Switzerland and Europe, are handling the transition.

Endnotes

1. Andrew Bailey, Chief Executive, Financial Conduct Authority, The Future of LIBOR at Bloomberg, London (July 27, 2017).
2. https://fas.org/sgp/crs/misc/IF11315.pdf.
3. Michael Bellucci & Jerome McClusky, The LSTA's Complete Credit Agreement Guide 71 (2d ed. 2017).
4. ICE Benchmark Administration, Roadmap for ICE LIBOR (2016), https://www.theice.com/publicdocs/ICE_LIBOR_Roadmap0316.pdf.
5. Overview, ICE, https://www.theice.com/iba/libor (last visited May 16, 2020).
6. *Id.*
7. Michael Bellucci & Jerome McClusky, The LSTA's Complete Credit Agreement Guide 110 (2d ed. 2017).
8. The Internal Revenue Service has made guidance available to borrowers, lenders and financial institutions with respect to the treatment of income tax in the context of transactions associated with the transition away from LIBOR.
9. Andrew Bailey, Chief Executive, Financial Conduct Authority, The Future of LIBOR at Bloomberg, London (July 27, 2017).

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