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Phase-Out of LIBOR: Implementing New ARRC Reference Rates for Floating Rate Loans and Derivatives, ISDA Revisions

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Today's faculty features:

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Phase-Out of LIBOR

Commercial Loans

Mark Heimendinger
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September 12, 2019

Lowndes

Phase-Out of LIBOR

1. Where are we and how did we get here?
2. Challenges for commercial loans
3. Risk mitigation
4. ARRC recommended language

Lowndes

Where are we?

- LIBOR phases out at the end of 2021, and there is a good chance that it will no longer be quoted
- Term SOFR and Compounded SOFR rates do not yet exist
- ARRC has released final Recommended Language for certain cash products, including Syndicated Loans, Bilateral Business Loans, Securitizations, and Floating Rate Notes
- ARRC intends to provide further guidance on the use of SOFR in cash products
- Voluntary Transition

How did we get here?

- LIBOR rate fixing scandal
- Wheatley Review 2012
- International Organization of Securities Commissions (IOSCO) principles 2013
- ICE Benchmark Administration takes over administration of LIBOR 2014
- Financial Stability Board (FSB) calls for development of alternative rates, and Alternative Reference Rates Committee (ARRC) convenes 2014
- ICE Benchmark Administration LIBOR Roadmap 2016
- Andrew Bailey announcement 2017
- Secured Overnight Financing Rate (SOFR) chosen by ARRC to replace LIBOR
- Paced Transition Plan (focuses on derivatives)
- ARRC reconstituted 2018
- ARRC released final Recommended Language for Bilateral Business Loans, Floating Rate Notes, Securitizations, and Syndicated Loans 2019
- ARRC released Incremental Objectives to compliment Paced Transition Plan

How did we get here? ARRC's relevant mandates

- Identify Alternative Reference Rate for LIBOR
- Create an implementation plan to support voluntary adoption of Alternative Reference Rate
- Identify "best practices" to create robust contracts

Challenges for commercial loans, i.e. why should you care?

- Need for polling of reference banks under temporary disruption language
- Base rate loans are often more expensive than LIBOR (often Alternative Base Rate is the highest of prime rate, fed funds + 50 bps, and 1 month LIBOR + 100 bps)
- Some loans provide for conversion to fixed rate based on last quoted LIBOR rate if polling rates not received
- LIBOR vs. SOFR
- Problem of value transfers (the choice of alternative rate not adequate without a spread change in light of the difference between LIBOR and a risk-free rate such as SOFR)
- Risk of "amendment crunch" and administrative challenges at the end of 2021
- Basis risk created by mismatched derivatives

Risk Mitigation

- Review your legacy contracts
  - Identify LIBOR-based loans with terms that extend beyond 2021, or with extension options that extend beyond 2021
  - Calculate exposure
- Identify any at-risk securitized loans first. These may be difficult to amend, but identify risks, and wait for further announcements
  - Review language and anticipate problems now
  - Fallback options? Are you able to prepay or defease, and what are the costs?
- Identify any at-risk syndicated loans. Is the agent authorized to make changes or will changes require 100% lender approval?
- Focus now on at-risk bilateral loans and new loans of all types
- Review related derivatives – per Cheryl's presentation

ARRC Language – fundamental issues to address

- Create clear triggers and identify what should act as triggers
- Balance flexibility and clarity for identification of new benchmark
  - Who decides Alternative Reference Rate? Is it the lender, do borrower and lender negotiate, does borrower have objection rights, or is it scripted in detail?
  - Given that there is no quoted Term SOFR or Compounded SOFR, what fencing is around the choice of Alternative Reference Rate?
- Anticipate the difference in magnitude between LIBOR and new reference rate
  - Is there a spread adjustment and, if so, how does it work? Will this need to be calculated under the contract and will there be an "official" or "recommended" adjustment, or at least an accepted methodology?
- Address necessary conforming changes to the loan documents
- Avoid value transfer
- Minimize market disruption
- Avoid manipulation

ARRC Language – Overview of choices

- Bilateral Business Loans (sample language)
  - Consultation was released for Comment December 2018
  - Comment Period ended February 2019
  - Final Recommended Language released May 2019
- Syndicated Loans
  - Consultation was released for comment September 2018
  - Comment Period ended November 2018
  - Final Recommended Language released April 2019
- Hardwired Approach
- Amendment Approach
- Hedged Loan Approach – defers to ISDA Definitions

Hardwired Approach

- Alternative Reference Rate decided by waterfall
- Theory is that neither borrower nor lender will be able to take advantage of market conditions to transfer value to themselves
- Issue is we don't yet know what Term or Compounded SOFR will be; they do not exist
- Borrower consent isn't necessary to amend the loan documents
- Risk: Future developments difficult to predict

Lowndes

Amendment Approach

- Specific fallback trigger events
- Adjustment to the successor rate
- Negotiate necessary amendments
- May include an objection right for the borrower
- Risk: “Amendment crunch” at the end of 2021 plus market conditions

Hedged Loan Approach

- To be used for hedged loans – defers to ISDA definitions
- Minimizes or eliminates basis risk
  - Standard derivatives are not expected to reference a forward-looking term rate
- May include an objection right for the borrower
- Risks:
  - ISDA is not analyzing whether the fallbacks it implements will be appropriate for cash products
  - Standard derivatives are not expected to reference a forward-looking term rate

Key Provisions and Comparisons: Triggers

- Benchmark Transition Events for Hardwired and Amendment Approaches
  - Permanent Cessation
    - Public statement or publication by IBA of permanent or indefinite cessation of LIBOR
    - Public statement or publication by FCA, Fed, or by insolvency official, resolution authority, or a court with jurisdiction over IBA of permanent or indefinite cessation of LIBOR
  - Pre-Cessation
    - Public statement or publication by FCA that LIBOR is no longer representative
  - Early Opt-In Trigger
    - Lender determines that at least [5] U.S. dollar syndicated or bilateral credit facilities [which are publicly available] reference (as amended or originally executed) a new benchmark rate; and
    - Provides written notice of election to borrower
  - Basis risk: What happens if hedge and ISDA doesn't include the same triggers?
- Straight to Benchmark Replacement Date for Hedged Approach
  - Automatically triggered by index cessation date under ISDA definitions
  - Triggers may be different under ISDA

Key Provisions and Comparisons: Benchmark Replacement – Hardwired Approach

- Hardwired Approach
  - Benchmark Replacement – waterfall:
    - Term SOFR + Adjustment
    - Next Available Term SOFR + Adjustment (if Corresponding Tenor isn't available)
      - Note the lack of an interpolated rate
    - Compounded SOFR + Adjustment (compounded daily average in advance or in arrears)
    - Lender Selected Rate + Adjustment
    - Note bracketed language for Lender selected rate: [giving due consideration to (i) selection or recommendation by Fed/NY Fed/ARRC or (ii) any evolving or then-prevailing market convention]

Key Provisions and Comparisons: Benchmark Replacement–Amendment and Hedged Approaches

- Amendment Approach
  - Benchmark Replacement - the sum of: (a) alternate benchmark rate (which may include Term SOFR) selected by the Lender giving due consideration to (i) selection or recommendation by Fed/NY Fed/ARRC or (ii) any evolving or then-prevailing market convention and (b) Adjustment; provided that, if less than zero then use zero.
- Hedged Approach – defers to ISDA definitions

Key Provisions and Comparisons: Adjustment

- Remember: SOFR is a secured, “risk free” rate that does not include a credit component
- Hardwired Approach: Waterfall
  - ARRC selected Adjustment or per their recommended methodology
  - ISDA fallback Adjustment
  - Lender selected Adjustment
  - Again, note bracketed language for Lender selected rate: [giving due consideration to (i) selection or recommendation, or recommended methodology, by Fed/NY Fed/ARRC or (ii) any evolving or then-prevailing market convention for determining, or such methodology]
- Amendment Approach: “Guardrails”
  - spread adjustment, or methodology, (which may be positive, negative or zero) that has been selected by the Lender giving due consideration to (i) selection or recommendation, or recommended methodology, by Fed/NY Fed/ARRC or (ii) any evolving or then-prevailing market convention for determining, or such methodology.
  - While the language here is not bracketed, lender arguably has more discretion because successor rate and adjustment are not predetermined
- Hedged Approach – defers to ISDA definitions

Key Provisions and Comparisons: Benchmark Replacement Conforming Changes

- Benchmark Replacement Conforming Changes made from time to time by Lender without further action or consent of Borrower
- Hardwired and Amendment Approaches
  - means, with respect to any Benchmark Replacement, any technical, administrative or operational changes (including changes to the definition of "ABR," the definition of "Interest Period," timing and frequency of determining rates and making payments of interest and other administrative matters) that the Lender decides may be appropriate to reflect the adoption and implementation of such Benchmark Replacement and to permit the administration thereof by the Lender in a manner substantially consistent with market practice (or, if the Lender decides that adoption of any portion of such market practice is not administratively feasible or if the Lender determines that no market practice for the administration of the Benchmark Replacement exists, in such other manner of administration as the Lender decides is reasonably necessary in connection with the administration of this Agreement).
- Hedged Approach
  - means, with respect to any Benchmark Replacement, any technical, administrative or operational changes (including changes to the definition of "ABR," the definition of "Interest Period," timing and frequency of determining rates and making payments of interest and other administrative matters) that the Lender decides may be appropriate to reflect the adoption and implementation of such Benchmark Replacement and to permit the administration thereof by the Lender in a manner Lender decides is reasonably necessary in connection with the administration of this Agreement).

Other language

- Not addressed
- Lender chooses alternative rate
- Lender chooses alternative rate plus spread based on “snapshot”
    - “Alternative Rate Spread” shall mean the difference (expressed as the number of basis points) between (a) the interest rate determined in respect of the loan interest accrual period for which LIBOR was last applicable to the Loan, and (b) the Alternative Index Rate on such date.
- Issues with taking a “snapshot” in time of LIBOR and the Alternative Reference Rate
    - Subject to manipulation by large participants?
    - Lack of perfect correlation between LIBOR and the Alternative Reference Rate likely to lead to mispricing
    - Perhaps focus on a stated number of multiple data points or historical average over a stated period

QUESTIONS?

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Phase-Out of LIBOR

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LIBOR in Derivatives Contracts

- LIBOR is used as a reference rate in $160 trillion (notional) of derivatives contracts
  - In many interest rate swaps, counterparties rely on a LIBOR-based rate to hedge against the floating rate risk in a loan or credit facility
- The vast majority of swaps and other types of derivative products incorporate the terms of the International Swaps and Derivatives Association ("ISDA") Master Agreement
  - As written, the LIBOR replacement language in the ISDA Master Agreement is insufficient
  - The 2006 ISDA Definitions create a fallback where LIBOR is unavailable, in which case the Calculation Agent can collect alternate rates from other major banks and use the arithmetic mean to determine the replacement

LIBOR in Derivatives – what to do now?

- First Step: portfolio review
  - Examine your company's derivatives portfolio (ideally as part of a review of all financial contracts), and determine which contracts reference LIBOR

- Second Step: divide derivatives into 3 categories
  1. Already-executed transactions that expire by the end of 2021
  2. Already-executed transactions that expire after 2021
  3. Transactions that have not yet been executed

- Third Step: watch and wait
  - Do not include LIBOR fallback language in derivatives documentation yet

The ISDA Solution

- ISDA is in the process of creating a universal LIBOR transition solution for derivatives and other financial contracts
- To date, ISDA has:
  1. Published a roadmap for the transition
  2. Drafted a report that includes the results of a market survey on the use of LIBOR, identified potential transition issues for existing and new contracts
  3. Hosted multiple symposia to educate stakeholders on the LIBOR issue
  4. Published a consultation related to the credit spread for fallback "adjustments" for the non-USD LIBOR alternative rates
- Going forward, ISDA expects to:
  1. Develop strategies related to term structures for the LIBOR replacement rate and the credit spread that will arise
  2. Amend the 2006 ISDA Definitions to incorporate the fallback terms
  3. Create a Protocol to incorporate the fallbacks into already-executed transactions

Michael Best

The ISDA Solution

- ISDA has identified the following “triggers” for use of its fallback language:

  1. A public statement by the ICE Benchmark Administration of its insolvency, with no successor administrator
  2. A public statement by the ICE Benchmark Administration that it will cease publishing USD LIBOR permanently or indefinitely, and there is no successor administrator to continue publication
  3. A public statement by the UK Financial Conduct Authority that USD LIBOR has been permanently or indefinitely discontinued
  4. A public statement by the UK Financial Conduct Authority that USD LIBOR may no longer be used

- The trigger timing is upon cessation of USD LIBOR, not at the time of the announcement

The ISDA Solution – Worth the Wait?

- Should derivative counterparties begin negotiating / amending their ISDA Master Agreements now? Or wait until an ISDA protocol is available?
  - Wait! The ISDA solution will likely be the most streamlined and universally-adopted, and acting now may be more problematic going forward
  - Remember: interest rate derivatives that hedge the floating rate risk in a related credit facility *must align fallback terms with the credit facility*
- Should derivative counterparties wait until the alternative reference rate is available before amending / updating contract terms? Or choose a new rate in the meantime?
  - Technically, there is no need to specify an alternative rate; swap counterparties can insert fallback terms with objective standards for when and how to pick a new rate if and when LIBOR becomes unavailable
  - However, some parties may desire the economic certainty of a set replacement rate, and the ISDA solution will likely be a fallback to SOFR plus a credit spread

Choosing an Alternative Reference Rate

- What makes a good financial benchmark?

  - Integrity and continuity. *The benchmark should be based on an underlying market with sufficient liquidity, transaction volume and resilience*
  - Soundness and robustness. *The benchmark should have standardized terms, transparent data, and readily available historical data (IOSCO Principles)*
  - Accountability. *The benchmark should have evidence of a process that ensures compliance with the IOSCO Principles*
  - Governance. *The benchmark should have governance structures that promote its integrity*
  - Ease of implementation. *The benchmark should allow for relative ease in transitioning to the new rate, including an assessment of the anticipated demand for hedging and trading, and the potential for a term market in the underlying rate*

The Alternative Reference Rate Committee

- In 2014, FSOC recommended that U.S. regulators identify an alternative to USD LIBOR, based on perceived shortcomings
- Later that year, the Federal Reserve Board convened the Alternative Reference Rates Committee (ARRC) to identify a new financial benchmark that:
  - is based on actual transactions
  - aligns with the *IOSCO Principles for Financial Benchmarks*
- The ARRC is a public-private partnership, comprising representatives of the Federal Reserve, Federal Reserve Bank of NY, and various banks
- In June 2017, after considering six potential replacement rates, the ARRC selected the Secured Overnight Financing Rate (SOFR) as its recommended alternative to USD LIBOR

ARRC Paced Transition Plan

- Infrastructure for futures and/or Overnight Index Swaps (OIS) trading put into place by ARRC members (2nd half of 2018)
- Trading begins in SOFR-based futures and uncleared OIS (end of 2018)
- Trading begins in SOFR-based cleared OIS in the current Effective Federal Funds Rate (EFFR) Price Alignment Interest (PAI) and discounting environment (end of 2018)
- CCPs begin offering a choice between clearing in current PAI and discounting environment or one that uses SOFR for PAI and discounting (1st quarter 2020)
- CCPs no longer accept new swap contracts for clearing with EFFR as PAI and discounting, and legacy contracts roll off as they hit maturity (2nd quarter 2020)
- Creation of a term reference rate based on SOFR derivatives markets once liquidity has developed sufficiently to produce a robust rate (end of 2021)

Secured Overnight Financing Rate (SOFR)

- What is SOFR?
  - Includes overnight, Treasury-backed repo transactions
  - All transactions take place in BNY's triparty repurchase system or are cleared on one of two Fixed Income Clearing Corporation platforms
  - Will be published daily at 8:30am ET based on prior day's trading activity

- The Federal Reserve Bank of New York, along with the Office of Financial Research, began publishing SOFR in April 2018
  - Market adoption still TBD
  - Early calculation errors were problematic but fixed

- Subsequently (in keeping with the ARRC's paced transition plan), the CME Group launched SOFR futures in May 2018
  - Fairly quiet opening, as expected

LIBOR vs. SOFR

- LIBOR is:
  - An index that reflects the interest rates at which banks borrow from one another overnight on an uncollateralized basis
  - Calculated daily in 5 currencies (USD, EUR, GBP, JPY, CHF) and for maturities ranging from overnight to 1 year
  - Formulated from pricing contributions by 17 panel banks (using "expert judgment" rather than transaction data)

- SOFR is:
  - An index that that is nearly "risk-free," reflecting a broad measure of overnight U.S. Treasury repurchase ("repo") financing transactions
  - Calculated based on transaction data (no subjective input)
  - Solely a replacement for USD LIBOR
  - Based on collateralized transactions in a liquid market (with about $660 billion in daily transactions)

Other LIBOR Alternatives

- United Kingdom: The Sterling Overnight Index Average (SONIA) will replace GBP LIBOR
  - SONIA is administered by the Bank of England, and is based on actual transactions in the UK overnight unsecured market
- Japan: The Tokyo Overnight Average Rate (TONAR) will replace JPY LIBOR, JPY TIBOR and Euroyen TIBOR
  - TONAR is calculated and published by the Bank of Japan, and is based on actual transactions in the Tokyo overnight unsecured market
- Switzerland: The Swiss Average Rate Overnight (SARON) will replace CHF LIBOR
  - SARON is administered by the Swiss National Bank, and is a secured overnight interest rate average based on the Swiss France interbank market
- EU: The euro short-term rate (ESTER) will complement Euribor and EONIA
  - ESTER is administered by the European Central Bank and will be an unsecured overnight rate based on transactions in the EU interbank market and estimates provided by those banks (a hybrid rate)

The Future of Benchmarks in Derivatives

- Despite references to the “end,” “demise” “phaseout,” etc. of LIBOR, the benchmark may very well continue to exist past 2021
  - The UK Financial Conduct Authority did not create a requirement for ICE Benchmark Administration to stop publishing LIBOR
  - Instead, it will no longer compel the LIBOR panel banks to submit pricing data to the publisher after 2021

- Regardless, LIBOR is no longer the reliable benchmark that it once was, and derivatives counterparties should not plan on using it past 2021

- Derivatives market participants should expect the transition from LIBOR to be a massive undertaking, but with advance planning and a thorough understanding of the new reference rate, the shift may be a smooth one

Thank You

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