Newsletter | LIBOR Transition – Issue 1

November 2019

Welcome to Greenberg Traurig's LIBOR Transition Newsletter, where we provide updates, analysis, and occasional commentary on the latest developments relating to the highly anticipated phasing-out of LIBOR at the end of 2021 – barely two years from now.

Why is LIBOR being phased out?

Since the global financial crisis, there has been greater awareness that LIBOR is not the best rate for short-term bank lending rates for various reasons including:

- banks have varying degrees of credit risk;
- reduction in the scale of inter-bank lending; and
- realization that certain participating banks may have been manipulating LIBOR for their own benefit.

In 2012, the Wheatley Review recommended reform (rather than replacement) of LIBOR; however, in July 2017, Andrew Bailey, chief executive of the United Kingdom Financial Conduct Authority (FCA, the entity responsible for regulating LIBOR), nonetheless declared that after the end of 2021 the FCA "*would no longer […] persuade, or compel, banks to submit*" quotations intended for the determination of LIBOR. This has resulted in regulators, market makers, and other participants working on orderly transitions to other reference rates which would (i) maintain the economic equivalence of existing financings and products maturing after 2021, and (ii) be incorporated into new financings negotiated during the transition period.

What will be the immediate effect?

The complex issues in the derivatives market arising from LIBOR transition will be addressed in the next newsletter.

While there is still considerable uncertainty, financings for a term expiring before the end of 2021 will not suffer major disruptions (absent a premature discontinuation of LIBOR).

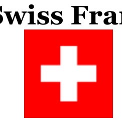
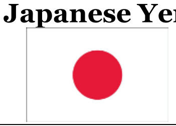
For existing financings with a term extending beyond Dec. 31, 2021, existing language providing for the unavailability of LIBOR may become obsolete or be defective if such language only contemplates temporary (and not permanent) disruptions to LIBOR. In some cases, where the parties have agreed to a fallback rate (e.g., PRIME in relation to U.S.-dollar LIBOR), the discontinuation of LIBOR may result in an important increase in financial costs for the borrower. Similarly, "yield protection" clauses may result in a disincentive for lenders or investors to sit down and renegotiate terms. If the replacement rate under a facility agreement ends up being different from the existing or replacement rate under a related hedging instrument, there is both a risk of increased cashflow volatility and a likely loss of any hedge accounting treatment.

For new financings denominated in LIBOR, parties are increasingly using standard replacement rate language proposed by different working groups (discussed below), or are using those replacement rates from the outset.

Where are we now?

Work has been conducted in parallel in the United States, the United Kingdom, the European Union, Switzerland, and Japan to determine a replacement reference rate for each of the five LIBOR currencies.

The following table summarizes the current position:

Currency	**U.S. dollar** 	**Sterling** 	**Euro** 	**Swiss Franc** 	**Japanese Yen** 
Alternative Reference Rate	SOFR (Secured Overnight Financing Rate)	Reformed SONIA (Sterling Overnight Index Average)	ESTER(€STR) (European Short-Term Euro Rate) – alternative to EONIA	SARON (Sales Average Rate Overnight)	TONAR (Tokyo Overnight Average Rate)
Administrator	Federal Reserve Bank of New York	Bank of England	European Central Bank	SIX Exchange	Bank of Japan
Working Group	ARRC (Alternative Reference Rates Committee)	Working Group on Sterling Risk-Free Reference Rates	Working Group on Risk-Free Reference Rates for the Euro Area	NWG (National Working Group on Swiss Franc Reference Rates)	Study Group on Risk-Free Reference Rates
Secured Rate?	Yes.	No. Unsecured rate.	No. Unsecured rate.	Yes.	No. Unsecured rate.

Based on?	Volume-weighted median of U.S.-Treasury repo market transactions.	Trimmed median of interest paid on short-term (overnight) wholesale funds where credit, liquidity, and other risks are minimal.	Wholesale euro overnight unsecured borrowing with financial counterparties.	Volume-weighted reading which reflects interest paid in Swiss franc repo market.	Volume-weighted average of uncollateralized overnight call rate market transactions.
Expected Publication Timing	0800 ET T +1	0900 GMT T +1	0900 CET T +1	1200, 1600 and 1800 CET Same day	1000 JST T +1
Overnight Rate Available?	Yes. (Since April 3, 2018)	Yes. (Since April 23, 2018)	Yes. (Since Oct. 2, 2019)	Yes. (Since 2009)	Yes. (Since 1996)
Forward Looking Term Rate Available?	No. Planned for 1H 2020 – to be based on SOFR derivatives.	No. TSRR (Term SONIA Reference Rate) planned.	No. Consultation ongoing.	No. Unlikely to be possible. NWG recommends using compounded SARON.	No. Under consideration.

Are market participants ready for LIBOR replacement?

The short answer is: probably not, and the derivatives market in particular is grappling with complex issues arising from it. All participants in the market will be affected differently, and so far, many actors are currently in the process of determining the exposure to the transition away from LIBOR.

In a recent communication from the U.S. Securities Exchange Commission (SEC) (which can be found here) (rightfully) stated, "*While not all issues related to alternative reference rates have been resolved, the Commission staff encourages market participants who have not already done so to begin managing their transition away from LIBOR. For many market participants, waiting until all open questions have been answered to begin this important work likely could prove to be too late to accomplish the challenging task required.*"

Two major points in particular remain open and are the subject of ongoing discussion:

- the establishment of forward-looking term rates (to assist the loan and bond markets, and which may then be used to create a market in term rate derivatives), and
- methodology to calculate the spread adjustment once a new reference rate replaces LIBOR.

That all said, SOFR and SONIA are already being used by market participants for securitizations, floating rate notes, and loans. We are also now seeing ongoing financings migrating from LIBOR to risk-free rates – in June 2019, Associated British Ports secured agreement from its (floating rate) bondholders to switch from Sterling LIBOR to SONIA.

Documentation and Other Recent Developments

The pace of activity is increasing, and there have been a number of recent developments.

International Swaps and Derivatives Association (ISDA)

On Sept. 19, 2019, ISDA published an ISDA Benchmarks Supplement. This can be contractually applied to update key IBOR definitions for trades covered by the 2006 ISDA Definitions, 2002 ISDA Equity Derivatives Definitions, 1998 FX and Currency Option Definitions, and/or the 2005 ISDA Commodity Definitions. Application should help ensure that trades covered by such Supplement will not become void for lack of a critical benchmark on the discontinuation of the relevant benchmark – either a Priority Fallback or Alternative Continuation Fallback will apply. There is an associated ISDA Benchmarks Supplement – FAQs, and ISDA has also opened a 2018 Benchmarks Supplement Protocol procedure. Note, however, that the benchmark fallback applied by such Supplement may not match the commercially required benchmark; therefore, additional contractual arrangements may be advisable to govern the requisite position on transition.

On Oct. 21, 2019, ISDA published a report summarizing the responses it received to a consultation on pre-cessation issues for LIBOR and certain other IBORs. The responses to the consultation indicate that a majority of market participants would generally not want to continue referencing a covered IBOR in existing or new derivatives contracts following a statement from a supervisor that it is no longer representative of the underlying market.

On Oct. 23, 2019, ISDA closed a consultation period on the spread and term adjustments in derivatives fallbacks for key IBORs. After consultation with market participants in 2018 and 2019, ISDA is developing fallbacks for inclusion in its standard definitions based on the compounded setting in arrears rate and the historical mean/median approach to the spread adjustment for derivatives that reference USD LIBOR, GBP LIBOR, CHF LIBOR, JPY LIBOR, and others.

USA

On Nov. 4, 2019, the Federal Reserve Bank of New York released a statement requesting public comment on a proposed publication of SOFR Averages and a SOFR Index, together with the calculation methodology (which can be found here). The NY Fed is proposing to publish daily three compounded averages of the SOFR with tenors of 30-, 90-, and 180-calendar days. It is expected that publication of these averages will commence in the first half of 2020, in conjunction with a daily SOFR index that would allow the calculation of compounded average rates over custom time periods. The public comment period is scheduled to end on Dec. 4, 2019.

On Sept. 19, 2019, the ARRC released a useful checklist for the practical implementation of SOFR in new financings (which can be found here). This followed on from the ARRC's contract language templates for bilateral business loans, floating rate notes, securitizations, and syndicated loans launched in April and May 2019 (each template can be found here).

On Oct. 1, 2019, the Loan Syndications and Trading Association (LSTA) published a Compounded SOFR in Arrears Concept Document, which is a syndicated credit agreement that incorporates a compounded average of daily SOFRs calculated in arrears.

On Oct. 10, 2019, the Internal Revenue Service (IRS) proposed regulations providing tax relief related to issues that may arise as a result of the modification of debt, derivative, and other financial contracts from

LIBOR-based language to alternative reference rates (which can be found here). The Treasury Department and the IRS "*expect that this guidance will reduce Federal income tax uncertainties and minimize taxpayer burden associated with this transition.*"

UK

The Loan Market Association (LMA) recently published:

- on Sept. 23, 2019, exposure drafts of facility agreements which include SOFR-based and SONIA-based provisions; and
- on Oct. 25, 2019, an exposure draft of a reference rate selection agreement in relation to existing transactions which have a term extending beyond Dec. 31, 2021.

What should market participants be doing now?

Waiting until, for example, forward-looking term rates are available may leave you exposed. Market participants may wish to consider the following as an initial step:

- Include appropriate post-LIBOR provisions in all new financings.
- Review all existing documentation to identify those with a maturity beyond Dec. 31, 2021, what fallback rates will currently apply to them, and whether a replacement rate will need to be agreed.
- Consider the impact on hedging documentation and accounting (a complex topic to be addressed in the next newsletter).
- If you are amending any transactions for other reasons, consider also incorporating amendments to the LIBOR provisions.

As part of this exercise, bear in mind that:

- Current LIBOR fallback language in existing financing documents may not work or may result in a significant adverse impact on the economic terms of the financing for one of the parties.
- Template LIBOR transition fallback language is becoming market; however, some of this also presents additional/unresolved issues.
- Monitor developments, as activity will continue to increase with the deadline now barely two years away.

Contacts

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