GT GreenbergTraurig

Newsletter | LIBOR Transition – Issue 2

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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.

LSTA – Concept SOFR Credit Agreement

The Loan Syndications and Trading Association (LSTA) has published a concept credit agreement that implements a secured overnight financing rate (SOFR) -based benchmark rate. While many theoretical articles have been published about how SOFR credit agreements would be drafted and negotiated, the LSTA's stated purpose in publishing this concept agreement is to provide actual language for market participants to analyze and stimulate more in-depth discussion about documenting this dramatic shift in the pricing of loans in the U.S. market.

The LSTA's SOFR credit agreement utilizes the compounded in arrears variant of SOFR. This is a material deviation from LIBOR, which, as a forward-looking rate, is ascertainable at the beginning of an interest period. Compounded SOFR in Arrears is not calculated until near the end of the interest period. The Compounded SOFR in Arrears variant was selected by the LSTA for inclusion in its concept credit agreement for two primary reasons. First, it is the variant that is referenced by many SOFR floating rate notes, which were the first cash products to utilize SOFR-based pricing. Second, Compounded SOFR in Arrears is the designated fallback rate for U.S. dollar LIBOR derivatives. Also, as a practical matter, regulators have noted that a forward-looking term SOFR reference rate may not be available by the end of 2021 because the data needed to generate a forward-looking variant would still be insufficient at that juncture.

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The definition of "Compounded SOFR" found in the LSTA's concept credit agreement is largely modeled from the definition used by the Federal Reserve Bank of New York. The LSTA's concept agreement also uses the concept of "SOFR floors," which is embedded within the definition of "SOFR." However, one aspect of the concept credit agreement that has generated much debate among industry observers is that the concept credit agreement does not include a breakfunding mechanism, which requires a borrower to prepay interest to mitigate a lender's yield loss in certain prepayment circumstances. The rationale for this exclusion is that compounded SOFR, as a collection of daily rates, does not contemplate the match funding mechanism used to formulate LIBOR pricing and is therefore not applicable.

While the market continues to evolve on SOFR-based pricing of debt products, the LSTA's concept credit agreement has provided a baseline for participants to discuss the various legal and operational implications of implementing SOFR. The LSTA has requested that members of its Primary Markets Committee submit comments to the concept credit agreement by the close of business on Jan. 17, 2020, and we anticipate that another redraft will be available in the first quarter of 2020.

Recent Developments

- *First SOFR Commercial Real Estate Securitization issued in December*. In an unrated multi-family securitization that priced on Dec. 12,2019, Freddie Mac issued a $765.6 million bond offering, joining Fannie Mae in its efforts to move multifamily finance to a SOFR-based environment. This is the first commercial real estate securitization to offer bonds indexed to SOFR. While the Structured Pass-Through K Certificates are backed by floating-rate multifamily commercial mortgages with 10-year LIBOR-based terms, Freddie structured the offering with $565.6 of the senior bonds tied to one-month LIBOR +60, and the remaining $200 million of the senior bonds indexed to SOFR. Freddie did its own calculation of a 30-day compound average of the benchmark for the SOFR bonds while the market waits for the New York Federal Reserve Bank to start publishing compounded rates in the first half of 2020.
- *SOFR Continues to get Traction*. In early December, MUFG Union Bank, N.A. closed a $1 billion bank note offering, which includes a tranche with a coupon tied to SOFR plus a spread of 71 basis points maturing in 2022. Similarly, Royal Dutch Shell PLC announced that it has signed a $10 billion line of credit linked to SOFR, which replaces its $8.84 billion revolving credit facility.
- *Issuers and Loan Servicers have reacted favorably to the proposed REMIC Regulations published by the Department of Treasury*, thus quelling the uncertainty as to whether replacing LIBOR or adding a fallback provision in the organizational documents of a REMIC would cause regular REMIC interests to be classified as residual interests.
- *CFTC Chairman Tarbert Warns About "Zombie LIBOR"*: On Dec. 11, 2019, the Chairman of the U.S. Commodity Futures Trading Commission (CFTC) stated that, in an effort to facilitate the transition away from LIBOR, "the CFTC staff is working to publish a series of relevant no-action letters by December 20, 2019." In addition, the CFTC suggested the recommendation of "pre-cessation triggers to change the referenced rate" to deal with a potential non-representative LIBOR rate in the event LIBOR is still published "but not enough panel banks submit daily rates." (Read the full LIBOR Transition statement.)
- *Treasury Secretary Mnuchin Suggests the U.S. Congress May Have to Pass Legislation…*: On Dec. 5, 2019, Treasury Secretary Steven Mnuchin testified before the House Financial Services Committee about risks to financial stability and the U.S. economy. In his statement, Secretary Mnuchin expressed that the Department of Treasury "may come back to Congress and suggest" Congress to pass legislation dealing with LIBOR transition issues. (Watch the testimony.)

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- *...While the Alternative Reference Rates Committee (ARRC) proposed New York State Legislation to Provide for LIBOR Transition Issues*: The ARRC, in its minutes from the Nov. 15, 2019, meeting, has proposed legislation that would "reduce the adverse economic outcomes of legacy LIBOR fallbacks" in contracts governed under New York law for all asset classes. In summary, the proposed legislation would apply on a mandatory basis to contracts considered "silent" and to other contracts with LIBOR-based fallbacks, and on a permissive basis to contracts where the determination of an alternative rate falls upon a party exercising discretion, for example, calculation agent or administrative agent. (Read the full ARRC minutes.)
- *New Recommended Fallback Language for ARMs*: The ARRC released on Nov. 15, 2019, recommended fallback language for Residential Adjustable-Rate Mortgages (ARMs). According to the ARRC, these provisions were "developed with the goal of reducing the risk of serious market disruption in the event that LIBOR is no longer available" and provide "clear language that would replace USD LIBOR with a spread-adjusted index based on the Secured Overnight Financing Rate (SOFR)." This is the first kind of fallback language issued for consumer products: this recommendation is "intended to be consistent with [the ARRC's] recommendations for other cash products, but it recognizes the need for simpler contract language in consumer products." It is anticipated that the ARRC "will work with all stakeholders to develop and recommend a spread adjustment and corresponding spread-adjusted SOFR-based replacement that reflects and adjusts for the differences between LIBOR and SOFR; thus, minimizing the impact to the borrower's interest rate if LIBOR is no longer available." (Read the ARRC recommended fallback language for ARMs).

Parting Shot – What if Someone Finds the Proposed LIBOR Replacement Fallback Language "Too Long"?

The perception is that lawyers tend to overcomplicate things, but the reality is that a lot of thought has been involved in the creation of template provisions by the different leading industry associations. There are benefits to having standard language universally applied: (i) it will be easier to identify the universe of affected contracts down the road – as opposed to trying to figure out minor differences between Contract X and Contract Y; (ii) it will increase the speed of execution by avoiding re-opening issues; and (iii) it will reduce transaction and transition costs.

Parties who insist on an abridged version of standard fallback language may consider the following critical elements:

- Establish objective triggers that answer the question: When do the parties understand LIBOR will no longer apply?
- Provide guidance on the reference rate: clauses expressing that the new rate would be such "widely used in the market" or "recommended by the New York Fed" would likely suffice.
- Include a margin adjustment mechanism, or at a minimum, a reference that the parties will follow market practice or recommendations made by authorities and/or regulators.
- Allow for a "further assurances" provision to amend any clauses that may be affected from the change in the rate, for example, adjustments resulting from switching from Term LIBOR (calculated at the beginning of the interest period) to compounded SOFR (calculated at the end of the interest period).

Read previous editions of GT's LIBOR Transition Newsletter.

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