GT GreenbergTraurig

# Newsletter | LIBOR Transition – Issue 3

**February 2020**

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 – less than two years from now.

## ARRC Releases a Consultation on Potential Spread Adjustment Methodologies

On Jan. 21, 2020, the Alternative Reference Rates Committee (ARRC) released a consultation on spread adjustment methodologies for cash products referencing USD LIBOR. Responses to the consultation must be submitted by March 6, 2020. The ARRC had previously recommended the Secured Overnight Financing Rate (SOFR) as the alternative to USD LIBOR, and the adjustment of the margin or spread for floating rate products is perhaps one of the most important aspects of assuring the economic equivalency of transactions currently using LIBOR when transitioned to SOFR. Previously, the International Swaps and Derivatives Association (ISDA) had recommended a methodology using a five-year median of the historical difference between USD LIBOR and SOFR for derivatives products. Respondents in the consultation have been asked to provide feedback on, among other subjects, whether cash products should follow the same methodology in order to achieve consistency with ISDA's recommendation; whether another method would be preferred; and whether a transition period of one year should be included for cash products. *See* the ARRC consultation and historical analysis, which demonstrate how different methods would have worked in the past.

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## Bank of England, FCA and Sterling Working Group Joint Statement

There has been a marked increase in publications regarding Sterling LIBOR transition over recent weeks. On Jan. 16, 2020, the Bank of England, the UK Financial Conduct Authority (FCA), and the Working Group on Sterling Risk-Free Reference Rates (RFRWG) jointly published a set of documents outlining priorities and milestones for 2020. These documents included (a) a joint letter from the Bank of England and the FCA to banks and other regulated entities supervised in the UK encouraging a switch in relation to Sterling interest rate swaps from LIBOR to SONIA by March 2, 2020, and (b) a statement from the RFRWG that market participants should (i) by the end of Q3 2020, cease the issuance of loans and other cash products linked to Sterling LIBOR, and (ii) by Q1 2021, establish a framework for the transition of legacy LIBOR products in order to reduce significantly the stock of LIBOR referencing contracts.

There is increased focus on the details involved in a switch to SONIA for loans and other cash products. Set out below are four examples of the issues currently being considered:

- *Overnight*: SONIA is currently published as an overnight rate. Establishing the interest rate for a longer period (of, for example, one month) presents various options including (i) aggregating the daily SONIA rates, but this is administratively onerous and leaves uncertainty regarding the rate to be applied for weekends and other days when the rate is not published, and (ii) the use of one overnight SONIA rate and multiplying it for the required period, which would ease the administrative burden and address weekends, but would likely generate an unrepresentative rate.
- *Backwards-Looking*: Where interest is payable in arrears, it will become necessary to have a SONIA observation period of the same duration as the interest period but which ends before the interest payment date. The Loan Market Association exposure draft of risk-free rate facility documentation (the "Exposure Draft") contemplates this observation period ending five business days before each interest payment date – at certain times of year, public holidays could result in a two-week mismatch between the observation period and the corresponding interest period. In addition, the adopted ISDA convention uses a different number of business days, potentially creating a mismatch between loans and the related hedging agreements.
- *Risk-Free*: LIBOR incorporates two risk premia which are entirely absent from SONIA, being (i) the time / liquidity premium which reflects the risks of longer-dated funding, and (ii) the credit premium which reflects the risk of lending to a particular LIBOR rate-setting bank. The first of these can be addressed by applying a compounding methodology when using overnight rates to calculate rates for longer periods. In relation to the second issue, we mentioned above that the spread adjustment is possibly one of the most important aspects of achieving economic equivalence, but considerable uncertainty persists in relation to products based on risk-free rates, and discussion is ongoing regarding the application of additional credit margins.
- *Break Costs*: Prepayment within an interest period currently results in the payment of term break costs to address the lender's match funding arrangements. The need for this disappears if the market switches to regarding lenders as obtaining funding on a rolling overnight basis, and the new contractual frameworks may result in the amount of interest / breakage costs not being ascertainable at the point of prepayment. The Exposure Draft currently contains a placeholder which acknowledges the issue but does not consider any solutions.

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## Other Recent Developments

- *"If we need a federal law change, we will let you know," Fed Chairman Powell declares in Congress*. Federal Reserve Chairman Jerome Powell appeared before the House Financial Services Committee on Feb. 11, 2020, and stated his agency does not, at the moment, see a need for legislation at the federal level to address the adoption of a fallback rate by financial institutions. "In terms of the need for federal legislation, we have not reached a point where we think it's going to be necessary," he said, adding that "on LIBOR, our process is ongoing, and we're really committed to having the banks ready by the end of next year to switch away from LIBOR in case it is no longer published."
- *ARRC Releases Consultation on Swaptions Impacted by Central Counterparty Clearing Houses' Discounting Transition to SOFR*. On Feb. 7, 2020, the ARRC released a consultation on USD LIBOR Swaptions focusing on the voluntary exchange of cash compensation between bilateral counterparties to legacy interest rate swaptions that could be exercised after Oct. 16, 2020, and conventions for new interest rate swaption contracts traded before Oct. 16, 2020. In 2019, the central counterparty clearing houses LCH and CME Group individually announced that, effective at the close of business on Oct. 16, 2020, the discounting and price alignment interest for USD-denominated interest rate swaps will transition from Effective Federal Funds Rate (EFFR) to SOFR. The transition will involve the exchange of cash (equal to the difference in valuation between the two discounting regimes) and risk compensations (in the form of at-market EFFR vs. SOFR basis swaps). *See* the ARRC consultation on swaptions.
- *ISDA to Re-Consult on Pre-Cessation Fallbacks*. On Feb. 5, 2020, ISDA announced it will re-consult on how to implement pre-cessation fallbacks. The new consultation is expected to be published later in February 2020 and will ask whether the 2006 ISDA Definitions should be amended to include fallbacks that would apply to all covered derivatives following the permanent cessation of an interbank offered rate (IBOR) or a "non-representative" pre-cessation event, whichever occurs first. An earlier consultation on pre-cessation fallbacks in 2019 failed to achieve market consensus on how to implement pre-cessation fallbacks in derivatives contracts. *See* the ISDA announcement to re-consult on pre-cessation fallbacks.
- *Fannie Mae, Freddie Mac to Stop Accepting LIBOR Mortgages*. On Feb. 5, 2020, the Federal Housing Finance Agency (FHFA) announced that on Sept. 30, 2020, Fannie Mae and Freddie Mac will no longer accept any LIBOR-based single-family and multi-family Adjustable Rate Mortgage (ARM) loan applications. The Agency lenders will begin to purchase SOFR indexed loans by Nov. 1, 2020, at the latest. By Dec. 30, 2020, they will no longer purchase any LIBOR-linked loans regardless of the loan application date or date of the note. *See* the FHFA announcement, Fannie Mae announcement, and Freddie Mac announcement. The FHFA's announcement intensified discussions among the Agency lenders at the Mortgage Bankers Association's CREFC/Multifamily Housing Convention held in San Diego Feb. 9-12. Many Agency and non-Agency lenders are concerned about the amount of outstanding legacy loans that will need to be transitioned when LIBOR becomes unavailable. While fallback language has started to appear in securitization documents, so far, no loans tied to a SOFR-based index have been originated. *See* Commercial Mortgage Alert, Feb. 14, 2020, at page 2.
- *ARRC Releases Vendor Survey and Buy-Side Checklist on Transition to SOFR*. On Jan. 31, 2020, the ARRC provided guidance to market participants to assess their readiness ahead of the transition to a reference rate alternative to USD LIBOR. *See* the ARRC vendor survey; *see* the checklist.
- *ARRC Releases Recommendations for Interdealer Cross-Currency Swap Market Conventions*. On Jan. 24, 2020, the ARRC released final recommendations for new interdealer cross-currency basis

swaps that use SOFR and overnight risk-free rates recommended by national working groups in other jurisdictions. *See* the ARRC recommendations.

### Parting Shot: Most-Favored Nation Clauses in LIBOR Fallback Provisions

The editors of this newsletter recently found a filing on the U.S. Securities Exchange Commission website from 2018, in which a public company published an amendment to a credit agreement with a major U.S. financial institution. Such amendment featured a "most-favored nation" clause with regards to LIBOR replacement. Here is the relevant extract:

*"[…] notwithstanding any provision contained herein to the contrary, the LIBOR Successor Rate shall be the then lowest interest rate determined and used by the Lender for its "most favored" borrowers, […]"*

Now that there is some clarity on proposed alternative reference rates, and customary fallback provisions are being widely accepted and used in the market, we believe that such a provision would – in 2020 – be "off-market." A clause of this nature would be hard to enforce, present a wide-ranging number of outcomes or interpretations, and potentially create an unwanted burden to a lender who may have to monitor several different economic terms. Notwithstanding these lurking issues, a borrower with sufficient leverage and a bank working to maintain a client relationship could still agree on some borrower-friendly feature that current template provisions do not include.

Read previous editions of GT's LIBOR Transition Newsletter.

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