

Newsletter | LIBOR Transition – Issue 6



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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 or *perhaps sooner*.

The FCA Message is Clear: LIBOR Cessation is Coming, Notwithstanding Pandemic

In a recent conference with the International Swap and Derivatives Association¹ (ISDA), the U.K. Financial Conduct Authority’s Director of Markets and Wholesale Policy, Edwin Schooling Latter, announced that the Financial Conduct Authority (FCA) would make a pre-cessation or cessation announcement regarding LIBOR before year-end 2020, notwithstanding the pandemic. The FCA had previously made this announcement in various trade publications. The FCA is the regulatory authority with jurisdiction over the LIBOR administrator.

A pre-cessation announcement would be an announcement by the FCA that the LIBOR rate is no longer representative of the interbank lending rate. A cessation announcement by the FCA would be a public announcement that the administrator of LIBOR (and other IBORs) has or *will* cease to provide LIBOR (and other IBOR) benchmarks. Either FCA announcement will trigger the industry-standard LIBOR fallback provisions that currently exist in many lending agreements, securitizations, and floating rate notes.

The FCA will not make this announcement until well after the publication of the ISDA IBOR Fallback Protocol (Protocol), which will address the alternative fallback provisions to be utilized when a LIBOR

¹ ISDA Webinar Conference, *The Path Forward for LIBOR Transition* (July 14, 2020).

cessation or pre-cessation announcement occurs for existing derivative transactions. Its publication has been delayed because ISDA has submitted the Protocol to the Antitrust Division of the U.S. Department of Justice for antitrust clearance.

What does this sudden and unanticipated announcement mean for market participants?

Loan Markets: Hardwired Approach

Despite the FCA statement, the battle between the hardwired approach and the amendment approach continues. The hardwired approach incorporates provisions for a fallback rate and spread adjustment upon the occurrence of a cessation or pre-cessation trigger (such as the FCA announcement). The amendment approach requires the parties to mutually agree to a fallback rate and amend their loan agreements accordingly.

In a presentation by the Loan Syndications & Trading Association (LSTA), the following statistic was presented: according to Covenant Review (a publication that tracks institutional loans and other financial products), in a survey of 288 new and amended institutional loans in 2020, no transaction parties adopted the “hardwired” approach in their loans. This is an impressive statistic and it shows that even though the Alternative Reference Rates Committee (ARRC) selected some time ago (in 2017) the Secured Overnight Financing Rate (SOFR) as the alternative rate that should be used by banks and borrowers in new financial agreements and derivatives, provided numerous guidance and best practices for the adoption of this alternative rate, and proposed comprehensive (and widely accepted) templates for fallback provisions in new contracts, market participants have not been keen on locking themselves to SOFR, in any of its forms, and have decided to punt the issue to a later date.

Setting aside the discussion on whether an alternative reference rate must have a credit risk component, whether the ARRC templates were too optimistic in assuming that by now there would be publicly “sourceable” term SOFR rate with an established market, or that different actors would have internalized a risk-free rate that experienced some level of volatility in the recent months, it is instructive in general that parties are relying upon reaching some form of agreement by the end of 2021 and ultimately surrender to “evolving or then-prevailing market convention[s].”

One might think that market participants are anticipating some form of extension of the self-imposed timeline set out by the FCA and that the FCA will continue to compel banks to require submissions past the end of 2021, creating some version of a game we can call “LIBOR-chicken²”: making LIBOR so entrenched in the financial system and the transition from it so difficult, burdensome, and expensive that there would be no alternative other than to extend LIBOR or try to “fix” what got us in this trouble in the first place. However, the FCA statement makes it clear that this view is unfounded and that the FCA will proceed with its plans for LIBOR cessation.

Whatever the view of loan market participants, the use of the “amendment” approach for new loans indexed in LIBOR or existing loans being amended to account for the discontinuation of LIBOR may signify a serious amount of work in 2021, requiring a high level of preparation from accounting, systems, and market professionals, without even considering those “tough legacy” contracts that do not even contemplate a workable fallback procedure or replacement rate upon LIBOR’s permanent cessation.

² Not to be confused with “Chicken LIBOR” which is sometimes used to refer to the “Georgia Dock Price Index” published by The Georgia Department of Agriculture. Chicken LIBOR was also subject to litigation for alleged manipulation and was indefinitely suspended in 2016.

In this context, the ARRC is strongly recommending, in its most recent publication of a [fallback template language for syndicated loans](#), the use of a “hardwired” approach going forward and is discouraging the use of the “amendment” approach in new loans. The new template also recommends the use of the backwards-looking daily simple SOFR as the second step of the waterfall (which is in theory easier to use and calculate than compounded SOFR) after term SOFR, and more flexible early opt-in language to accommodate any events causing LIBOR to be no longer representative, even when it may continue to be published.

Is this sufficient? Even for those who assess risk by profession, this remains difficult to answer, but more because of systemic issues. As a legal matter, the “hardwired” approach provides more certainty from a documentary point of view, but it is certainly difficult to recommend if there is little-to-no visibility as to how term SOFR will operate, what the market will look like, or whether market participants in fact will be switching *en masse* to SOFR. These issues exist without even considering what kind of SOFR will be mostly used (e.g., daily simple in arrears, compounded in arrears, term SOFR in advance, compounded in advance) or how the spread adjustment will be calculated. Additionally, market participants are concerned with efficient hedging of new SOFR loans which requires resolution of these issues in both the loan and derivatives market.

In the end, adopting the “hardwired” approach involves a leap of faith. Perhaps the FCA statement of a LIBOR announcement before year-end will cause that leap of faith.

Derivatives Market: Waiting for The ISDA Protocol

Perhaps the leap of faith can come from some certainty on these issues in the derivatives market. To that end, the derivatives market has been waiting for the publication of the ISDA IBOR Fallback Protocol, which will contain the fallback provisions for legacy derivative contracts. The 2006 ISDA Definitions will be similarly amended to incorporate these provisions for new derivative contracts. This Protocol has been long-awaited because market participants are anxious that the derivatives and loan markets utilize similar methodology to ensure efficient hedging of alternative rate loans. While new derivative transactions are expected to utilize rates other than LIBOR, LIBOR-based derivative transactions still abound because many hedging interest rate transactions are still hedging LIBOR loans.

The Protocol will provide the alternative fallback rate for each major currency, the methodology for calculating the fallback rate, and the relevant spread adjustments for each fallback rate. The Protocol is not limited to LIBOR but will include provisions for new fallback rates for all major currencies.

Unlike the amendment-versus-hardwired approach being discussed in the loan markets, the derivatives market has agreed to a protocol process to avoid the amendment of tens of thousands of derivative contracts. This protocol process has been successfully used in the past to adopt important regulatory changes, such as those relating to Dodd-Frank or EMIR, in derivative contracts. Under this process, once the Protocol is published, each party to a derivative transaction will be asked to adhere to the ISDA Protocol on the ISDA website. By adherence to the Protocol, the derivative contracts of all adhering parties will be automatically amended to incorporate the provisions of the Protocol in these derivative contracts with counterparties that have also adhered.

The clearinghouses that clear swap transactions have already announced that they will adopt the Protocol immediately upon publication. The adoption of the Protocol by the clearinghouses will ensure that all cleared derivative transactions will have a fallback rate as soon as the FCA announcement is made. Parties to cleared derivatives are subject to the rules of the clearinghouses, so they will not have a choice about adherence.

However, in uncleared derivative transactions, each party must affirmatively consent to adherence to the Protocol. What happens if a party refuses to adhere? In such a case, their derivative contracts will not be amended with the Protocol fallback provisions. The outcome will depend on what, if anything, their derivatives contract says about LIBOR cessation. If a derivatives contract is silent on LIBOR cessation, the parties could mutually agree to a fallback procedure. Otherwise, the derivatives contract would terminate when LIBOR actually ceases to exist (not when the FCA announcement is made), and breakage costs would be calculated. To prevent the latter outcome, the FCA has been considering publication of LIBOR solely for legacy contracts.

The Protocol was expected to have been published by now. However, ISDA has sought antitrust clearance from the Antitrust Division of the U.S. Department of Justice to prevent antitrust claims from market participants. Publication has been delayed until this clearance is obtained, and publication may be in September. However, the Department of Justice is not on any timeline to provide clearance.

The FCA has stated that it would wait until the publication of the Protocol and provide sufficient time for adherence by a significant segment of the derivatives industry before making its LIBOR cessation or pre-cessation announcement. The Department of Justice may be the last hurdle before the FCA announcement.

Other Recent Developments

- **Regulatory Bodies Intensify their Focus on LIBOR Transition.** Recent statements from regulators suggest that LIBOR transition efforts will be front and center and the subject of review and examination over the next months. The [Federal Financial Institutions Examination Council released a statement](#) highlighting “financial, legal, operational, and consumer protection risks that will result from the expected discontinuation of LIBOR and to encourage supervised institutions to continue their efforts to prepare for this change and address its associated risks.” The Office of Compliance Inspections and Examinations (OCIE) of the U.S. Securities and Exchange Commission (SEC) identified LIBOR transition in its [examination priorities for fiscal year 2020](#). The Office of the Comptroller of the Currency (OCC) stated in its [Semiannual Risk Perspective Report](#) that the OCC will increase oversight with respect to exposure to LIBOR.
- **ARRC Continues to Deliver Guidance and Templates.** Together with an updated template for syndicated loans (see the note above), the ARRC has actively provided further guidance and templates with respect to a variety of products, most notably, on the [use of conventions for SOFR “in arrears” for syndicated business loans](#), mainly with respect to “daily simple SOFR” and “daily compounded SOFR,” released [recommended fallback language for private student loans](#), and provided further details in connection with the [spread adjustment mechanics for cash products](#), after receiving feedback from market participants.

[Read previous editions of GT’s LIBOR Transition Newsletter.](#)

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