GT GreenbergTraurig

Disaster Averted, Questions Remain: A Greenberg Traurig Partner on the LIBOR Transition

By Oscar Stephens | February 4, 2021 | Law.com International

At the end of 2020, the Intercontinental Exchange announced that ICE Benchmark Administration Limited (IBA) – the administrator of the London Interbank Offered Rates (LIBOR) – had consulted on its intention to cease the publication of the one, three, six and twelve-month USD LIBOR by June 30, 2023, instead of the original discontinuation target date in December 2021.

This announcement, which will likely result in a delay of LIBOR cessation, was met with general approval and praise by regulators in the U.K. and the U.S. It was perceived as a relief to LIBOR transition efforts that, prior to this announcement, were expected to be disruptive at best or catastrophic at worst.

Moreover, regulators and industry groups continued to encourage market participants to originate products based upon alternative reference rates (such the Secured Overnight Financing Rate (SOFR) for U.S. dollar products) as soon as practicably possible, and hence, stop LIBOR originations towards the end of 2021.

While market participants are not compelled to follow these recommendations, it has been widely understood that the IBA's announcement signifies a way to "smooth-out" the transition from LIBOR to other rates by permitting such contracts maturing between now and June 30, 2023 to run their course, and consequently, allowing a longer period to renegotiate other contracts maturing after such date.

Prior to this announcement, lenders and borrowers were looking at documenting a large number of amendments to existing financings during 2021, many of them constituting "tough legacy" contracts that did not have a fallback provision properly addressing a permanent discontinuation of LIBOR.

Additionally, it gives more time to enact federal or state legislation that could provide safe harbors in situations where contracts maturing after June 30, 2023 are silent or do not establish a clear alternative rate upon LIBOR cessation.

Industry groups, such as the Alternative Reference Rates Committee (ARRC) in the U.S. continue to promote SOFR as an alternative rate for new cash products and the use of fallback templates for related LIBOR-based contracts, principally by "hardwiring" SOFR as the replacement reference rate once LIBOR ceases to being quoted, together with an adjustment factor that takes into consideration the historical differences between LIBOR and SOFR.

This approach is generally considered a good alternative to prevent value transfer upon LIBOR cessation, by including clear, neutral and objective rules that would apply across the board.

However, questions remain as to whether SOFR would be a universally accepted rate by both lenders and borrowers in financial products, and many in the U.S. have expressed a preference for other rates such as PRIME or AMERIBOR. For example, SOFR – which is quoted daily by the New York Federal Reserve – currently does not have a "forward looking" term rate that is published in a way that LIBOR is, preventing counterparties from calculating and knowing debt service payments at the beginning of an interest period.

Currently, the most common SOFR variances are daily simple SOFR and compounded SOFR, each of them calculated on a "backward looking" basis shortly before the relevant interest payment date. In addition, there is more than one alternative being used as a convention to calculate SOFR rates.

Similarly, industry experts continue to raise alarms as to whether a "credit risk" component for SOFR would be required given that SOFR is based upon the U.S. Treasuries repo market, and hence, it does not necessarily reflect or match a financial institution's cost of funding.

It has been suggested that SOFR should either incorporate such component in its calculation or add an additional adjustment factor in order to narrow that gap. Further, the migration from LIBOR to SOFR (or another risk-free rate) will result in market participants getting acquainted with a rate that has limited history in the context of financial products, in a very short period of time, akin to becoming fluent in a new language in which not many are native.

Over the next months, we expect to see a more orderly transition from LIBOR to alternative reference rates such as SOFR, although pricing of SOFR-indexed financial products will continue to be a challenge until a more robust SOFR market exists.

As we move forward with 2021, we also expect that more questions will arise with respect to how to adapt to a new environment in which multiple alternative rates using various conventions, with respect to different markets and currencies, will aim to maintain the economic equivalence of LIBOR-indexed products beyond June 2023.

Reprinted with permission from the international edition of Law.com © 2021 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited, contact 1.877.257.3382 or reprints@alm.com.

About the Author:

Oscar Stephens, *a shareholder at Greenberg Traurig, represents lenders and borrowers in a variety of multi-currency financing transactions with a cross-border component. Stephens is one of the editors of Greenberg Traurig's LIBOR Transition Newsletter.*

Oscar Stephens
stephenso@gtlaw.com