

The Clock Is Ticking Towards the End of LIBOR; What Borrowers Can Do Now to Mitigate the Risks

Since the end of 2017, we have been talking about the discontinuation of LIBOR as a reference rate for borrowers who finance with floating rate loans. The December 2021 end date is fast approaching, but much work remains to insure a smooth transition.

The Alternative Reference Rates Committee (ARRC), formed in April 2014 to lead the transition from U.S. LIBOR, has recommended the Secured Overnight Financing Rate (SOFR) as the appropriate replacement index for U.S. LIBOR, and the New York Federal Reserve has been publishing SOFR since April 2018.

SOFR is a secured, overnight (backward-looking) rate based on actual repurchase (repo) transactions collateralized by Treasury securities. As a historical transaction-based rate, SOFR better reflects current financing costs. LIBOR, on the other hand, is an unsecured, forward-looking term rate based on selected banks' quotes and expert judgment. Since bank-to-bank lending is unsecured, LIBOR has a credit risk premium incorporated within it. Since its inception, SOFR has been more volatile than LIBOR on a day-to-day basis, but much of that volatility is offset when you take the compound average of SOFR over a one-month or three-month period. Because of these fundamental differences between the two rates, there are significant challenges to transitioning from LIBOR to SOFR. The goal is for the two rates to be economically neutral to the parties.

Considerable changes will be required to the existing operations systems and credit documentation of financial institutions in order to accommodate SOFR in lieu of LIBOR. Unlike LIBOR, which is set at the beginning of an interest period, the applicable compounded SOFR would not be determined until the end of an interest period. As a result, in a SOFR borrowing, borrowers and lenders would not know the amount of a particular interest payment until the end of each interest period. A forward-looking SOFR (that is, a one-month or three-month SOFR that represents the market's expectations for SOFR over the relevant period) would function very similarly to existing LIBOR loans and would be easier to incorporate into existing documentation and operations systems to replace LIBOR. However, forward SOFR is not currently available to any meaningful extent.

Forward-looking rates would be based on SOFR futures and would require a large and robust SOFR derivatives market. While the derivatives market for SOFR has been developing since 2018, that market is still relatively small compared to the LIBOR market. Regulators believe that the SOFR derivatives market may not be sufficiently developed by the time LIBOR is discontinued.

To account for the credit risk premium included in LIBOR, a spread will need to be added to SOFR in order to make that rate economically neutral to LIBOR. What that spread will be, and how it will be determined, are still unresolved issues.

The market will also need to come to a consensus regarding the calculation of SOFR in both cash and derivative instruments in order to prevent a potential mismatch between a loan and the related hedge instrument. The International Swaps and Derivatives Association (ISDA) is currently working to replace LIBOR with SOFR in its master agreements and has elected to use a compounded in-arrears methodology as the replacement rate. ARRC is working with ISDA to reconcile any potential mismatch between the fallbacks on a loan and on the related swap in the case of existing credit facilities, but exactly how this will work has not yet been definitively determined.

Replacing LIBOR with SOFR (or any other benchmark) will require existing loan documentation for credit facilities that extend beyond 2021 to be amended or replaced. If the loan is covered by an interest rate swap based on LIBOR, parties would also need to negotiate an amendment to existing loan documentation to provide that the loan replacement interest rate calculation will default to whatever fallbacks ISDA implements for derivatives, as well as an amendment to the swap documentation.

While the transition from LIBOR is still in flux, the work to reconcile these and other issues is proceeding with increasing urgency among regulators and financial institutions. More details can be expected during the remainder of 2020 to provide borrowers and lenders with greater clarity and direction as to the best ways to prepare for the end of LIBOR. Borrowers, as well as lenders, should be taking steps now to understand their exposure with LIBOR-based instruments and to mitigate the risks associated with that exposure as much as possible.

In the case of borrowers with existing financial contracts maturing after 2021, there are a number of steps that are advisable to be taken now to address the risks arising from the LIBOR transition, including:

Each of the foregoing steps is likely to be time consuming, requiring consultation with legal and financial advisors, re-negotiation with the financial institution involved (which will be undergoing its own disruptions and uncertainty as a result of the transition), and re-documentation or additional documentation. This is particularly true of large, complicated credit facilities such as syndicated credits or CMBS loans. Because of the confusion in the debt markets anticipated for the latter part of 2021 as a result of the termination of LIBOR, it would not be advisable to wait until the deadline is imminent to address these issues. Preparation and planning now can do much to mitigate the risks of the LIBOR transition for borrowers.

Finally, borrowers should try to avoid entering into new credit facilities now that bear interest by reference to LIBOR and mature after 2021, especially if those contracts fail to address adequately the issues outlined above.

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