Finance

MAY 2019

New Guidance Issued to Help Finance Industry Move Out of LIBOR Limbo

In just two and a half years, the global financial services industry is expected to cease using the London Interbank Offered Rate (LIBOR), the standard measure of interest rates for many financial products. Trillions of dollar-equivalent-valued products use LIBOR in some way, and transitioning to an alternative rate will affect both the loan market and the derivatives market.

When Andrew Bailey, the Chief Executive of the United Kingdom's Financial Conduct Authority, stated in 2017 that the use of LIBOR should end by December 2021, the global financial services industry was faced with several significant questions and no immediately clear answers. (Read our alert on the end of LIBOR here).

The Alternative Reference Rates Committee (ARRC) was created to address these significant challenges, which included:

(a) Determining a rate to serve as an alternative to LIBOR.

(b) Incorporating protective language in existing loan agreements should LIBOR no longer exist during the term of the particular financing.

(c) Ensuring the impending changes will not disrupt markets.

Recently, ARRC has issued an update on the transition that will help ensure loan documents are updated to address the new rate and to minimize disruption during the transition. According to ARRC, the Secured Overnight Financing Rate (SOFR) will replace LIBOR as the U.S. dollar reference rate for derivatives. SOFR may also be the likely replacement rate for loans, collateralized loan obligations (CLOs) and floating-rate notes. Because SOFR is expected to be lower than LIBOR because it is secured, SOFR will require a spread adjustment to make the rate more comparable to LIBOR.

ARRC has offered language that will be needed, when LIBOR ends, in order to protect syndicated loans and outstanding CLOs by indicating the rate to which a loan would fall back. This "fallback" language should have two components — the trigger that initiates the transition from LIBOR to the replacement rate, and the replacement rate itself. In the absence of adequate fallback language, the default rate is likely to be the prime rate, cautions ARRC.

To avoid market disruption, financial products including derivatives, loans and CLOs rely on the same triggers to ensure a smooth transition. Accordingly, ARRC has proposed that these facilities have the following triggers: (i) a statement by the benchmark administrator or by the administrator's regulator that the administrator will no longer provide

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the benchmark rate, or (ii) a public statement by the LIBOR administrator's regulator that the rate is no longer representative. After one of these triggers occurs, the fallback language will replace LIBOR with the new rate.

ARRC has also recommended opt-in triggers so that parties can decide to switch to using SOFR before LIBOR ends.

Once the triggers have occurred, ARRC offers two options: a hardwired switch to SOFR approach or an amendment approach where no replacement baseline rate is expressly indicated. Over time, the market will gravitate to one or the other as we approach 2021. We are aware of at least one recent instance when the recommended ARRC hardwired approach was implemented by way of a prospectus for floating-rate notes issued by an international bank in the market.

We anticipate that ARRC will also offer similar suggested language for bilateral loan documents. Of course, the pending replacement of LIBOR will likely require operational adjustments to implement the change. Loan systems should be reviewed to ensure the fallback language will take effect once the trigger occurs.

Please reach out to your Loeb & Loeb finance contact with any questions or to discuss the specifics of the ARRC recommendation.

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5948 REV1 07.25.2019