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What Happened To My Interest Rate? Planning Now To Avoid Value Transfer And Other Risks Upon The Demise Of U.S. Libor

As the title suggests, U.S. LIBOR (LIBOR) is going away, with official announcements expected as soon as year-end 2020 of LIBOR's December 31, 2021 demise. The end of LIBOR will be replete with a plethora of risks for banks, sponsors, strategics, governments and regulators and consumers. The overriding risk with disappearance of LIBOR is value transfer, whether intentional or inadvertent, from one entity to another, such as a borrower to a lender or a swap counterparty to another swap counterparty. Additional risks, to name a few, include operational, credit, regulatory, consumer protection, reputational, documentation and litigation risk. In this Client Alert, we (a) briefly discuss LIBOR, (b) identify LIBOR's widely anticipated replacement and (c) summarize areas of concern for any institution or organization with exposure to variable (floating)-interest rates based on LIBOR.

U.S. LIBOR IDENTIFIED:

At its simplest, LIBOR is a reference "index" that serves as a primary component of a large number of variable (floating) interest rates in credit agreements, loans, notes, mortgages and other extensions of credit and derivatives based on such interest rates. In other words, many such interest rates that adjust periodically, whether daily, monthly or every three months or more, are based on LIBOR plus a "margin".

LIBOR is an acronym for London Interbank Offered Rate, which is the purported rate by which top-rated banks in London loan U.S. dollars to each other on an unsecured basis. For reasons beyond the scope of this writing, the U.K.'s Financial Conduct Authority announced in 2017 that LIBOR will be phased out of existence as a dependable index for variable interest rates no later than December 31, 2021. It is foreseeable that LIBOR may continue to be published after such deadline, but LIBOR will be designated by regulatory authorities as not representative. We believe continued use of a non-representative rate post-December 31, 2021 may lead to all of the same risks identified for discontinuance of LIBOR.

SOFR IDENTIFIED AS U.S. LIBOR'S PREFERRED REPLACEMENT:

SOFR (rhymes with gopher) has been identified by working groups assembled by the U.S. Federal Reserve as the preferred primary component of an interest rate index replacing LIBOR. SOFR is the Secured Overnight Funding Rate: such rate reflects the cost of borrowing in dollars in the daily overnight treasury repo market (i.e., a rate based on overnight loans secured by U.S. Treasuries). Because LIBOR is a unsecured rate and SOFR is a secured risk-free rate, the replacement formula for LIBOR will require reconciliation as follows to minimize value transfer: LIBOR equals SOFR plus an "adjustment" referred to in industry as a "spread adjustment".

KEY AREAS OF CONCERN:

We highlight below summaries of areas of concern for institutions and organizations with exposure to variable (floating)-interest rates based on LIBOR with a focus on value transfer and operational, credit, regulatory, documentation, reputational and litigation risks.

For purposes of issues 4, 5 and 6 below, parties to such agreements should start to think now about identifying agreements with LIBOR discontinuance risks. Beginning in Q4 2020, we believe such agreements can be amended to automatically "fall back" to SOFR (plus the spread adjustment referred to above) in replacement of LIBOR upon certain pre-agreed, regulatorily-approved triggers. For example, ISDA recently updated the public on its plans for voluntary adherence to LIBOR fallbacks in derivatives instruments. We expect that public disclosure of the terms of ISDA's agreement for such voluntary adherence will be a material inflexion point toward amending legacy credit agreements, loans, notes, mortgages and other extensions of credit to fall back to a SOFR-based floating rate of interest.

1. Value Transfer: Any non-de minimis value transfer will have litigation risk in addition to reputational risk. Solely by way of example, in the absence of express fallbacks to SOFR, the first fallback or replacement of LIBOR in innumerable credit agreements is the higher of a rate of interest equal to (a) Federal Funds plus 0.50% and (b) a bank's or a bank agent's Prime Rate. Substitution of Prime Rate for LIBOR has the possibility of value transfer of approximately 300 basis points per annum on outstanding debt balances.
2. Regulatory Oversight—General: Regulated financial institutions face pressure from regulatory bodies to show progress toward compliance deadlines for new-money transactions and compliance deadlines for de-risking value transfer issues in legacy documentation having LIBOR-based interest rates and related operational, credit, documentation, reputational and litigation risk.
3. Regulatory Oversight—Capital Markets and SEC Disclosures: Among other things, institutions and organizations with meaningful exposure to LIBOR-based instruments should review and revise risk factors and related disclosures in public filings to address evolving risks.
4. Variable Rate Credit Agreements, Loans, Indentures, Notes and Mortgages based on LIBOR: In the absence of a clear substitution for LIBOR, among other things, parties to these agreements will face uncertainty on costs of capital, financial covenant issues and interest rate hedging issues.
5. Fund Limited Partnership Agreements and other Fund Documentation with Extensions of Credit Based on LIBOR: In addition to issues of uncertainty around capital costs, parties to these agreements will have uncertainty around general partner and limited partner loans and penalties for failure to fund.

6. <u>Interest Rate Hedging Agreements and Other Derivatives Contracts based on LIBOR</u>: In addition to issues of uncertainty around capital costs, parties to these agreements will face accounting issues, auditor concerns and, in the case of borrowers, potential ineffectiveness of hedging instruments. If not already in process, institutions and organizations may want to engage with their respective auditors, accountants and tax advisors.

7. <u>Legislation</u>: The European Union and New York are working to implement legislation that purports to, in the absence of contractual language or intent to the contrary, retroactively provide for a fallback to a LIBOR replacement in agreements subject to applicable EU or New York law.

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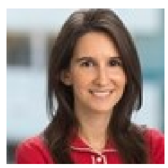

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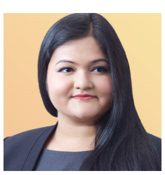

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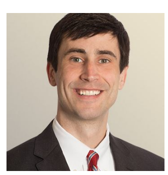

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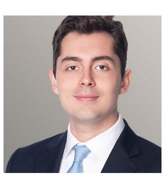

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