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Client Alert

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US Dollar Term SOFR is Here – Why is This Different and How Does it Affect My Loan?

INTRODUCTION

On July 29th, 2021, the Alternative Rates Reference Committee (the "**ARRC**") formally recommended the adoption of CME Group's forward-looking Secured Overnight Financing Rate ("**SOFR**") term rates. According to the ARRC, this announcement completes the transition plan that ARRC has been working towards since 2017 and provides all market participants with the tools they need to transit from USD LIBOR to SOFR.

This latest development is significant to any market participant who is either borrowing or lending in US Dollars, as it represents a springboard that could accelerate the transition away from LIBOR as the default benchmark rate and encourage the widespread adoption of SOFR in the market for syndicated and bilateral business loans. In this client alert, we will provide a background on the 7-year LIBOR transition journey that has occurred to date and, in simple terms, provide responses to some of our clients' frequently asked questions in a straightforward and accessible manner.

WHO ARE THE ARRC AND WHY ARE THEY RELEVANT TO MY LOAN?

The Alternative Rates Reference Committee ("**ARRC**") is a group of private-market participants convened in 2014 by various US governmental agencies (including the Federal Reserve Board and Federal Reserve Bank of New York, the U.S. SEC and the U.S. Treasury Department) to identify risk-free reference rates for USD LIBOR and to create an implementation plan to support an orderly adoption of the chosen alternative rate. Since inception, ARRC has driven this transition by regularly publishing recommendations, conventions, principles of use and drafting language to give market participants the tools to adopt the chosen alternative rate in lieu of USD LIBOR.

The ARRC had identified the Secured Overnight Financing Rate (SOFR)[1] as its recommended alternative to USD LIBOR as early on as March 5, 2018[2]. Progress in the intervening three years has been very gradual to date, which stands to reason given that the size of commercial activity currently referencing USD LIBOR was about US$200 trillion as of 2018. Therefore, any project to move those transactions away from the *status quo* would take a monumental amount of effort to complete.

The ARRC is the leading authority on the drive towards transiting to an alternative reference rate for US Dollars, both in the US domestic market and internationally. Their views and recommendations will therefore be relevant if you are lending or borrowing in US dollars.

WHAT HAVE BEEN THE KEY DEVELOPMENTS IN THE USD LIBOR TRANSITION JOURNEY TO DATE?

As a quick summary of the state of play for USD LIBOR today, the UK's Financial Conduct Authority ("**FCA**"), in its role as the regulatory supervisor of USD LIBOR's administrator (the "**IBA**"), announced on March 5, 2021 that the various USD LIBOR settings would cease to be published according to the timetable below[3], with all rates in any event being constituted after December 31, 2021 on a "synthetic" basis (more on this later):

After 31 December 2021	1-week and 2-month interest periods
After 30 June 2023	Overnight and 12-month interest periods
After 30 June 2023 (but could be extended subject to further review)	1-month, 3-month and 6-month interest periods

There is nearly *7 years* of history in the LIBOR transition journey leading up to this announcement which we would like to help you unpack. If you are already familiar with the background, please feel free to skip ahead to the next section.

ARRC's primary role has been to promulgate guidance and contractual language to market participants to encourage the adoption of SOFR in the syndicated loan market[4]. The recommended rate configuration prior to the latest announcements was the use of SOFR "in arrears", meaning that interest would be calculated using daily SOFR rates published by the New York Fed for the duration of the relevant interest periods. These "in arrears" configurations allowed for interest accruals to be calculated daily, set by reference to transactions in the Treasury repurchase market from the previous day (and is therefore observable and generally verifiable). A compounding methodology would be applied to these daily rates to arrive at a final interest amount at the end of the relevant interest period.

However, a rate that has been set "in arrears" has been challenging for lenders' internal teams to operationalize, because it would require fundamental changes in the way their systems calculate and report the applicable interest rates, when compared with LIBOR which is set in advance and is therefore known at the start of the relevant interest period. Although some sophisticated commercial banks have convened specialized LIBOR transition teams to spearhead the transition, adoption has been uneven and not all lending participants (and the relevant national regulators) have been pushing the transition at the same pace. Some corporate treasury teams have also been reluctant to drive a transition to SOFR themselves as they want to retain the benefit of knowing what their interest rate is "in advance" of an Interest Period.

Commercially, repricing contracts from USD LIBOR to SOFR is also challenging because they are two different rates that measure different things. SOFR represents loans that are secured by US Treasury Bonds and are virtually risk-free. In contrast, USD LIBOR represents the rate at which banks would lend to each other on an unsecured basis and therefore incorporates an element of credit risk. Historically, SOFR calculated over the relevant tenor has trended lower than USD LIBOR to reflect the different risk profiles so any attempt to approximate the rates would require a "spread adjustment" to be incorporated (the "**Spread Adjustment**"). How this Spread Adjustment was to be determined had until recently been a bone of contention between counterparties, but has largely been resolved by the ARRC's supplemental guidance that was released in March 2021, prescribing fixed adjustment values for different available SOFR interest periods[5]. These fixed adjustment values are briefly set out below:

- 1-month interest periods: 0.11448% above the selected SOFR rate configuration
- 3-month interest periods: 0.26161% above the selected SOFR rate configuration
- 6-month interest periods: 0.42826% above the selected SOFR rate configuration

This development, and the latest announcement from the ARRC described below, are helping to reduce the significant inertia in the transition away from USD LIBOR which has been prevalent until now.

HOW IS THE LATEST DEVELOPMENT DIFFERENT FROM PREVIOUS DEVELOPMENTS?

Concurrent with promulgating the switch from USD LIBOR to SOFR using the "in arrears" rate configurations, the ARRC has also been on the hunt for an administrator of a SOFR term rate that is determined "in advance" ("**Term SOFR**") as a means of addressing the reservations of market participants with adopting an '*in arrears*' rate (as described above). This process started in September, 2020 and was completed in May, 2021, with CME Group being selected as the administrator of Term SOFR. The continued growth in the SOFR derivatives markets (where SOFR was formally adopted in October, 2020) coupled with the gradual, incremental growth in the cash markets, finally led the ARRC to recommend Term SOFR on July 29, 2021[6].

ARRC's formal recommendation of Term SOFR is a big deal because it operates similarly to LIBOR and will require much less of a shift in how syndicated and bilateral loan facilities are documented and administered than other versions of SOFR.

Importantly, Term SOFR is a forward-looking set of rates just like LIBOR. From an administrative standpoint, the main difference will be the reference to SOFR instead of USD LIBOR and the application of the Spread Adjustment to obtain a SOFR equivalent of an existing LIBOR margin. Concepts of breakage, interest periods, continuation and conversion, etc. should all work basically the same way as LIBOR, which should make the transition much less difficult for borrowers to understand and for lenders to operationalize.

Together with the prescription of fixed Spread Adjustments, the formal recommendation of Term SOFR should remove the remaining inertial barriers and accelerate the transition to SOFR in the syndicated loans market.

HAVE THE APLMA AND THE LMA APPROVED THE USE OF TERM SOFR?

Not yet. The recommendation of Term SOFR has only just taken place so the LMA has not yet published any updated template documentation specifically referencing the use of Term SOFR. However, the LMA's recommended multicurrency term and revolving loan templates already contain references to SOFR as the benchmark for calculating interest of USD-denominated loans "in-arrears", and its American sister organization the LSTA already has LIBOR fallback language specifically referencing Term SOFR. It should therefore be the case that the LMA will update their templates to reflect the ARRC's latest Term SOFR recommendation.

The above should also be true for the APLMA, although any updates to the recommended APLMA templates would usually only follow after the corresponding updates are made by the LMA.

However, as a note of caution, the debate about which replacement benchmark rate will succeed USD LIBOR is not quite set in stone. In recent months, some market participants in the US have questioned whether SOFR is an appropriate reference rate for previous LIBOR-based transactions, mainly because SOFR does not reflect bank credit risk and could move in opposite directions in times of economic distress when the Federal Reserve pushes rates on US Treasury securities down in order to stimulate the economy (whereas bank lending rates would be expected to climb in that time). Consequently, three alternative benchmark rates[7] that are credit-sensitive have received more attention from market participants recently, which leaves open the possibility that the transition to SOFR from USD LIBOR may not be as linear as the ARRC suggests.

That being said, there is nothing stopping market participants from amending the relevant APLMA/LMA-based loan documents now if the intention is to make the switch to Term SOFR in the near future, and this may well become the prevalent trend.

WHY SHOULD I MAKE THE SWITCH TO TERM SOFR NOW?

The main reason to make the switch now is because USD LIBOR will cease to be representative of any underlying market and economic realities by December 31, 2021.

On March 5, 2021, the FCA publicly announced that a majority of the 35 LIBOR benchmark settings would cease to be published, and those that remain would continue to be published on a "synthetic" basis[8]. The reason why the rates would be "synthetic" moving forward is because the majority of the IBA's panel banks would stop providing quotations for LIBOR benchmark settings by the end of the year, so any amended methodology used in order continue publishing remaining LIBOR settings would have to rely on extrapolations and not *actual* bank quotations.

Therefore, if a loan permits the selection of a USD LIBOR setting that will cease to be published, it would be advisable to start the transition to SOFR now in order to meet the year-end cessation date. For loans that only permit selection of rates that will continue to be published post 2021 (including 1, 3 or 6 month USD LIBOR), one could view relying on a "synthetic" version of LIBOR as being a step further in the wrong direction, given that LIBOR itself has not necessarily been reflective of market conditions for some time now.

The FCA also made clear that its March 5, 2021 announcement would be a "Screen Rate Replacement Event" as such term is defined in the LMA and APLMA's standard-form "Replacement of Screen Rate" drafting (*de rigueur* in all syndicated loan agreements executed since 2014 when that language was first promulgated).

In this context, the occurrence of a Screen Rate Replacement Event presents borrowers and lenders with the opportunity to engage each other now on transitioning from USD LIBOR to an alternative benchmark.

HOW WOULD I DOCUMENT TERM SOFR IN MY LOAN DOCUMENTS?

Since the Term SOFR Rate will be a screen rate that is available on the relevant data distribution pages (on Bloomberg or Refinitiv), it can be incorporated into a loan agreement (including LMA/APLMA standard documentation) in a similar manner to existing market-standard loan agreements' incorporation of USD LIBOR rates. That being said, the language would need to be calibrated for the latest ARRC principles and conventions as these have not yet been incorporated in the LMA documentation.

As Tom Wipf, the Chairman of the ARRC has said, "With just five months until no new LIBOR, significant work remains and I urge everyone with LIBOR exposures to immediately take action and base their new contracts on forms of SOFR." We are ready assist with the transition of your LIBOR-based loan agreements to SOFR and would welcome the opportunity to discuss it with you.

[1] SOFR is a fully transactions-based rate that has the widest coverage of any Treasury repo rate available and it has been published on a daily basis by the Federal Reserve Bank of New York beginning April 3, 2018. Because of its range of coverage, SOFR is a good representation of the general funding conditions of the overnight Treasury repo market. As such it reflects an economic cost of lending and borrowing relevant to a wide array of market participants active in these markets, including broker dealers, money market funds, asset managers, insurance companies, securities lenders and pension funds
[2] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-second-report-press-release
[3] https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf
[4] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_SOFR_Synd_Loan_Conventions.pdf
[5] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/20210325-arrc-press-release-updated-hardwired-language
[6] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Press_Release_Term_SOFR.pdf
[7] An analysis of what these rates are and their attributes can be found in an article covered by our US colleagues, available at: https://kslawemail.com/398/8152/uploads/ca.pdf
[8] https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf

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