Update

Recent Developments in the Transition from LIBOR

While the end of widespread use of the U.S. Dollar London Inter-Bank Offered Rate ("LIBOR")[1] has been looming for several years, there have been a number of key developments recently in the transition away from LIBOR that have brought the process and timeline into greater focus.

This client alert provides an overview of important recent developments related to the LIBOR transition, including (i) the timing of the cessation of the publication of LIBOR, (ii) the effect of recent events on contracts using ARRC Fallback Language (defined below), (iii) the enactment of legislation in New York to address the problem of existing contracts that reference LIBOR but do not include LIBOR replacement provisions and (iv) additional considerations for market participants planning their transition away from LIBOR.

Authors

Joseph W. Aaker
Shareholder
816.360.4180
jaaker@polsinelli.com

Cynthia M. Weiss
Shareholder
202.626.8317
cweiss@polsinelli.com

Timing of Transition from LIBOR

Following an initial announcement by the UK Financial Conduct Authority (the "**FCA**") in 2017 indicating that LIBOR might not continue to be published beyond year-end 2021, market participants have worked to identify and implement successor rates for new contracts and to create fallback provisions to address the replacement of LIBOR with a successor rate in existing contracts. The timing of the cessation of LIBOR was confirmed on March 5, 2021, when the ICE Benchmark Administration Limited (the "**IBA**"), the administrator of LIBOR, and the FCA issued separate statements confirming the dates on which LIBOR will no longer be published by the IBA or will be deemed no longer "representative" by the FCA.[2] These announcements stated that one week and two month LIBOR will no longer be published (or deemed representative) after December 31, 2021 and all other LIBOR tenors (including the frequently-used 1-month and 3-month tenors) will no longer be published (or

1 The transition from interbank offered rate usage has been a global issue, with separate processes and successor rates occurring around the globe and for rates in different currencies. This client alert focuses on the replacement of U.S. Dollar LIBOR in the United States, and all references herein to "LIBOR" refer to USD LIBOR.

2 ICE LIBOR® Feedback Statement on Consultation on Potential Cessation (March 5, 2021); available at https://www.theice.com/publicdocs/ICE_LIBOR_feedback_statement_on_consultation_on_potential_cessation.pdf and Financial Conduct Authority (FCA) announcement on future cessation and loss of representativeness of the LIBOR benchmarks," (March 5, 2021); available at https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf. The less commonly-used one week and two month LIBOR maturities will cease to be published after December 31, 2021.

deemed representative) after June 30, 2023.

Impact on new floating rate loans and other financial instruments: Market regulators are already urging market participants to issue contracts and instruments that do not use LIBOR as a reference rate, and the pressure to do so is expected to increase over the course of 2021. Nevertheless, LIBOR remains the floating rate of choice for much of the U.S. debt market, despite prior statements from U.S. bank regulators indicating that any new contracts referencing LIBOR after December 31, 2021 may present safety and soundness concerns.[3] Federal Reserve Governor Randal Quarles reiterated this warning to the financial markets in a speech on March 22, 2021, saying that examiners "should consider issuing supervisory findings or taking other supervisory actions" against regulated entities that "are not making adequate progress in transitioning away from LIBOR".[4] The adoption of alternative reference rates is likely to necessitate operational and administrative changes for many market participants, and the deadline by which to adopt such measures is rapidly approaching.

Impact on existing contracts referencing LIBOR: Statements by regulators starting in 2017 had specified that LIBOR might not continue to be published beyond the end of 2021. However, given the large volume of existing financial contracts and instruments that use LIBOR and that have not been amended to include language providing for a fallback reference rate, the IBA decided to extend the publication of the most widely-used LIBOR maturities to June 30, 2023, as confirmed in the IBA's March 5th announcement. The extension will allow a significant number of existing contracts to expire without the need to add language providing for replacement rates, which is an important consideration for certain contracts where it is difficult to obtain amendments. However, it is important to note that this extension does not mean that all existing contracts referencing affected LIBOR tenors will delay transition to a replacement rate until June 30, 2023. "Early Opt-In" provisions under the ARRC Fallback Language, as well as contract provisions allowing replacement at one party's discretion or other trigger events, may result in some contracts or markets transitioning ahead of that date.

Effect of the March 5th Announcements under ARRC Fallback Language

The Alternative Reference Rates Committee (the "**ARRC**"), a working group convened by the Federal Reserve Board of Governors and the Federal Reserve Bank of New York to suggest solutions to guide the LIBOR transition process, has published multiple versions of recommended contract language to implement LIBOR replacement in existing contracts (the "**ARRC Fallback Language**"). Key terms used in the ARRC Fallback Language are described below:

ARRC Fallback Language Key Terminology:

"**Benchmark Replacement**" – the successor rate determined based on a specified hierarchy of rate selections—starting with Term SOFR and Daily Simple SOFR (discussed in more detail below)—along with a Benchmark Replacement Adjustment.

"**Benchmark Replacement Adjustment**" – the spread adjustment calculated for the Benchmark Replacement to reflect the difference between the Benchmark Replacement and the original benchmark.

"**Benchmark Transition Event**" – defined objective events, including statements from the benchmark administrator or applicable governmental body, that trigger the start of a transition to a Benchmark Replacement.

"**Benchmark Replacement Date**" – the date the Benchmark Replacement becomes effective, following the occurrence of a Benchmark Transition Event. This term appears in legacy ARRC Fallback Language, but is collapsed into the Benchmark Transition Event concept in the latest version.

"**Benchmark Replacement Conforming Changes**" – "technical, administrative or operational changes" needed to reflect a Benchmark Replacement in an existing contract, including business days, interest calculation periods, index reference dates/times, etc.

Benchmark Transition Event:

On March 8, 2021, the ARRC released a statement providing its opinion that the March 5th announcements by the IBA and the FCA constituted the occurrence of a Benchmark Transition Event under the ARRC Fallback Language.[5] However, the occurrence of a Benchmark Transition Event does not mean that replacement rates would become effective as of the date of such Benchmark Transition Event. Under the versions of the ARRC Fallback Language in use at the time of the ARRC statement, a "Benchmark Replacement" would not

3 Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency. *Statement on LIBOR Transition* November 30, 2020. Available at **https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf.**

4 See Keynote Remarks by Vice Chair for Supervision Randal K. Quarles at "The DOFR Symposium: The Final Year," an event hosted by the Alternative Reference Rate Committee, New York, New York (via webcast). Available at **https://www.federalreserve.gov/newsevents/speech/quarles20210322a.htm**.

5 Alternative Reference Rates Committee.. *ARRC Confirms a "Benchmark Transition Event" has occurred under ARRC Fallback Language* March 8, 2021 Available at **https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Benchmark_Transition_Event_Statement.pdf** See also the ARRC's published Benchmark Transition Event FAQs available at **https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Benchmark_Transition_Event_FAQs.pdf.** Note that ARRC's opinion is not binding on contract parties, but the consensus view is that the March 5th announcements constituted a Benchmark Transition Event under standard ARRC Fallback Language.

be effective until a "Benchmark Replacement Date"—which would be expected to occur immediately after June 30, 2023 for the most widely used LIBOR tenors, as discussed above.

While the March 5th announcements would not generally trigger an immediate replacement of LIBOR with a successor rate, under the ARRC Fallback Language in use at the time of the announcements, the occurrence of a Benchmark Transition Event typically would trigger a notice obligation of the lender or similar party of the occurrence of a Benchmark Transition Event, or, under certain earlier iterations of the ARRC Fallback Language, the beginning of an amendment process to select a replacement rate. Market participants should consider whether the March 5th announcements trigger any notice obligations or amendment processes under the LIBOR replacement language in their existing contracts.

Spread Adjustment:

LIBOR replacement language, including the ARRC Fallback Language, typically includes the concept of a spread adjustment to reflect the different economic characteristics of a replacement rate versus LIBOR. The ARRC has previously recommended following the spread adjustment methodology published by the International Swaps and Derivatives Association ("**ISDA**"), which is based on historical average differences during a five-year lookback window set by the occurrence of a Benchmark Transition Event. As a result of this framework, the occurrence of a Benchmark Transition Event on March 5th, 2021 fixed the lookback window for this calculation and allowed Bloomberg Index Services Limited, as ISDA's vendor for calculating spread adjustments, to publish a list of adjustments based on the specified calculation methodology.[6] Consequently, market participants can now refer to definitive numerical spread adjustments in their replacement rate language as opposed to general concepts such as the "Benchmark Replacement Adjustment" as set forth in earlier iterations of the ARRC Fallback Language.

New York Legislation

On April 6, 2021, the State of New York enacted legislation to provide, by operation of law, a fallback reference rate based on SOFR for contracts that do not include replacement rate language in the event that LIBOR is no longer published or deemed unrepresentative ("**Legacy LIBOR Contracts**"). For contracts governed by New York law that use LIBOR as a reference rate, but do not either (i) include a procedure for determining the interest rate once such tenor of LIBOR ceases to be published or is deemed to no longer be representative or (ii) include such a procedure, but use an alternative that is also based on LIBOR, the New York statute provides that, on the date that LIBOR permanently ceases to be published, or is announced by a relevant regulatory or supervisory body to no longer be representative, LIBOR will be deemed by operation of law to be replaced by the "recommended benchmark replacement" (as defined in the statute). That replacement rate will be based on SOFR as selected or recommended by the Federal Reserve Board, the Federal Reserve Bank of New York or the ARRC for the applicable type of contract, security or instrument, and will include any applicable spread adjustment between LIBOR and the SOFR-based rate. The statute also provides that any conforming changes selected or recommended by those bodies will also be deemed by operation of law to have been integrated into the relevant contract. The statute explicitly states that it does not alter or impair any contract where the parties have agreed to use a replacement rate that is not based on SOFR (as long as such alternative rate is not based on LIBOR or otherwise based on a poll, survey or inquiries for quotes or information concerning interbank lending rates).[7]

The New York statute also provides contract parties with a safe harbor from liability in connection with transitioning from LIBOR, stating that neither the selection of a recommended benchmark replacement or the determination, implementation or performance of benchmark replacement conforming changes as permitted by the statute will give rise to liability for damages or a claim for equitable relief. In addition, the law prohibits contract parties from refusing to perform their obligations under the applicable contract due to the selection of a recommended benchmark replacement or the determination, implementation or performance of benchmark replacement conforming changes as permitted by the statute. By its terms, the New York statute only applies to contracts governed by New York law, but may provide a model for similar legislation in other states. Certain industry groups and market participants are encouraging similar legislation at a federal level, so that there would be a unified approach to existing LIBOR contracts nation-wide.

6 See Bloomberg Index Services Limited *Technical Notice – Spread Fixing Event for LIBOR* March 5, 2021 Available at **https://assets.bbhub.io/professional/sites/10/IBOR-Fallbacks-LIBOR-Cessation_Announcement_20210305.pdf.** The notice includes calculated spread adjustments for various LIBOR currencies and maturities, including a spread adjustment for 1-month USD LIBOR of 0.11448% or 11.448 basis points.

7 See Section 18-401 of the New York General Obligations Law. Available at **https://www.nysenate.gov/legislation/laws/GOB/18-401**.

Additional Considerations and Current Developments

New Contract Language to Reflect the Occurrence of a Benchmark Transition Event:

For instruments executed after March 5, 2021, parties need to decide how to reflect the effect of the March 5th announcements in their fallback language. On March 25, 2021, the ARRC published Supplemental Recommendations of Hardwired Fallback Language for Syndicated and Bilateral Business Loans.[8] The new language explicitly references the March 5th announcements as an event that will result in the occurrence of a Benchmark Replacement upon the earlier of cessation/loss of representativeness, or the occurrence of an Early Opt-in. While some market participants have begun using this latest language in new contracts, another approach being used in the market is to retain the prior ARRC Fallback Language but include contract language stipulating that the March 5th announcements constitute the occurrence of a Benchmark Transition Event.

Remediation of Legacy LIBOR Contracts:

As the year 2021 approached, market participants expressed growing concern with the logistical issues in obtaining amendments to modify existing contracts that did not yet have LIBOR replacement language. The extension to June 30, 2023 of the most widely-used tenors of LIBOR, along with the New York legislation adding fallback language by operation of law, has likely greatly reduced the number of outstanding contracts that will ultimately need to be remediated. However, we encourage lenders to take every opportunity to reduce the number of outstanding Legacy LIBOR Contracts on their books and to include LIBOR replacement language as part of any contemplated amendment of an outstanding Legacy LIBOR contract. It is also likely that market participants will need to implement operational and administrative changes to adjust to non-LIBOR reference rates. These changes should be implemented as soon as possible, as the market is under continuing pressure by regulators to stop issuing new contracts referencing LIBOR by the end of 2021.

Credit Sensitive Rates:

Some market participants have continued to express dissatisfaction with the selection of SOFR as a successor rate since, unlike LIBOR, it is a secured rate and would not reflect a similar credit risk premium over a risk free rate. On April 13, 2021, the Loan Syndication Trading Association (the "**LSTA**") published model language for the inclusion of credit sensitive rate options in LIBOR fallback language for syndicated and bilateral loans.[9] It is not yet clear whether significant portions of the market will coalesce around an alternative successor rate that is credit sensitive.

SOFR Terminology:

"**SOFR**" – an index published daily by the Federal Reserve Bank of New York based on overnight repurchase agreement transactions on U.S. Treasury securities.

"**Term SOFR**" – the calculation of an implied forward-looking term SOFR based on observed transactions in derivatives referencing SOFR. As of the date of this alert, the ARRC has not yet recommended any available Term SOFR as a sufficiently robust replacement for LIBOR.

"**Daily Simple SOFR**" – an interest convention of applying daily SOFR to an outstanding loan balance for each day during an observation period without any compounding.

"**Daily Compounded SOFR**" – an interest convention of applying daily SOFR to an outstanding balance on a daily compounded basis.

"**SOFR Average**" – the calculated compounded average of observed SOFR during a specified observation period. The Federal Reserve Bank of New York publishes 30, 90 and 180-day compounded average SOFR calculations.

Continued Push toward Term SOFR

The ARRC announced on March 23, 2021 that it will not be able to recommend Term SOFR as a replacement rate by mid-2021, and may not be able to recommend such a rate by year-end 2021, and therefore encouraged market participants to begin transitioning to available SOFR successor rates rather than waiting until Term SOFR becomes available. On April 21, 2021 the CME Group, which operates an exchange for the interest rate derivative transactions that would provide the pricing inputs to the development of term SOFR, announced the launch of publication of forward-looking SOFR term rates for 1-, 3- and 6-month tenors. While the CME Group contends that these rates are "robust and sustainable" and aligned with the principles for a Term SOFR put forth by ARRC, it is unclear whether or when the ARRC may endorse the CME Group's term SOFR publications, or any future term rates published by other providers.

SOFR Variants and Operational Complexity:

This client alert has generally discussed the leading successor rate to LIBOR as "SOFR", but it is important to recognize that there are multiple ways to calculate SOFR and to choose the

8 Available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/20210325-arrc-press-release-updated-hardwired-language.

9 Available to LSTA members at https://www.lsta.org/news-resources/credit-sensitive-hardwired-fallbacks/.

method of calculating SOFR that works best operationally for you. LIBOR is an estimate of what a bank would be charged to borrow funds over a prospective period, so it is a forward-looking rate. SOFR, in contrast, is an index of overnight borrowing rates based on observed transactions. Unless and until Term SOFR develops, which would allow market participants to set their reference rate in advance for a prospective interest rate calculation period, variants of SOFR will necessarily be calculated in arrears or based on observed rates from a prior period. Seeking to use current period SOFR observations and calculate in arrears leads to various practical problems regarding the timing of calculation and notice of payment amounts, which may require shifts in the observation period. Additionally, while Daily Compounded SOFR was originally identified as a means to replicate the term structure of LIBOR, it has generally been abandoned in replacement rate language due to the complexity of calculation and the fact that the market to date has shown there to be little difference between the calculated values of Daily Compounded SOFR and Daily Simple SOFR.[10] A full discussion of the calculation differences and options available is beyond the scope of this Client Alert, but we wish to emphasize that calculation complexity and systems limitations will be an important factor in how and when lenders and other service providers are able to implement LIBOR replacement.

Multiple Versions of Fallback Language in Existing Contracts

The continued changing circumstances have resulted in several iterations of ARRC Fallback Language being published, including the latest March 25, 2021 version discussed above. Additionally, the LIBOR replacement language used by most lenders has evolved over time. Furthermore, individual contracts may contain language variations due to negotiations in the course of a transaction. Due to these factors, lenders may have a large volume of contracts outstanding with slightly (or not so slightly) different versions of replacement rate language. Lenders with large portfolios of outstanding contracts with a wide degree of variation in replacement rate language will face a difficult task in developing operational solutions that can accommodate the language in all such contracts, and/or determining that certain contracts won't fit the lender's preferred solution and trying to amend such contracts or use multiple operational solutions for contracts with different replacement rate language.

While the last few months have produced important developments and more insight as to what is to come in the LIBOR replacement process, we expect changes will continue to occur and market participants will need to follow developments closely and plan for flexible solutions that will remain functional in the face of continued uncertainty. If you have any questions related to the latest developments or the LIBOR transition in general, please reach out to the authors of this Client Alert or your regular Polsinelli contact.

10 Note that Daily Compounded SOFR (rather than Term SOFR) occupies the first place in the replacement hierarchy under standard language in the derivatives market. Therefore, in loans where a derivatives hedge may be in place, the parties may choose to specify Daily Compounded SOFR as a replacement to eliminate or reduce basis risk between the loan and the derivatives hedge.