LIBOR PRIMER

LIKE Y2K, BUT FOR REAL

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LIBOR	The reference rate provided by selected panel banks to the LIBOR administrator, **ICE Benchmark Administration (IBA)** and that is used to establish interest rates on many loans, notes, bonds and other financings, derivatives, and in purchase agreements and other contracts.[i]
DISCONTINUANCE OF LIBOR	As a result of the decrease in the volume of inter-bank financings on which to base quotes and the manipulation of the rate by panel banks[ii], the LIBOR regulator, **the Financial Conduct Authority (FCA)**, announced in 2017 that it would no longer require panel banks to provide quotations after 2021.[iii] The FCA confirmed that the panel banks agreed to support the LIBOR benchmark during the intervening period.[iv]
ALTERNATIVE REFERENCE RATES COMMITTEE (ARRC)[v]	The ARRC was created by the U.S. Federal Reserve Board and the Federal Reserve Bank of New York in 2014 and reconstituted in 2018 to include broad industry representation. It has made recommendations for an alternative reference rate to replace LIBOR in financings, as well as recommendations for related provisions.
SECURED OVERNIGHT FINANCING RATE (SOFR)[vi]	The ARRC has recommended SOFR as the reference rate to replace USD LIBOR. The chart below shows some of the ways in which SOFR and LIBOR differ. Certain adjustments will need to be made to financings that refer to SOFR for that rate to be comparable to LIBOR, in particular with respect to the credit risk embedded within LIBOR and the various tenors for which LIBOR is calculated. These adjustments are reflected in the ARRC recommendations described below.

LIBOR	SOFR
Unsecured rate at which banks can borrow in interbank market	Secured rate based on cost of borrowing with U.S. Treasuries as collateral
Based on expert judgment and, in part, on transactions	Based entirely on actual transactions in repo market
Numerous term rates available (O/N to 12 months)	Only O/N available currently
Administered privately by ICE	Administered publicly by US Federal Reserve
Credit risk inherent in rates	Minimal credit risk due to security

Note that some in the market continue to consider alternatives to LIBOR in addition to SOFR.

ARRC RECOMMENDATIONS	After publishing its "guiding principles" for LIBOR fallback language in cash products[vii], in 2018, the ARRC published recommended fallback language for new originations and issuances of Bilateral Business Loans[viii], Floating Rate Notes[ix], Securitizations[x], Syndicated Loans[xi], and Adjustable Rate Mortgages[xii], including recommendations regarding "**triggers**", referred to as "**Benchmark Transition Events**" and which describe when SOFR will replace LIBOR as the reference rate for an instrument. Such events include specified official public statements that LIBOR will no longer be available, and a pre-cessation trigger – a public statement by the FCA that LIBOR is "no longer representative". The recommendations also include **successor rate waterfall** provisions, which specify the fallback rate and adjustments to SOFR to be used.

NEW FINANCINGS

Borrowers and lenders, issuers and investors must decide with respect to new floating rate financings:

- Whether to use LIBOR as the reference rate for the financing – with fallback provisions for when LIBOR is no longer available – or to use SOFR or another alternative to LIBOR as the reference rate from the start.
- If LIBOR is used, whether all ARRC fallback and related recommendations should be followed, or just some.
- How to account for term financings if there is no term SOFR: compounded or simple interest calculation to determine interest for the interest payment period; calculated in advance or in arrears, etc.
- Whether a **hardwired approach** (fallback language is built into the financing agreement; the financing automatically converts to a new reference rate following a trigger event) or **amendment approach** (following a trigger event, the bank group enables a streamlined amendment to replace LIBOR) should be used.

LEGACY INSTRUMENTS

One of the most daunting challenges for the LIBOR transition is its impact on outstanding financings and other contracts (legacy instruments). While almost all institutions know the capital markets characteristics of their LIBOR-based assets and liabilities, many who have large portfolios of assets or large numbers of liabilities do not know the details of the plumbing: the often disparate fallback and trigger provisions in instruments created over time and with varying counterparties.

If they have not already done so, both large and small institutions are taking inventory of their LIBOR-based instruments to unearth the plumbing and to be able to properly evaluate their risks. Many institutions, especially those with numerous affected contracts, will use AI/machine learning tools to extract the relevant LIBOR-related provisions as well as relevant amendment provisions in the instruments reviewed.

Certain legacy instrument challenges (outside of derivatives) may be addressed by prospective legislation (discussed below). Some of those challenges also may be addressed through amendments to the applicable instruments. However, while amendments may be feasible (subject to the vagaries of negotiations) for bi-lateral loan agreements, amendments would be more difficult – and perhaps impossible – for widely distributed capital markets financings, which require very high – if not 100% – consent to an amendment affecting an interest rate term, and for which outreach to investors could be very difficult.

DERIVATIVES

ISDA has taken the lead in facilitating the transition of the derivatives market by publishing consultations and building consensus on LIBOR fallback provisions.[xiii] The bulk of the consultations has focused on deciding how to account for differences between LIBOR and SOFR for term and credit.

The 2006 ISDA Definitions, incorporated into almost all interest rate derivatives, generally provide that the relevant LIBOR rate applicable to a swap is determined by looking to a specific published rate or, if that rate is not available, based on dealer quotations. Of course, such a fallback may work as a stop-gap measure in the case of a temporary disruption, but in the case of a permanent discontinuance of LIBOR, it would be unworkable.

ISDA is expected to publish a Supplement to its 2006 ISDA Definitions that will specify trigger events and fallbacks to the applicable successor rate. New transactions incorporating the supplemented 2006 Definitions automatically would be governed by those provisions. Legacy transactions also could incorporate those provisions voluntarily through a Protocol mechanism being developed by ISDA.

ISDA continues to consider whether to provide for "pre-cessation" triggers in the Supplement – in other words, whether fallbacks should be triggered upon a determination by the FCA that LIBOR is "no longer representative"[xiv].

DIFFERENCES AMONG FALLBACK PROVISIONS ACROSS PRODUCTS

Consistency across cash and derivatives products will reduce operational, legal and basis risk. However, cash product fallback provisions may differ in some respects from derivative fallback provisions (e.g., a "pre-cessation" trigger for cash products, which has not yet been adopted by ISDA; term SOFR, if available, at the top of the successor rate waterfall for cash products vs. compounded SOFR in arrears plus a spread adjustment for derivatives). There are also differences among the structure and terms of various cash products that may warrant differences in their fallback provisions, including differences in the successor rate waterfall and inclusion of the amendment approach for bilateral business loans.

"When you looked at the underlying contracts that used LIBOR, they didn't provide very well for LIBOR simply disappearing.... This is a DEFCON 1 litigation event if I've ever seen one."

- NY Fed Exec. VP and General Counsel Michael Held

POTENTIAL SOURCES OF LEGAL EXPOSURE

Some legacy instruments may provide for a LIBOR-based interest rate without any fallback provisions in the event of the unavailability of LIBOR. Others may provide for a dealer poll if LIBOR is not available, or a fallback to the last available LIBOR. Still others may provide for a fallback to the prime rate, which is about 300 basis points higher than LIBOR. In any event, when fallbacks were put into financing instruments, the intent was to cover a circumstance in which LIBOR was temporarily, not permanently, unavailable. Some legacy instruments also may include trigger provisions that are not entirely clear. All of these situations open up the possibility for disputes, challenges and claims, including for breach of contract, impracticability, impossibility, mutual mistake of fact, force majeure and frustration of purpose, among others.

NEW YORK STATE LEGISLATIVE FIX PROPOSALS UNDER CONSIDERATION BY THE ARRC

The ARRC is considering proposing legislation in New York that would insert the ARRC-recommended SOFR fallback provisions into New York law governed contracts that have no fallback provisions or that provide for a fallback to a LIBOR-based rate, such as the last available LIBOR. The legislation also would apply, on a permissive basis, where, e.g., a calculation agent or administrative agent that is required under the contract to determine the alternative rate elects to use the ARRC-recommended rate/spread adjustment. In that case, the agent would benefit from a safe harbor from legal action. Contracts with fallbacks to rates other than LIBOR (e.g., prime) would remain in place and would not be affected by the statute. (Additional alternatives - leaving LIBOR outstanding for legacy instruments; creation of a synthetic "LIBOR" reference rate, etc. - are also under consideration by the market.)

U.S. CONSTITUTIONAL LAW CONSIDERATIONS

Any state legislation that purports to effect a change in an outstanding contract could possibly be subject to challenge under the "Contracts Clause" of the United States Constitution (Article I, section 10, clause 1). That Clause prohibits states from passing any "Law Impairing the Obligation of Contracts". Despite the categorical terms of the Contracts Clause, U.S. Supreme Court opinions have generally tended to be forgiving toward state legislation with retroactive effects on contracts.

The Contract Clause has been interpreted by the Supreme Court liberally over the years. The Court has considered the following in evaluating possible violations of the Contract Clause[xv]:

- Does the statute effect a "substantial impairment" of contracts?
  - Is the law designed to reflect the intent of the parties?
  - Is the law likely to disturb the expectations at the time of contracting?
- If a "substantial impairment exists", does the statute advance a legitimate public purpose?
- If a "substantial impairment exists", is the means-ends fit reasonable?

All of these decisions are heavily dependent on the facts of a particular case. Although there are reasons to believe that the proposed legislation would survive constitutional challenges, such litigation could take several years to culminate in a definitive resolution. Given the amounts potentially at stake, counterparties adversely affected by this legislation may have every incentive to litigate to a conclusion.

Related Orrick Client Alerts

- The LIBOR Transition – Legislative Solutions/ Constitutional Law Considerations
- The LIBOR Transition – What a Legacy!
- LIBOR . . . Coming to an End?
- LIBOR and Derivatives
- Tax Relief for Replacing LIBOR in Tax-Exempt Debt and Swaps
- Takeaways from the June 3 ARRC Roundtable
- LIBOR Transition: Takeaways from the Benchmark Rates Series Benchmark Rates Forum New York

Endnotes

i ICE LIBOR. The London Inter-Bank Bank Offered Rate (LIBOR) is administered by the ICE Benchmark Administration. "The LIBOR methodology is designed to produce an average rate that is representative of the rates at which large, leading internationally active banks with access to the wholesale, unsecured funding market could fund themselves in such market in particular currencies for certain tenors. LIBOR is currently calculated for five currencies (USD, GBP, EUR, CHF and JPY) and for seven tenors in respect of each currency (Overnight/ Spot Next, One Week, One Month, Two Months, Three Months, Six Months and 12 Months). This results in the publication of 35 individual rates (one for each currency and tenor combination) every applicable London business day."

ii Criminal and civil actions and subsequent settlements by Barclays, UBS, RBS, and Rabobank, etc. revealed significant fraud and collusion by panel banks connected to rate submissions.

iii Speech by Andrew Bailey, Chief Executive of FCA

iv FCA statement on LIBOR panels

v ARRC

vi Federal Reserve Bank of New York Secured Overnight Financing Rate Data. Secured Overnight Financing Rate (SOFR) In June 2017, the ARRC announced SOFR as its recommended alternative to the USD LIBOR. "SOFR is a broad Treasury repo financing rate; a fully transactions based rate published on a daily basis by the Federal Reserve Bank of New York (beginning April 2018); a good representation of the general funding conditions of the overnight Treasury repo market, reflecting an economic cost of lending and borrowing relevant to a wide array of market participants active in these markets.

vii ARRC Guiding Principles for More Robust LIBOR Fallback Contract Language in Cash Products

viii ARRC RECOMMENDATIONS REGARDING MORE ROBUST FALLBACK LANGUAGE FOR NEW ORIGINATIONS OF LIBOR BILATERAL BUSINESS LOANS MAY 30, 2019

ix ARRC RECOMMENDATIONS REGARDING MORE ROBUST FALLBACK LANGUAGE FOR NEW ISSUANCES OF LIBOR FLOATING RATE NOTES APRIL 25, 2019

x ARRC RECOMMENDATIONS REGARDING MORE ROBUST FALLBACK LANGUAGE FOR NEW ISSUANCES OF LIBOR SECURITIZATIONS MAY 31, 2019

xi ARRC RECOMMENDATIONS REGARDING MORE ROBUST FALLBACK LANGUAGE FOR NEW ORIGINATIONS OF LIBOR SYNDICATED LOANS APRIL 25, 2019

xii ARRC RECOMMENDATIONS REGARDING MORE ROBUST LIBOR FALLBACK CONTRACT LANGUAGE FOR NEW CLOSED-END, RESIDENTIAL ADJUSTABLE RATE MORTGAGES November 15, 2019

xiii ISDA Benchmark Fallbacks

xiv The FCA is required to make an assessment of LIBOR's representativeness in certain circumstances, such as the departure of one or more panel banks, or, in any event, every two years. If the FCA determines that LIBOR is "no longer representative of the underlying market or economic reality," under the EU Benchmark Regulation, EU-supervised entities could be prohibited from referencing LIBOR in new derivatives and securities.

xv Sveen v. Melin (2017); Home Building Assoc. v. Blaisdell (1934)