REGULATORY INSIGHTS

The Great Transition: A 2020 LIBOR Transition Recap and Things to Keep in Mind as We Approach 2021

BY KIM DESMARAIS

Lenders and borrowers have had much to contend with in 2020, including an unforeseen and devastating pandemic upending the way we live and conduct business. One constant remains though, and that is that LIBOR is widely expected to cease to be the benchmark rate for loan and derivative products after 2021 and transition efforts remain underway.

It is hard to believe that it has been over three years since the July 2017 announcement by the then-chief executive of the UK's Financial Conduct Authority ("FCA") that the FCA had reached an agreement with LIBOR panel banks to continue submitting London Interbank Offered Rate ("LIBOR") quotations through the end of 2021, but that the financial markets should not expect LIBOR to continue to be published after that date. While market participants around the world have recovered from the shock of that statement and come to terms with the expected cessation of LIBOR, there remains a significant amount of work to ensure a smooth transition to a new benchmark rate, including the Secured Overnight Financing Rate ("SOFR"), which has emerged as the leading contender to serve as the primary alternative to USD LIBOR. This article provides a brief recap of where we are today, a look at potential replacement rates and suggestions as to things that lenders and borrowers should keep in mind as we approach 2021.

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2020 has been a productive year on the transition front despite COVID-19

The Alternative Reference Rate Committee ("ARRC"), a group of private-market participants convened by the Federal Reserve Board and the New York Fed to help ensure a successful transition from USD LIBOR to a more robust reference rate, was reconstituted in 2018 to, among other things, coordinate and track LIBOR transition planning. Consistent with its "Key Objectives for 2020"[1] and despite hurdles posed by the pandemic, a significant amount of work has been done in 2020 to further aid market participants in the transition away from LIBOR. Below are a few highlights.[2]

- "Consultation on Spread Adjustment Methodologies for Fallbacks in Cash Products Referencing USD LIBOR" — released January 2020
- Released "Best Practices for Completing Transition from LIBOR", clarifying recommended timelines and interim milestones for the transition away from LIBOR in a way that will minimize market disruption – May 2020
- Published "Further Details Regarding Its Recommendation of Spread Adjustments for Cash Products" – June 2020
- Developing conventions related to using SOFR in arrears, both daily simple SOFR and daily SOFR compounded in arrears, in syndicated loans – July 2020
- Hosted a multi-session webinar called the "SOFR Summer Series," which was designed to, among other things, educate the public about the development and strengths of SOFR
- Released "Internal Systems & Processes: Transition Aid for SOFR Adoption", to assist lenders with operationalizing the transition to new benchmark rates – July 2020
- Updated "Hardwired Approach" recommended language for syndicated loans released in June 2020 and recommended language for bilateral loans released in August 2020
- Released a "SOFR Starter Kit" to provide market participants with the primary tools for the use of SOFR in new loan and derivative products – August 2020
- Released two RFPs to the market for selection of administrators and publishers of Term SOFR and SOFR spread adjustments – September 2020

The Loan Syndications and Trading Association ("LSTA") also is having an active and productive 2020, including in its role as co-chair of the

[1] See "ARRC Announces its Key Objectives for 2020", April 17, 2020.
[1] See link to ARRC website with additional details. https://www.newyorkfed.org/arrc/announcements

ARRC's Business Loan Working Group ("BLWG"). Summarized below are a few of the key documents and announcements released by the LSTA to assist the syndicated loan market with the transition to and operationalization of new SOFR-based rates.[3]

- Developing "concept" credit agreements based on daily simple SOFR in arrears and daily SOFR compounded in arrears;
  — As noted by the LSTA, the concept credit agreements are "illustrative examples" and were developed as an "educational tool" to support the transition to SOFR-referenced loans.
- Establishing a working group to develop operative terms that can be used in amendments and other documents to aid in the transition from LIBOR to Daily Simple SOFR in Arrears in legacy syndicated loans
- Publishing examples of the various SOFR-based rates and analysis of the related conventions to assist the market with understanding how the rates operate relative to each other and LIBOR. LIBOR: Conventions for Unconventional Thinking – July 2020[4]

SOFR – What It Is and What Has Changed Since 2019

SOFR is the average rate at which institutions can borrow U.S. dollars overnight in the repo market secured by U.S. Treasury securities. It is published by the New York Fed on each business day at approximately 8 a.m. Eastern time and reflects the previous day's SOFR. The ARRC selected SOFR as its preferred rate to replace USD LIBOR. As noted in the ARRC "SOFR Starter Kit", "SOFR has several characteristics that make it much safer and less vulnerable to manipulation by private actors than LIBOR, including that it:

- Is based on an active underlying market with a diverse set of borrowers and lenders;
- Is based entirely on transactions (not estimates);
- Is produced in compliance with international best practices; and
- Covers multiple market segments, ensuring robust transaction volumes in a wide range of market conditions."

However, it is well documented that there are certain fundamental differences between SOFR and LIBOR, which are summarized in the table below:

Feature	LIBOR	SOFR
Term	Forward term rates (seven tenors, from overnight to one year)	Backward-looking overnight rate
Credit Spread	Reflects bank credit risk	(Nearly) zero credit risk
Construction	Bank submissions, based on actual transactions and "expert judgment"	Based solely on actual transactions

To address the "term" difference between LIBOR and SOFR, the ARRC has set a goal of actively finding an administrator to develop and publish forward-looking term rates or "Term SOFR". As noted by the LSTA[5], all cash asset classes prefer this SOFR-reference rate to the other options, which are summarized below, because (1) it is known in advance of the applicable interest period and (2) since it will operationalize similar to LIBOR, operational risk will be minimized upon LIBOR cessation. The creation of a "Term SOFR" is the final step in the ARRC's Paced Transition Plan and, based on the RFP released by the ARRC in September 2020 and assuming sufficient liquidity in the SOFR derivatives market, it is aiming to have these forward-looking rates available to the market by the end of the first half of 2021.

In the meantime, a few overnight SOFR-based rates have emerged over the last year and a half or so for use in the loan markets to assist with the transition away from LIBOR. These are based on certain "conventions" in terms of how daily SOFR is used to determine the interest rate for the applicable period. In the case of "Compounded SOFR in Arrears", "Compounded SOFR in Advance", "Simple SOFR in Arrears" and "Simple SOFR in Advance", instead of being based on a single day's published rate, each of these rates are based on an average of published rates over a predetermined period.

- Compounded SOFR in Advance – References the average of SOFR published rates determined *prior to* the beginning of the current interest period and multiplied by the outstanding principal + accrued and unpaid interest
- Compounded SOFR in Arrears – References the average of SOFR published rates *during* the current interest period and multiplied by the outstanding principal + accrued and unpaid interest
- Simple SOFR in Advance – References the average of SOFR published rates determined *prior to* the beginning of the current interest period and multiplied by the outstanding principal
- Simple SOFR in Arrears – References the average of SOFR published rates *during* the current interest period and multiplied by the outstanding principal

The ARRC has concluded that such averaging "will accurately reflect movements in interest rates over a given period of time and smooth out any idiosyncratic, day-to-day fluctuations in market rates."[6] The averaging, from a technical perspective, may be either "simple" or "compounded". A fundamental difference between the two conventions relates to the time value of money, which is not addressed

Takeaways

1 **2020 has been an active year on the LIBOR transition front. The ARRC and LSTA have released further guidance and updated documents to assist the market with the transition away from LIBOR.**

2 **Understand SOFR, SOFR-based rates and the related conventions. Doing so will aid lenders and borrowers as the loan market moves to "hardwiring" in alternative benchmark rates.**

3 **Have a LIBOR transition plan. While the impact of the transition is uncertain, working with experienced advisors to assist with the legal, regulatory and the operational impact will assist with anticipating the potential impact.**

[3] See link to LSTA website with additional details. https://www.lsta.org
[4] See https://www.lsta.org/news-resources/libor-conventions-for-unconventional-thinking
[5] See "To Dream The Possible Dream: Term SOFR & Spread Adjustments" published by the LSTA on September 15, 2020. https://www.lsta.org/news-resources/to-dream-the-possible-dream-term-sofr-spread-adjustments

with the "simple" convention and could be an issue in rapidly changing interest rate markets. While the "simple" convention could result in significant value variation, the ARRC and the LSTA have indicated that their analysis suggests this is only a theoretical concern, i.e., when applied and compared to one another, the basis, if any, between "simple SOFR" and "compounded SOFR" has typically been not more than a few basis points. The "simple" convention, on the other hand, offers ease of implementing since it can be accommodated by current systems. Moreover, in the case of "in arrears" calculations, since the rate is not known at the beginning of the interest period, there could be issues associated with calculating the rate in enough time to invoice the borrower. Certain conventions, as summarized below, have been developed to address this issue. It is worth noting that the "plain" payment convention has generally not been considered a workable solution since it does not sufficiently address the timing issue.

Convention	Compounded or Simple SOFR in Arrears
Plain Payment	Averaged SOFR over the current interest period is paid on the first day of the next interest period. Requires payment on the same day that final interest payment amount is known.
Payment Delay	Averaged SOFR over current interest period is paid [x] days after the start of the next interest period.
Lookback	For every day in the current interest period, use the SOFR rate from [x] days earlier.
Lockout	Averaged SOFR over current interest period is used with last rates set at the rate fixed [x] days before the period ends – may be necessary for terminal interest accruals under the "Payment Delay" convention.

In July of this year, the ARRC released "SOFR 'In Arrears' Conventions for Syndicated Business Loans" in which it recommended that either Compounded SOFR in Arrears or Daily Simple SOFR in Arrears be used in syndicated business loans. Consistent with these recommendations, the ARRC updated its "Hardwired Approach" recommended fallback language for syndicated loans to replace "Compounded SOFR in Arrears", which was the second step in the rate fallback waterfall after "Term SOFR", to "Daily Simple SOFR in Arrears". To assist the market in transitioning to this rate, both in new syndicated loans and as a fallback in USD LIBOR legacy loans, the LSTA shortly thereafter published its "Daily Simple SOFR in Arrears" Concept Credit Agreement. A comparison of this concept credit agreement against the LSTA form term loan credit agreement is equally useful in understanding the technical modifications required to implement Daily Simple SOFR in Arrears into syndicated credit agreements. Understanding these rates and the various conventions will become increasingly critical as we approach June 30, 2021, the cutoff date

Convention or Feature	Daily Compounded SOFR in Arrears	Daily Simple SOFR in Arrears
Calculation	Daily SOFR pulled for each day in the current interest period and on each business day multiplied by (a) the outstanding principal + accrued and unpaid interest or (b) 2 different methodologies that apply a calculated rate of daily compounded interest to principal – a "Cumulative Compounded Rate" and a "Noncumulative Compounded Rate"	Daily SOFR pulled for each day in the current interest period and on each day multiplied by the outstanding principal
Payment Delay, Lookback or Lockout?	Business day lookback without an "observation shift" (without shifting the observation period so that each daily SOFR rate applies to repo transaction period it represents)	Same as Compounded
Holiday & Weekend Convention	Apply preceding business day's rate, weighted by the number of calendar days until the next business day	Same as Compounded
Day Count	Actual/360 days	Same as Compounded
Floors (new SOFR loans)	Floor calculated daily, not at the end of an interest period	Same as Compounded
Spread Adjustment (Fallback to SOFR in LIBOR legacy loans)	ARRC/ISDA spread adjustment for the appropriate tenor, provided that while the daily SOFR is compounded the spread adjustment and the loan margin would be treated as simple interest added to the compounded rate	ARRC/ ISDA spread adjustment for the appropriate tenor
Floors (Fallback to SOFR in LIBOR legacy loans)	Apply LIBOR legacy floor, but as applied would be the difference between the LIBOR Floor Rate and the SOFR spread adjustment	Apply LIBOR legacy floor to the daily SOFR rates plus the SOFR spread adjustment

[6] See "A User's Guide to SOFR", the Alternative Reference Rate Committee, April 2019.
[7] See Staff Statement on LIBOR Transition Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets, and Office of the Chief Accountant, July 12, 2019.
[8] See Office of Compliance Inspections and Examinations Risk Alert - Examination Initiative: LIBOR Transition Preparedness, June 18, 2020.

for new issuances of USD LIBOR loans as recommended by the ARRC in its “Best Practices”. The ARRC’s recommended conventions are summarized on the table on previous page.

To address the “credit spread” and “calculation” or cost of funds issue in USD LIBOR legacy transactions that will transition to SOFR, the ARRC has actively been working to develop “spread adjustments” and “spread adjusted rates” that look at the historical difference between LIBOR and SOFR based on a 5-year look-back period and, for consumer products, with a 1-year transition period. As noted above, the ARRC recently issued an RFP for the selection of “one or more firms” to publish indicative and static spreads and spread-adjusted rates for cash products that will transition away from USD LIBOR. The RFP requires the administrator(s) to be ready to publish the spreads and rates no later than March 31, 2021. As a result of the RFP and the publication deadline, we may see more interest by the market to implement LIBOR fallback language in syndicated and bilateral loans based on the “Hardwired Approach.” This interest could build off of the momentum we saw in the syndicated loan market as we approached the ARRC’s September 30, 2020 recommended date for implementation of hardwired fallback language in new syndicated business loans and in connection with the press release by the Federal Financial Institutions Examination Council in July 2020 guiding banks to include language, presumably hardwired, in their new contracts that provides for a “clearly defined alternative reference rate” upon LIBOR’s cessation.

Year-end goals and possible 2021 LIBOR resolutions

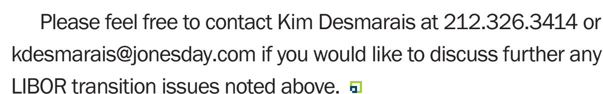
As we approach the last part of 2020, it is a good time to consider what we hope to resolve in 2021. While the impact of LIBOR cessation on the U.S. lending market remains to be seen, there are many steps that can be taken now and into 2021 to ease the transition for both lenders and borrowers. Seeking the assistance of experienced advisors to assist with the legal, regulatory and the operational impact of the transition, both on legacy transactions referencing LIBOR and new SOFR rate loans, would be prudent and can help both lenders and borrowers anticipate the impact of LIBOR’s expected cessation.

Knowing your portfolio is a primary goal for all market participants and a key factor in the ARRC’s “Best Practices.”[7] If you are a public filer or SEC registrant, this takes on even greater importance in light of the SEC’s Staff Statement on LIBOR Transition released in 2019 and the risk alert on LIBOR Preparedness released by the Office of Compliance Inspections and Examinations in 2020[8], each of which focus on LIBOR exposure assessments and risk mitigation strategies in connection with the cessation of LIBOR. Lenders that have a comprehensive understanding of their LIBOR exposure, including now and through the transition to new benchmark rates, should experience an easier path to remediation and the transition of their portfolio to new SOFR-based rates, including greater success in amending their contracts when required. It also will allow both lenders and borrowers to immediately understand the impact of legislative solutions should they emerge in the United States, regulatory changes that U.K. regulators may implement that could allow “LIBOR” to continue beyond 2021 in the United States, or judicial decisions that could inform the interpretation of legacy contracts.

The ARRC has recommended in its “Best Practices” that new issuances of USD LIBOR-based loans should cease by June 30, 2021. Assuming that the market adheres to this best practice, we could see a significant number of lenders moving to SOFR-based rate loans as we approach and head into 2021. Since the loan markets appear to be coalescing around the SOFR-based options noted above, it would be pragmatic to review and understand those rates and their related conventions and adjustments. It would likewise be prudent for borrowers to understand how and when these rates will be calculated and any effect the conventions have on timing of interest payment dates to ensure existing payment systems can be adjusted accordingly. Lenders will want to consider what SOFR-based rates can be operationalized today and those that will require further enhancements or modifications to their existing systems. The ARRC’s “Internal Systems & Processes: Transition Aid for SOFR Adoption” provides a useful guide when thinking about how to transition systems to handle SOFR-based rates and the systems and processes impacted at each step of the transition.

A critical concern with the LIBOR transition from a tax perspective is whether a taxable event would occur upon the transition to a new rate. In response to regulatory relief sought by the ARRC and other private sector groups overseeing the LIBOR transition, on October 9, 2019, the Treasury and Internal Revenue Service published Proposed Treasury Regulations intended to facilitate transitions from LIBOR (and other interbank offered rates) to alternative rates without adverse tax consequences. There are, however, certain parameters that must be met for contract changes addressing a transition from LIBOR to a new replacement rate to not result in a “significant modification” or a taxable event, including that the replacement rate must be classified as a “qualified rate.” As a result, it would be prudent for both borrowers and lenders to consult with their tax advisors as they are negotiating these contract changes, including the implementation of fallback language.

Please feel free to contact Kim Desmarais at 212.326.3414 or kdesmarais@jonesday.com if you would like to discuss further any LIBOR transition issues noted above.



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