



# LOCKE LORD® QUICK Study

## **Introduction**

The London interbank offered rate (LIBOR) presently serves as the benchmark rate for over \$200 trillion of US dollar-based derivatives and loans.<sup>1</sup> In 2012, financial industry regulators discovered manipulation of the rate-setting process that underlies LIBOR. The Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (ARCC) in 2014 in order to, among other things, identify the best practices for establishing an alternative reference rate in replacement of LIBOR.<sup>2</sup> In June 2017, the ARCC announced its identification of the Secured Overnight Financing Rate (SOFR) as its preferred rate to replace LIBOR.<sup>3</sup>

## **What is SOFR?**

SOFR is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities.<sup>4</sup> The Federal Reserve Bank of New York started publishing SOFR on April 3, 2018.

## **SOFR vs. LIBOR: Spot Rate / Term Rate**

LIBOR is quoted across seven tenors ranging from one day to one year (with one-month and three-month LIBOR being the most often used tenors in the loan market). By contrast, SOFR is a spot rate – it is calculated by taking the average of certain Treasury repo transactions that were entered into on the preceding day. Accordingly, a SOFR “term curve” will need to develop in the market in order to provide forward-looking one-month and three-month SOFR quotations. The development of the term curve will be established through the trading of SOFR-linked derivatives. In May 2018, the CME Group began offering futures trading for one-month and three-month SOFR futures.

## **SOFR vs. LIBOR: Secured / Unsecured**

LIBOR is based on the rate that banks charge one another for short-term loans on an unsecured basis. Accordingly, LIBOR includes a risk premium in order to capture the underlying credit risk of entering into such an interbank lending transaction on an unsecured basis. By contrast, SOFR is based on transactions that are secured by Treasury securities. Market participants are working on a “credit spread” adjustment to SOFR that would help approximate the credit risk component of LIBOR. It remains to be seen whether the credit spread will be static or dynamic, i.e., whether the spread will be fixed at a permanent stated amount or will float based on market conditions. The spread between LIBOR and interest rates that are similar to SOFR (i.e., secured overnight interest rates) has typically been less than 50 basis points in normal market conditions – however, that spread increased to over 100 basis points for much of the period between October 2007 and May 2009, and peaked at over 450 basis points in October 2008.<sup>5</sup> Accordingly, a static spread

would seem to have significant shortcomings that will need to be addressed in the market. It is worth noting that the credit risk component of LIBOR inures to the benefit of floating-rate lenders, who typically welcome the increased compensation in times of financial distress.

### **Planning Ahead: LIBOR Fallback Language**

Credit agreements for syndicated loans have traditionally contained “LIBOR fallback” language that specifies what happens in the event LIBOR becomes temporarily unavailable. In general, this language provides that LIBOR-denominated loans outstanding under the credit facility are converted into “alternate base rate” loans with an interest rate that is typically determined by making reference to the Prime Rate. While this fallback mechanism provides for a safeguard in a worst-case scenario where LIBOR unexpectedly ceases to exist for a period of time, it is not a feasible long-term solution since the Prime Rate is currently over 200 basis points higher than three-month LIBOR.

A general framework has arisen in the syndicated lending market to provide for an efficient amendment mechanism in the event that LIBOR becomes permanently unavailable. As noted by the Loan Syndications and Trading Association (LSTA) in an update they provided last month,<sup>6</sup> the new amendment framework addresses three fundamental points:

1. First, it identifies the type of event that will trigger the requirement to enter into an amendment. The trigger event will typically occur upon LIBOR permanently becoming unavailable, either because it is no longer being published or because a governing body has made an announcement that LIBOR will no longer be used after a certain date. A minority of credit agreements include an additional triggering event that occurs upon LIBOR no longer being a widely recognized benchmark rate for syndicated loans.
2. Second, it specifies who determines the new interest rate. The replacement rate is typically determined by either (A) the administrative agent or (B) the administrative agent in consultation with the borrower.
3. Third, it provides for a specified level of control that individual lenders have over the selection of the new interest rate. The Required Lenders (usually those lenders holding at least 51% of the outstanding loan commitments) are typically granted a five business day negative consent right with respect to the chosen replacement rate, although we have seen a number of credit agreements where the Required Lenders are not provided with such a negative consent right.

### **Conclusion**

The job of replacing LIBOR is a significant undertaking that will require a number of years of additional work before it can be accomplished. While loan market participants have started to incorporate broad fallback language into credit agreements in anticipation of the upcoming change, the proposed solution continues to evolve. Lenders and borrowers should carefully review the LIBOR fallback language in their existing credit facilities as well as those credit facilities entered into in the months and years to follow. The identification of SOFR marked a significant step toward the full replacement of LIBOR, however, significant work remains in order to make SOFR a feasible solution in the loan market.

1 <https://www.reuters.com/article/us-usa-bonds-libor/u-s-libor-exposures-larger-than-thought-at-200-trillion-arrc-idUSKBN1GH2Z8>

2 LIBOR is available for five different currencies (USD, EUR, GBP, JPY and CHF). While the focus of this article is on the replacement of US Dollar LIBOR, it should be noted that similar LIBOR replacements are in process with respect to the other four LIBOR currencies.

3 <https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Jun-22-2017.pdf>

4 <https://apps.newyorkfed.org/markets/autorates/sofr>

5 <https://www-2.rotman.utoronto.ca/~hull/DownloadablePublications/LIBORvsOIS.pdf>

6 <https://www.lsta.org/news-and-resources/news/libor-fallbacks-a-snapshot-of-syndicated-loans>