

Fund Finance Friday



FFA Next Gen Event: 'Into the Unknown': A Fund Finance Perspective on 'Letting LIBOR Go'

February 26, 2021 | Issue No. 115

The U.S. chapter of FFA Next Gen held its second virtual panel session this week, titled "Into the Unknown": A Fund Finance Perspective on "Letting LIBOR Go." Over 215 attendees heard from expert panelists Jean MacInnes, Executive Director and Counsel at Mizuho Americas, Jeff Nagle, Partner at Cadwalader, and Tess Virmani, Associate General Counsel and Executive Vice President for Public Policy at LSTA. I appreciated the opportunity to serve as panel moderator. Read on for some key takeaways.

- "LIBOR is like glitter" as it is everywhere!
- The panelists provided a refresher on why LIBOR is going away and what the ARRC (Alternative Rates Reference Committee) is and its role in LIBOR transition.
- When your current benchmark ceases to be available, selecting the replacement rate depends on whether the Credit Agreement includes the "Amendment Approach," whereby the parties will negotiate and agree to an amendment to provide for the replacement rate, or the "Hardwired Approach," whereby there is a defined waterfall as to what replacement rate will apply. In the Hardwired Approach, when LIBOR does go away, typically if Term SOFR is available, then the parties will use that, but if not, then the parties will use the next available rate (Daily Simple SOFR, Daily Compounded SOFR, etc.). The intent behind the Hardwired Approach is to agree to the game plan up front before LIBOR goes away. In the Hardwired Approach, a borrower having consent rights to the replacement rate undermines the intent to agree to a replacement rate at the time of signing up the Credit Agreement.
- In 2020, the ARRC and U.S. regulators issued statements in favor of adopting the Hardwired Approach on the basis that (i) the SOFR market has matured in the past few years and there is more information and comfort around the replacement rates, and (ii) millions of Credit Agreement negotiations and amendments will be operationally challenging, especially as we approach the end of 2021.
- In December 2020, the IBA launched a consultation to extend most tenors of US Dollar LIBOR until 2023, which effectively is an 18-month extension to address operational issues. However, just because most tenors of USD LIBOR aren't going away until 2023, that additional 18 months is intended to provide time to transition legacy deals. U.S. banking regulators have said that no new LIBOR contracts should be entered after December 31, 2021 except in limited circumstances. The clear message is that all parties need to move off LIBOR with all due speed. An upcoming IBA announcement will come out soon with results of this consultation and will likely set benchmark spread adjustments for loans using ARRC fallbacks.
- State of Play on New Loans: LSTA has put out model Credit Agreements that use both Daily Simple SOFR and Daily Compounded SOFR. Banks are very busy putting in place the systems and operational capability for the pricing change. Changing the documentation is just one component of the transition; there is also a lot to do beneath the surface. Some SOFR-based products have been issued in the bilateral market, but it is limited, and we do expect SOFR to hit the syndicated market soon. Furthermore, there is an uptick in the derivatives market. With Sterling LIBOR fading out in Europe next month, it will drive the timeline for multicurrency deals. In the next quarter, we expect an increasing amount of SOFR issuance to hit the market.
- SOFR: "Secured Overnight Financing Rate" is based on the repo rates for U.S. Treasuries. The Fed gathers information about Treasury rates in the market, approximately \$1 trillion of daily activity. There is currently a very robust volume of market activity supporting SOFR. The Fed publishes SOFR the next morning. The intent is to implement SOFR as the replacement benchmark for LIBOR but to seek to avoid value transfer for existing deals.

Since SOFR is very different from LIBOR and traditionally a lower amount, a spread adjustment is needed to keep things comparable from a pricing perspective; this spread adjustment is different from margin over the benchmark.

- **Term SOFR:** A forward-looking version of SOFR that can be locked in for a fixed period (similar to 1-month or 3-month LIBOR) and the rate will hold for that period. The market is used to this from LIBOR, but it is looking less likely that we will have a Term SOFR by the timelines necessary to meet regulatory guidelines (it may not be available in 2021). The only way to have a robust Term SOFR is to have a very active SOFR market in derivatives. Many parties in the market are using provisions in hardwired language to “climb up” the waterfall in the event that Term SOFR is not available at the time of transition but becomes available later.
- **Multicurrency Facilities:** LSTA plans to issue suggested language to provide guidance.
- **IBA Announcement:** An announcement will be coming out soon with more information about cessation dates. This will also set the spread adjustments for both ISDA and ARRC and will provide much-needed transparency for the economics. The cessation dates will impact numerous Credit Agreements since the dates will effectively start the clock for amendments in transactions that have the Amendment Approach in place.
- **Banks’ To-Do List:** Bankers are extremely busy dealing with LIBOR transition since there is client outreach, banker training, operational transition, pricing, etc. It’s a real and major transition that requires extensive training and socialization across multiple stakeholders. The banks have a very large volume of existing loans of all types with LIBOR-based benchmarks. For these reasons, banks also have a huge need to have consistent language to operationalize the processes – this is just too big of an operational challenge to customize – so many banks have migrated to the ARRC-recommended Hardwired Approach language.

The FFA Next Gen team is always looking for new ideas, so please reach out to committee chairs [Jorge Grafal](#) and [Alexa Schult](#).