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LIBOR'S ENDGAME
A BRIEF PAUSE, NOT A REPRIEVE
A SAFE HARBOR, BUT A NEW PENALTY

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As the December 2020 AmTrust Client Alert *"Reports of The Imminent End of LIBOR May Be Premature"* discussed, in November 2020 the UK's Financial Control Authority (FCA), which regulates LIBOR, announced new powers to ensure an orderly wind-down of LIBOR, and the ICE Benchmark Administration (IBA), which administers LIBOR, announced that it would consult with its stakeholders about ceasing publication of the four non-US currency IBORs (UK, EURO, Yen and Swiss Franc). Their failure to mention USD LIBOR in their announcement, however, unsettled the financial markets.

A BRIEF PAUSE

Then, in an unexpected development, the IBA announced on November 30 that it would also consult on a possible extension of its publication of USD LIBOR's most frequently used tenors (overnight, 1-, 3-, 6- and 12-month) beyond the original cessation date of December 31, 2021 (when 1- week and 2- month tenors would still cease) until June 30, 2023. Because 1- month LIBOR is most frequently used tenor in real estate transactions and 3-month LIBOR is the most widely used tenor in all other cash markets, the 18-month extension would allow most legacy LIBOR contracts (those executed before January 1, 2022) to mature by their own terms before publication of LIBOR ceases at end of June 2023.

The IBA's November announcement was supported by the FCA for addressing the problem of legacy contracts and "protecting consumers and market integrity." While the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (Bank Regulators) issued a joint statement in support of the extension, they made clear that the banks "(f)ailure to prepare for disruptions to USD LIBOR, including operating with insufficiently robust fallback language, could undermine financial stability and banks' safety and soundness." The Alternative Reference Rates Committee (ARRC), a market participants group convened by the Fed and the Federal Reserve Bank of New York (NY Fed) to identify, implement, and support the replacement benchmark rate, emphasized that the delay in cessation did not change the regulatory mission to stop writing new (or extending legacy without robust fallbacks) LIBOR contracts now.

To be clear, the previous announcements and statements made by the FCA and the IBA in the UK and the Bank Regulators or the ARRC are **not** to be considered "official" cessation or non-representativeness statements regarding LIBOR and were not to be regarded as "trigger events" under either ARRC's Fallback language or the ISDA Protocol moving LIBOR to SOFR; or setting the lock date for the SOFR spread-adjustment calculation five-year look back period.

USD LIBOR Transition Delays

Yet, what had changed? As late as July 13, the NY Fed President's insisted that "the importance of transitioning from LIBOR is so great that despite the effects of COVID-19, the overall timeline remains the same…the existence of LIBOR can longer be assured. The clock is still ticking…." The sudden postponement of cessation, however, was not in response to the pandemic or to any one event or confluence of factors, but to the growing recognition of the accumulation and continuation of many different issues, which if they persisted and were left unresolved or not addressed, threatened to undermine the orderly wind-down of LIBOR and risked disruption of the financial markets. We discussed in our last Client Alert the more obvious issues of new LIBOR-based originations as well as legacy contracts facing a hard deadline: many banks continue to originate LIBOR-based loans without ARRC recommended fallback language, or with bank-discretion fallback language, or because of uncertainty just resisting the use of SOFR altogether; market concerns about difficulties in amending/modifying LIBOR legacy bi-lateral and syndicated loans; a borrower perception that there is no "standard" non-LIBOR benchmark replacement language; counterparties' concerns about their ability to hedge a SOFR floating rate in an as of yet not fully liquid market; the recognition after legacy portfolio diligence that many loans have no fallback rate, or fallback to individual panel bank quotes, or "zombie" LIBOR (the last announced quote as a fixed rate), or a much higher "Prime" rate , but in all events "only" upon temporary interruption and not cessation of LIBOR; the failure of ARRC's proposed remedial benchmark replacement safe harbor legislation to be enacted in either New York State or by the US Congress to address the lack of robust legacy contractual fallbacks and minimize disputes and negative economic consequences; and the ongoing concerns of banks and other financial institutions about impact of the LIBOR transition on their operations, regulatory capital, and liquidity requirements.

Growth of LIBOR-Based Legacy Contracts

While the foregoing concerns about the transition from LIBOR to SOFR may not have been expressed publicly, it is beyond doubt that these obstacles (and others) were on the minds of the Bank Regulators who continue in their efforts to mitigate the economic consequences of the risks to individual participants of the trillions of dollars of legacy LIBOR-based contracts having inadequate or no replacement rate language in the face of the hard stop on December 31, 2021. The original cessation date was based on the belief that at least 80% of $200 Trillion in outstanding legacy cash and derivative LIBOR-based contracts would expire by their own terms by that date. In fact, as the cash and derivatives markets continue to originate (and extend legacy) LIBOR-based contracts and the outstanding legacy contracts outstanding today have increased to $223 Trillion. Faced with the significant increase in outstanding LIBOR-based legacy contracts that had to be addressed, the Bank Regulators issued a statement supporting the extension because the "(f)ailure to prepare for disruptions to USD LIBOR, including operating with insufficiently robust fallback language, could undermine financial stability and banks' safety and soundness." The ARRC has estimated that the 18-month extension will allow only about 60% of this larger outstanding legacy LIBOR-based contracts to mature by their own terms prior to the new cessation date mitigating the serious economic market risks inherent in LIBOR-based legacy contracts being outstanding without a robust representative published LIBOR rate. But, there will still be $90 Trillion legacy contracts outstanding after final cessation.

NOT A REPRIEVE

With their approval of the proposed extension of USD LIBOR, the Bank Regulators also made it clear that US banks:

> 1) must stop making LIBOR-based loans "as soon as practicable," but in no event later than December 31, 2021 (and obviously have them mature by June 30, 2023); and
>
> 2) that making new (or extending legacy) LIBOR-based loans beginning on January 1, 2022 would create safety and soundness risks will be examined, and dealt with, as such by the Bank Regulators.

On December 4, the ARRC published its *Guide on the Endgame for USD LIBOR* to:

> a) explain the recent regulatory developments regarding LIBOR;
>
> b) detail what must occur in the endgame of USD LIBOR, such as setting the spread adjustment, the need for the ARRC proposed legislation, and ARRC's Best Practices; and
>
> c) attach an Appendix regarding the ISDA Protocol and the Bloomberg Rate Adjustment Rule Book.

The IBA Consultation

The effectiveness of these proposals was conditioned upon and to subject to completion of IBA's Consultation regarding its ceasing publication of all LIBOR settings on December 31, 2021, other than the specific US LIBOR settings to be extended to June 30, 2023. The IBA commenced its consultation on LIBOR cessation, as well as the limited extension, with its multiple stakeholders in December 2020.

Upon completion of its Consultation and its receipt of notices of future departure from the panel banks, IBA formally notified the FCA of its determination to cease publication of LIBOR in all tenors for GBP, EUR, CHF and JPY currencies and for some USD tenors; but to extend publication of the most frequently used USD tenors to June 30, 2023.

THE ENDGAME

Cessation Date(s) Set

Upon receipt of the IBA's formal notice that all LIBOR tenors (other than the USD tenors extended) will cease to be provided, the FCA confirmed that LIBOR will cease to be published, or be no longer representative, for all currencies and tenors by December 31, 2021, with the exception of key USD LIBOR tenors (including one- and three- month) which will continue publication until June 30, 2023. That official announcement on March 5 was immediately followed by a series of notices, announcements, statements and formal guidance issued by the IBA, the FCA, the Bank Regulators, the ARRC, and the International Swaps and Derivative Association (ISDA) regarding the end of LIBOR at the end of this year and the necessity to adopt SOFR as the replacement benchmark. ISDA also announced that FCA's official statement triggered the application of fallbacks to derivatives under its 2020 IBOR Fallback Protocol (for bilateral contracts and amendments) and its IBOR Fallbacks Supplement to the 2006 ISDA Definitions (for automatic incorporation on January 25, 2021).

Transition Away From LIBOR Begins

As a result of the FCA's statement, on March 8 ARRC confirmed the occurrence of a **"Benchmark Transition Event,"** which marked the official beginning of process of transition away from LIBOR and the ARRC fallback language being applicable to all USD LIBOR tenors for new issuances or originations of LIBOR floating rate notes, bilateral business loans, syndicated business loans and securitizations, the occurrence of which pursuant to specific transaction documents may require lenders to send notices to borrowers and other lenders confirming the beginning of the transition. The Loan Syndications and Trading Association (LSTA) has published a sample form of transition notice which can be modified to fit the subject transaction.

More importantly, as a result of the occurrence of the Benchmark Transition Event, the ISDA determined that the **"Index Cessation Event"** had occurred causing the ISDA fallback spread adjustments (based on the historical five-year difference between LIBOR and SOFR) published by Bloomberg to become fixed (static not dynamic) as of March 5, 2021 for all LIBOR tenors and currencies and which the ARRC confirmed would apply to cash contracts and derivatives. The ARRC has chosen Refinitiv to publish the recommended spread adjustments to SOFR-based rates for cash contracts.

Practice Note: Lenders should review their transaction documents' LIBOR replacement language to confirm the nature and extent of their obligations. And new loan originations (and any modifications of existing legacy loans) should be modified to confirm that the Benchmark Transition Event has occurred and that the spread adjustment published by Bloomberg has been fixed for all LIBOR tenors. This, however, is not the "Benchmark Replacement Date" which is discussed below.

Transition to New Benchmark Required

As defined in the ARRC fallback language, the **Benchmark Replacement Date** is the date(s) that the floating rate loans and other LIBOR-based cash contracts will transition away from LIBOR and to SOFR as their floating rate benchmark beginning the *day after* the cessation of the specific USD LIBOR tenor on December 31, 2021 or June 30, 2023. Yet there always remains the significant risk that pursuant to the ARRC recommended pre-cessation trigger for LIBOR being no longer representative because its quality is deteriorating to an extent that could have a "negative impact on its liquidity and usefulness to market participants"

Practice Note: LIBOR-based cash contracts should always be reviewed to ascertain whether they contain bespoke "opt-in language," which would allow one or more parties to the LIBOR-based contract to transition to SOFR or another replacement benchmark in advance of June 30, 2023. It is critical that a business and possibly a legal review of such contracts be conducted with respect to the specific fallback language, as well as other bespoke provisions, which may affect the timing of and required notices for the transitional occur.

Transition Process Acceleration

In its March 22 *Progress Report on the Transition from USD LIBOR*, the ARRC stressed that market participants "will need to materially accelerate" the transition of LIBOR-based loans and securitizations to SOFR '"to be adequately prepared for the transition to SOFR before cessation at end of the year." The Report provides an overview and timeline of transition steps to accomplish materially accelerating the transition process to assure a disruption-free cessation.

Forward Looking Term Rate

At "The SOFR Symposium: The Final Year" on March 23 sponsored by the ARRC, the Vice-Chair of the Fed stated that there should be no "remaining doubts as exactly when and whether LIBOR will end," Yet despite its assurances in the past, he also announced that the ARRC had determined that it was not yet possible to recommend creating a Forward Looking Term SOFR rate by June 2021 and could not guarantee that it would be able to do so by year-end or beyond. Creating a term rate would, however, require sufficient volume and values in a variety of tenors in the SOFR futures market to constitute a robust liquid derivatives market which, unfortunately, has not yet developed enough liquidity to support such a viable term SOFR rate.

At the Symposium, Lender and the Non-Financial Corporate Borrower panels discussed their perspectives on the status of progress of market participants in the transition process. The Lender panel discussed the desire for a term SOFR rate. The Borrower perspectives were that: there were not yet enough discussions or offerings between borrowers and lenders; a Term SOFR was not enough, but a range of tenors was needed for different products, assets and structures; the operational complexities of completely overhauling and converting their entire financial infrastructure for use of an "in arrears" rate (instead of an "in advance" rate) were enormous and difficult to accomplish with less the a year to complete and would clearly impact negatively their ability to plan and forecast. Their preference was for a simple daily "in advance" rate which their operational systems could easily handle. But the Regulators reiterated that the "in arrears" rate can work as it does in derivatives market and that the ARRC's *User's Guide to SOFR* provides the tools to allow it to work and that lenders and borrowers do not have time to wait for an "in advance rate" to develop and should not wait but transition now.

ENDGAME OBSTACLES

Now that the final transition away from LIBOR has officially begun and final cessation date(s) are set and clearly visible on the horizon, there are still several issues and concerns which must addressed to encourage market participants to materially accelerate their adoption of SOFR as the new replacement benchmark in a timely manner to avoid any unnecessary market disruption at cessation.

To that end, the ARRC has published and periodically updates a set of *Frequently Asked Questions* for market participants as a ready source of relevant information on the transition to SOFR as well as a User's Guide to SOFR explaining how to use SOFR in cash contracts. On March 25, the ARRC released supplemental versions of its 2020 *Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans and Syndicated Business Loans* to incorporate the dates certain for USD LIBOR cessation and the economics of the fixed spread adjustments and clarified that the 2021 abridged fallback language should be used in lieu of the earlier 2020 language. To avoid delays and disagreements faced by lenders with borrowers and among lenders using the "amendment approach," in legacy LIBOR-based agreements, the ARRC suggested that the use of the "hardwired approach" may be preferable or simply going directly to the SOFR rate as the spread adjustments have now been set and are publicly available. In addition, on March 30, the ARRC published a White Paper providing a model for using SOFR in asset-backed securities, mortgage-backed securities, and commercial mortgage-backed securities (other than collateralized loan obligations) for new issues.

The most serious obstacle to a smooth transition from LIBOR to SOFR will be the legacy LIBOR-based cash contracts that (a) have no fallbacks whatsoever or fallback to any LIBOR value (including polling of panel banks), neither of which contemplate permanent cessation (as opposed to temporary interruption), and (b) are difficult to amend or renegotiate or have no suitable alternative, e.g. floating rate notes. These “tough legacy” contracts are a significant problem now and will be a greater problem at final cessation. While the FCA is currently contemplating conducting a consultation to continue publication of a “synthetic” GBP LIBOR rate for some tenors for one year to deal with such tough legacy contacts, those synthetic rates will not be representative and will not be allowed to be used in new contracts.

A SAFE HARBOR

There is no indication that the ARRC is considering a synthetic USD LIBOR. To deal with tough legacy contracts in the US, the ARRC has proposed legislation to address these contracts (many of which are often governed by New York law) at cessation by amending the NY General Obligations Law to add a new Article 18-C. This LIBOR legislation was proposed in the Governor’s budget and has been passed by NY Assembly and Senate and awaits the Governor’s signature (which is expected).

The legislation provides that a LIBOR-based rate in a tough legacy contract will be replaced by operation of law with SOFR and the spread adjustment as recommended; will prohibit parties refusing to perform contracts or claiming a contract breach of contract for the discontinuance of LIBOR or the use of a replacement; establish that the legislative benchmark replacement is commercially reasonable substitute for, and a commercially equivalent to, LIBOR ; and grants a safe harbor from litigation for use of the recommended Benchmark replacement. However, this will not be applicable to any contract that has a workable fallback regardless of how inequitable the replacement is, e.g., Prime Rate.

While the New York City Bar Association supports the legislation, it has also noted that the legislation might violate the unanimous consent requirements of the federal Trust Indenture Act and discussed other possible State and Federal Constitutional concerns. Nonetheless, it is hoped that this legislation will give an impetus to the pending federal proposed legislation addressing the tough legacy LIBOR contracts not governed by New York Law as well as serve as a model for other states to adopt.

A PENALTY

Concerned about the less than adequate progress of the transition given the set cessation dates and to effectively better coerce the banks to materially accelerate the transition from LIBOR to SOFR, the Fed issued *Supervisory Letter SR 21-7* on March 9 as a follow up to the Bank Regulators earlier interagency statement in November 2020 to stop entering new LIBOR contracts. The new supervisory letter warns that banks not making adequate progress may be creating safety and soundness issue for their institutions and the financial system generally

The Supervisory Letter requires bank examiners to “consider issuing supervisory findings and other supervisory actions if a firm is not ready to stop issuing LIBOR-based contracts by December 31, 2021”. The examiners are also directed to assess whether the bank has (a) established a detailed plan to transition away from LIBOR-based financial contracts; (b) accurately measured its financial exposure and risk by product, counterparty and business line; (c) prepared for operational adjustments to internal and vendor-provided systems; (d) identified contracts that reference LIBOR and modified with robust fallback language; (e) communicated sufficiently to clients and counterparties on the LIBOR transition; and (f) provide the transition plan to bank management for implementation and for the board’s periodic oversight of their bank’s progress

Because of the difference in their potential LIBOR exposures, banks with less than $100 Billion in consolidated assets are treated differently than those with $100 Billion or more in consolidated assets in their being required to have “less extensive and less formal transition efforts.” While no such legal directive or regulatory mandate exists to compel or even incentivize non-financial LIBOR contract counterparties to consent to or accept, the transition from LIBOR to SOFR (or another replacement), the banking system (as the principal financial intermediaries in the cash and derivatives markets), in complying with the Fed’s mandates in their financial transactions in those markets will cause their respective non-bank customers and counterparties to acquiesce and conform if and when they enter, directly or indirectly, into cash and derivatives floating rate contracts with their banks or a group of banks.

STEPS TO ACCELERATE THE TRANSITION

As the NY Fed President clearly stated on March 5 "(t)hese announcements represent critical steps in the effort to facilitate an orderly wind- down of USD LIBOR” and "(t)hey propose a clear picture of the future, to help support transition planning over the next year and beyond."

Many of the obstacles to the transition away from LIBOR to a robust risk-free replacement benchmark rate have been removed, mitigated or addressed with viable work-arounds at the official beginning of the transition: the Fed’s recognition and acquiescence to credit-sensitive rates as an alternative to SOFR; providing a longer runway to transition by the extension of publication of the most often used USD LIBOR tenors for 18 months; firmly setting the date for final cessation of all USD LIBOR on June 30, 2023; the ISDA fallback spread adjustments became fixed for USD LIBOR tenors going forward, which ARRC confirmed would apply to cash contracts; the ARRC publication of new abridged recommendations of more robust fallback language for bilateral business loans and syndicated business loans incorporating the fixed spread adjustment and the set cessation dates which can be hardwired into new contracts or into legacy contracts when amended which would also allow parties to go directly to a SOFR rate; the tools recommended provided in the ARRC User’s Guide to SOFR explain how to use SOFR in cash contracts in the continuing absence of a Forward Looking Term Rate; and the potential transition safe harbor protection to lenders and agents for LIBOR transition for tough legacy contracts by the recently passed New York legislation and the proposed Federal legislation.

There is also the significant incentive of the Fed's warning of its implementation of a supervisory penalty for a bank's lack of, inadequate, or delay in, progress of the transition away from its LIBOR exposures and the safety and soundness risk which upon examination may lead to supervisory action against the bank.

CONCLUSION

Given the continued growth and the sheer size of current legacy LIBOR-based contract exposures, and the Bank Regulators' efforts to minimize the potential legal uncertainty and adverse economic consequences and risks to the financial system generally resulting from a disruptive and unstable cessation, the Fed Vice Chair was extremely blunt when he said at the ARRC's SOFR Symposium that:

> [t]hese announcements are *absolutely not* meant to support new LIBOR activity or continued business as usual. Instead, they are meant to completely end the new use of LIBOR while allowing a significant portion of *legacy* contracts to roll off before the key dollar LIBOR tenors stop publication." *(emphasis in original)*

In other words, take very seriously the regulatory warnings and just stop originating new (or extending legacy) LIBOR-based loans now with the guidance that the ARRC has provided to accelerate the transition.

April 6, 2021

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ADDENDUM - April 8, 2021

The ARRC's proposed LIBOR transition safe harbor legislation was signed into law by NY Governor Cuomo, on April 6, 2021, as Chapter 94, Laws of 2021. The legislation amends the NY General Obligation Law by adding a new Article 18-C. The US Congress is now scheduled to hold hearings mid-April to consider similar LIBOR safe harbor legislation at the federal level.

Practice Note: In the event that a replacement reference rate, other than SOFR, is chosen as appropriate for an institution's "funding model and customers' needs," the non-SOFR replacement rate must be robust and have "a robust fallback rate if the initial reference rate is discontinued."

REFERENCES:
Alternative Reference Rates Committee | Newsletter (February – March 2021)
The ARRC Website
Questions can be addressed to the ARRC Secretariat at arrc@ny.frb.org