LIBOR Discontinuance: What you need to know

presented by
Vorys, Sater, Seymour and Pease LLP

November 20, 2019

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Vorys represents commercial banks, other financial institutions, non-bank lenders, and public and private companies in all types of complex commercial financings, including asset-based lending, multi-currency and syndicated credit facilities, second lien and mezzanine financings, note purchase transactions, real estate financings, development and construction financings, receivables financings and factoring, acquisition financings, and structured finance transactions.

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Today’s Speaker

Zach Brumfield
614.464.5410
ztbrumfield@vorys.com

Scope of Presentation

- Agenda

    I. Background of LIBOR Discontinuance

    II. Market Initiatives

    III. Loan and ISDA Documentation and Fallback Language

    IV. Legal and Practical Considerations

- The scope of today's presentation will focus primarily on documentation considerations. There are a number of other issues that should be considered in respect of LIBOR discontinuance, including accounting, tax, operations, risk, SEC reporting and other regulatory considerations that are beyond the scope of this webinar.

Background of LIBOR Discontinuance

Background of LIBOR Discontinuance

- History
  - During and following the financial crisis, allegations of LIBOR manipulation caused concerns in the market about the reliability and robustness of LIBOR
  - By the end of 2021, the U.K. Financial Conduct Authority will no longer compel panel banks to make submissions of LIBOR
  - If LIBOR unexpectedly (or expectedly) ceases or is deemed unreliable, significant issues could arise under ~ $200 trillion of financial contracts

Background of LIBOR Discontinuance

- Market Response
  - Syndicated Loans
    - Ø Most current syndicated loan documents include LIBOR fallback language to address <u>temporary</u> market disruptions to LIBOR
    - Ø After the public statement by FCA of possible <u>permanent</u> LIBOR discontinuance, market participants began to supplement their temporary LIBOR disruption provisions to include LIBOR fallback provisions relating to LIBOR's permanent discontinuance

Background to LIBOR Discontinuance

- Market Response
  - Derivatives
    - Ø ISDA Master Agreements and the related ISDA Definitions include LIBOR fallback language that was built for <u>temporary</u> market disruptions to LIBOR; however, the existing fallback language is not well suited for <u>permanent</u> LIBOR discontinuance
    - Ø In a more limited way than the syndicated loan market, buy and sell side derivative participants have started to include LIBOR fallback language in ISDA Master Agreements to address permanent LIBOR discontinuance

Background to LIBOR Discontinuance

- ## U.S. Successor Rate
  - Secured Overnight Financing Rate (SOFR) has been identified as the rate that will replace LIBOR in U.S. by the Alternative Reference Rates Committee (ARRC) and ISDA
  - SOFR and LIBOR are inherently different:

SOFR	LIBOR
Based on actual overnight treasury repo rates	Based on interbank loan quotes of submitting banks
Secured rate	Unsecured rate (includes bank credit risk)
Overnight rate	Different Tenors

Market Initiatives

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Market Initiatives

- **ARRC**: Formed by Federal Reserve Board to address LIBOR discontinuance and create standardized LIBOR fallback language for various cash products
  - Membership includes regulators, trade associations, exchanges, and buy and sell side market participants
  - Loan Syndication and Trading Association (LSTA) is an influential member of ARRC
- **ISDA**: At request of the Financial Stability Board, ISDA is working on fallback language to include in the 2006 ISDA Definitions

Loan and ISDA Documentation and Fallback Language

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Loan Fallback Language

- In April/May 2019, ARRC released recommended LIBOR fallback language for floating rate notes, syndicated loans, bilateral loans and securitizations

  - Anatomy of ARRC Recommended LIBOR fallback language

    - Ø Triggering Events – What causes LIBOR to be replaced?
    - Ø Establishment of Successor Rate – SOFR? Who decides? How to decide?
    - Ø Spread Adjustments – necessary to avoid unintended windfall to either party; unsecured to Secured Rate (loss of value?)
    - Ø Other Adjustments – Technical, operational and administrative

  - OPTIONS: <u>Amendment</u>, <u>Hardwired</u> or <u>Hedged Loan Approach</u>

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ARRC – Loan Fallback Language

- ARRC – Amendment Approach
  - Focus on specificity of triggering events
  - No prescribed successor rate or spread adjustment
  - Streamline amendment process for negotiation of a successor rate and spread adjustment in the future
  - The process and parameters for selecting a successor rate and spread adjustment are set forth with specificity

ARRC – Loan Fallback Language

- ARRC – Hardwired Approach
  - Triggering Event Occurs – Waterfall of successor rates and spread adjustments
  - First Waterfall – Forward looking SOFR plus spread adjustment (ARRC or ISDA)
  - Second Waterfall – Compounded overnight SOFR plus spread adjustment (ARRC or ISDA)
  - Final Waterfall – Amendment Approach applied

ARRC – Loan Fallback Language

- ARRC – Hedged Loan Approach
  - Designed to avoid basis risk (i.e. any mismatch between the terms of the loan and a related hedge) in the event that LIBOR is discontinued
  - Allows the parties to designate that the benchmark replacement would be based upon the successor rate and spread adjustment that would apply for derivative transactions referencing the ISDA Definitions
  - Provides certainty in respect of the basis risk issue; however, introduces certain costs (and would preclude fallback to a forward-looking term SOFR Rate) and operational and funding risks

ISDA – Derivative Fallback Language

- ISDA
  - ISDA plans to amend certain rate options in the 2006 ISDA Definitions to include fallbacks and spread adjustments that would apply upon the permanent discontinuation of LIBOR (amendments expected Q1 of 2020)
  - ISDA plans to publish a Protocol to incorporate the amendments to the 2006 ISDA Definitions for legacy derivative contracts

Legal and Practical Considerations

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Legal Considerations

- Uniformity Risk
  - Problem: Legal documents referencing LIBOR have non-uniform approaches to address LIBOR discontinuance
  - Risk: Legal documentation using non-standardized LIBOR fallback language could create operational and other issues in event LIBOR is discontinued
  - Solution: Review existing legal documents and create internal policy and procedures to standardize existing and future legal documents with respect to LIBOR fallback language
  - Solution: Provide instructions and guidance to outside counsel drafting legal documentation (amendments to existing agreements and drafting of future agreements)

Legal Considerations

- Basis Risk (Fallback language and Spread Adjustment)
  - Problem: Both ARRC and ISDA are establishing slightly different approaches to LIBOR fallback language and methodology for the calculation of spread adjustments
  - Risk: Cash products and derivative products using different LIBOR fallback language and methodologies for the calculation of spread adjustments for successor rates
  - Risk: Imperfect hedges or mismatch in treatment between cash products and derivatives create basis risk
  - Solution: Understand differences between ARRC and ISDA fallback language and spread adjustment methodology and create internal policy and procedures to mitigate basis risk between cash products and derivatives that hedge them

Legal Considerations

- Loss of Value Risk
  - <u>Problem</u>: A transition from LIBOR to SOFR could create windfall losses or gains for parties to financial contracts
  - <u>Risk</u>: The “benefit of bargain” on pricing could be manipulated to cause one party to win and one party to lose on transition from LIBOR to SOFR
  - <u>Solution</u>: Negotiation of legal documents to properly allocate the risk of value loss among the parties or to mitigate any potential windfall losses or gains from transition from LIBOR to SOFR

Practical Considerations

- Operational Risk
  - <u>Problem</u>: Lack of process, procedure or communication between respective internal constituencies with respect to how SOFR will replace LIBOR
  - <u>Risk</u>: Value loss resulting from inadequate or failed internal processes, people and systems to efficiently transition from LIBOR to SOFR
  - <u>Solution</u>: Formation of internal working group for LIBOR discontinuance with representatives from appropriate constituencies (tax, accounting, IT, operations, legal, sales, etc.)
  - <u>Solution</u>: Creation of monitoring system of legal documents (drafted internally or externally by outside counsel) that have been amended to standardized LIBOR fallback language

Practical Considerations

- The Path Forward:
  - **Randal K. Quarles**, Vice Chair for Supervision of Federal Reserve and Chair of Financial Stability Board at the ARRC Roundtable on June 3, 2019:

    *"The ARRC's fallback recommendations represent a significant body of work on the part of a wide set of market participants and set out a robust and well-considered set of steps that expressly consider an end to LIBOR. I urge everyone to avail themselves of this work; it is, again, important for prudent risk management and your fiduciary responsibilities that you incorporate better fallback language…**There is, however, also another and easier path, which is simply to stop using LIBOR**…[M]ake no mistake—as good as the fallback language may be, simply relying on fallback language to transition brings a number of operational risks and economic risks. Firms should be incorporating these factors into their projected cost of continuing to use LIBOR, and investors and borrowers should consider them when they are offered LIBOR instruments. If you do consider these factors, then I believe you will see that it is in your interest to move away from LIBOR."*

  - **ACTION**: Initiate task groups, organize discussions with appropriate personnel and begin employing an internal plan of action to prepare now for LIBOR's permanent discontinuance

QUESTIONS?

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Thank You!

Zach Brumfield
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