LIBOR and the Year Ahead

January 4, 2022

No matter how you spent your New Year's Eve, one midnight deadline likely passed unnoticed. As of January 1, 2022, the US London Interbank Offered Rate, or LIBOR, can no longer be used for new loan or derivatives contracts.

The phase-out of the benchmark rate, discredited by a market manipulation scandal at the height of the 2008 financial crisis, may not come as a surprise, as it was formally announced by the ICE Benchmark Administration (IBA) in November 2020. Publication of the rate will cease altogether on June 23, 2023.

For most large financial institutions, the likely replacement for LIBOR, as recommended by the Federal Reserve Board and other regulatory agencies, will be the Secured Overnight Financing Rate, or SOFR. SOFR is favored as a metric because it is "backward-facing" and is based on the cost of transactions in the market for overnight repurchase agreements. LIBOR, by contrast, measures bank borrowing costs and increases during periods of stress. Although lenders have adapted by pricing loans with a spread to SOFR, those spreads could underprice risk if there are unexpected periods of credit stress.

The new rate has already caught on in the interest rate and currency swaps market, but it has been slower to take hold in the business loan market, which is just a fraction of the size. According to *The Wall Street Journal*, of nearly $600 billion worth of junk-rated corporate loans sold last year through December 27, 2021, just 2.6% referenced SOFR. Notwithstanding the looming deadline, banks were still issuing—and borrowers were still requesting—LIBOR-based loan agreements during the waning days of 2021.

Most big banks have been preparing for the switch, and their existing loan contracts already contain fallback language to provide for a new rate after the final LIBOR publication in 2023. But some regional banks and smaller institutions have been slower to make the transition, so borrowers are advised to take care to review their loan contracts for references to LIBOR and LIBOR replacement provisions.

Since April 25, 2019, the Alternative Reference Rates Committee (the "ARRC") has published fallback language for syndicated loans, together with updates thereto, which have been incorporated in credit facilities (syndicated or otherwise), whether by amendment to or at the closing of such credit facilities. On March 8, 2021, the ARRC confirmed that, in its opinion, the announcements made by the IBA and the U.K. Financial Conduct Authority on March 5, 2021, on the future cessation and loss of representativeness of the LIBOR benchmarks, constituted a "Benchmark Transition Event" with respect to all USD LIBOR settings pursuant to the ARRC recommendations. On March 25, 2021, the ARRC released supplemental recommendations for hardwired fallback language for business that includes, among other things, guidance for establishing margins to be added to SOFR loans to relate to LIBOR loans of similar tenors.

New York sprang to action in order to minimize disruptions. On April 7, 2021, former Gov. Andrew Cuomo signed a law passed by the state legislature on March 24, 2021. The law provides that SOFR will be the statutory replacement benchmark rate for those agreements, governed by New York law, which use LIBOR and either contain no fallback provisions or contain fallback provisions which result in replacement rates linked to LIBOR in some other way. The law prohibits parties from refusing to perform contractual obligations or declaring a breach of contract as a result of the discontinuance of LIBOR and provides a safe harbor from litigation over the use of the recommended benchmark replacement.

Following New York's lead, on Dec. 8, 2021, the U.S. House of Representatives passed a bill, H.R. 4616, the Adjustable Interest Rate (LIBOR) Act of 2021, which provides for a uniform, nationwide process for replacing LIBOR in existing contracts lacking fallback provisions. The bill has been referred to the U.S. Senate, where it currently awaits consideration.

Other regulatory agencies have taken note and weighed in with new rules as well. On December 8, 2021, the Securities and Exchange Commission issued a statement to (i) remind investment professionals of their obligations when recommending LIBOR-linked securities and (ii) remind companies and issuers of asset-backed securities of their disclosure obligations related to the transition from LIBOR. The SEC highlighted that if transaction documents for LIBOR-linked securities contain language contemplating only a temporary cessation of LIBOR, or no fallback language at all, the operation of those securities and their expected returns will likely experience material changes when the rate is discontinued. Even for newer issuances of LIBOR-linked securities which likely contain fallback language, because no replacement rate is a perfect match for LIBOR, the value of LIBOR-linked securities—and consequently their potential returns—may experience material changes upon LIBOR's discontinuation.

On December 22, 2021, the Commodity Futures Trading Commission announced that the Division of Clearing and Risk, Division of Market Oversight, and Market Participants Division have each issued revised no-action letters to swap dealers and other market participants related to the LIBOR transition. Earlier in the year, the CFTC's Market Risk Advisory Committee formally adopted a timeline for switching interdealer trading conventions from LIBOR to SOFR for linear interest rate swaps, cross currency swaps, non-linear derivatives and exchange-traded derivatives.

The Internal Revenue Service finalized its own new regulations on December 30, 2021. The new rules generally provide that modifying a debt instrument, derivative, or other contract in anticipation of the elimination of LIBOR (or another interbank offered rate) is not treated as an exchange of property for other property differing materially in kind or extent for purposes of Section 1.1001-1(a) of the Internal Revenue Code. The final regulations also adjust other tax rules to minimize unintended consequences in connection with integrated transactions and hedging transactions, withholding under Chapter 4 of the Code, fast-pay stock, investment trusts, original issue discount, and real estate mortgage investment conduits.

We expect the new year will likely bring further developments as banks, regulators, and other stakeholders continue to react to the latest phase of the LIBOR transition.

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