

## THE PHASE-OUT OF LIBOR AND IMPACT ON FINANCIAL TRANSACTIONS (Initial SOFR Quoted at 1.80%)



For nearly fifty years, the London Interbank Offered Rate (LIBOR) has been used by banks and other financial institutions as a global floating reference rate (benchmark). It is the primary benchmark for short-term interest rates around the world and underpins more than \$350 trillion in mortgages, commercial loans, bonds and derivatives. LIBOR is the average of interest rates at which large banks can borrow from one another on an unsecured basis. LIBOR comes in seven maturities (from overnight to 12 months) and in five different currencies. The official LIBOR interest rates are announced once per working day at around 11:45 a.m. London time by ICE Benchmark Administration. The U.S. Dollar LIBOR is calculated based on data submitted by a panel of 18 major banks. Each bank is asked the same question: “At

what rate could you borrow funds, were you to do so, by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11:00 a.m.?” Once the rates are submitted, the four highest and four lowest rates are discarded, and the remaining rates are averaged to calculate the U.S. Dollar LIBOR for such day. Understandably, fluctuations in LIBOR impact the global financial system's critical infrastructure.

As a result of well-publicized scandals involving the manipulation of LIBOR by panel banks, the subjective nature of panel bank submissions, and the lack of actual transactions to support LIBOR, the International Organization of Securities Commissions established Principles for Financial Benchmarks by Administrators of EURIBOR, LIBOR and TIBOR in 2014, which included the principle that reference rates should be transitioned to “rates that are anchored in observable transactions.” Also in 2014, the Federal Reserve convened the Alternative Reference Rates Committee (AARC) to identify a set of alternative reference interest rates that could serve as an alternative to LIBOR for use in new derivative and other financial contracts that are more firmly based on actual transactions and that would have a deep underlying market that is robust over time.

In June 2017, AARC selected the Secured Overnight Funding Rate (SOFR), a fully-transactional based rate, as its recommended replacement for the U.S. Dollar LIBOR. In recommending SOFR, AARC concluded that it is the most robust reference rate available with underlying transactions of approximately \$700 billion per day or more, much larger than the volumes associated with other potential LIBOR alternatives. SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities. SOFR includes all trades in the Broad General Collateral Rate (which is a measure of rates on overnight Treasury general collateral repurchase agreement (repo) transactions) plus bilateral Treasury repurchase agreement (repo) transactions cleared through the Delivery-versus-Payment (DVP) service offered by the Fixed Income Clearing Corporation (FICC), which is filtered to remove a portion of transactions considered “specials.” Specials are repos for specific-issue collateral, which take place at cash-lending rates below those for general collateral repos (GCF) because cash providers are willing to accept a lesser return on their cash in order to obtain a particular security. SOFR is calculated as a volume-weighted median of transaction-level tri-party repo data collected from the Bank of New York Mellon as well as GCF repo transaction data and data on bilateral Treasury repo transactions cleared through FICC's DVP service, which are obtained from DTCC Solutions LLC, an affiliate of the Depository Trust & Clearing Corporation. Each business day, the Federal Reserve Bank of New York publishes the SOFR on the Reserve website at approximately 8:00 a.m. EST. (See Secured Overnight Financing Rate Data published by the Federal Reserve Bank of New York <https://apps.newyorkfed.org/markets/autorates/sofr#Chart12>.)

After AARC's recommendation, in July 2017, the UK Financial Conduct Authority, planning to phase-out LIBOR by 2021 and replace it with a more reliable benchmark, announced that it would no longer use its influence or legal powers to compel or persuade banks to submit to LIBOR panels after the end of 2021.

As LIBOR is phased out and SOFR is phased in, the Federal Reserve Bank of New York began publication of SOFR on April 2, 2018 at the initial rate of 1.80% based upon \$849 billion in overnight transactions from April 1 to April 2. Although SOFR has the distinct benefit of being a transaction based robust reference rate, SOFR has two distinct challenges relative to its appropriateness for loan transactions. First, SOFR is a secured rate based upon U.S. Treasury securities serving as collateral and LIBOR is an unsecured rate. Secured borrowing rates are generally lower than unsecured borrowing rates. Second, SOFR is an overnight rate only, while U.S. Dollar LIBOR is currently published in seven tenors: overnight, one week, one month, two months, three months, six months and one year. Shorter tenor instruments (e.g., an overnight rate) generally have lower borrowing costs than longer tenor instruments (e.g., one-year LIBOR). Thus, LIBOR will generally be higher than SOFR since SOFR is a secured rate currently only having an overnight tenor.

In addition to impacting other markets, the LIBOR phase-out will have a broad impact on the derivatives market and the \$4 trillion syndicated loan market, including currently existing loan transactions that extend past 2021. With respect to derivatives, such as futures contracts, forward contracts, options, swaps, and warrants, the International Swaps and Derivatives Association (ISDA) is

leading an initiative to determine fallbacks for LIBOR (and other key IBORs) that would apply if an IBOR is permanently discontinued. The working group is expected to suggest (i) a fallback rate or fallback rates and other fallback mechanisms, that would apply in the event that the applicable IBOR is permanently discontinued; (ii) amendments to the ISDA 2006 Definitions to add selected fallbacks that would apply upon any such permanent discontinuation; and (iii) the development of a proposed plan to amend legacy contracts referencing the applicable IBORs, including amended definitions, and the potential development of a protocol mechanism to facilitate multilateral amendments. See Development of Fallbacks for LIBOR and other Key IBORs - Work of the FSB Official Sector Steering Group and International Swaps and Derivatives Association <https://www.isda.org/a/vKiDE/development-of-fallbacks-for-libor-and-other-key-ibors.pdf>.

With respect to loan transactions, banks and financial institutions should review their existing portfolio to determine those LIBOR based transactions that terminate after the end of 2021 to prepare for the LIBOR phase-out. Since LIBOR will continue to be published until the end of 2021, transactions that terminate prior to the end of 2021 may simply expire upon their respective terms. For those LIBOR transactions that terminate after the end of 2021, the existing fallback provisions of the transaction documents should be evaluated to determine the applicable rate should LIBOR become unavailable and the associated risks and shortcomings of the existing fallback provisions. Although typical fallback provisions may include a waterfall of alternative reference rates if LIBOR is unavailable (i.e., an alternative base rate or prime rate, a rate selected by the administrative agent, a reference bank rate or mean of several reference banks rates, or the lender's cost of fund), some fallback rates may result in a substantially higher interest than was intended by the parties. If so, the transaction documents may need to be amended. For new LIBOR transactions that terminate after the end of 2021, flexible fallback provisions that anticipate the substitution of LIBOR with alternative reference rates should be incorporated into the transaction documents.

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