Milbank

Alternative Investments Practice – Derivatives

Client Alert

We've Come So Far, SOFR

March 16, 2021

Contact

John Williams
Partner
+1 212.530.5537
jwilliams@milbank.com

Megha Kalbag
Associate
+1 212.530.5395
mkalbag@milbank.com

Elizabeth Martinez
Associate
+1 212.530.5652
eamartinez@milbank.com

Devan Zorn
Associate
+1 212.530.5699
dzorn@milbank.com

This Client Alert summarizes key announcements made on March 5, 2021 regarding the transition away from the US dollar ("USD") London Interbank Offered Rate ("LIBOR") and highlights their impact on the terms of certain transaction types.

The Announcements

On March 5, 2021, announcements were made by LIBOR's regulator,[1] the Financial Conduct Authority (the "FCA") and LIBOR's administrator,[2] ICE Benchmark Administration Limited (the "IBA") regarding precisely when LIBOR panels will end. These announcements are important for several reasons:

- They serve as a likely trigger event ("Trigger Event") for recommended fallback language (in both the amendment approach and the hardwired approach, described below) issued by the Alternative Reference Rates Committee ("ARRC") – as well as for many other variants of fallback language in credit agreements.[3]
- The International Swaps and Derivatives Association, Inc. ("ISDA") has confirmed that these announcements constitute an "Index Cessation Event" under the IBOR Fallbacks Supplement (Supplement Number 70 to the 2006 ISDA Definitions) (the "IBOR Supplement") and the ISDA 2020 IBOR Fallbacks Protocol (the "ISDA Protocol"), which in turn triggers a "Spread Adjustment Fixing Date" under the Bloomberg IBOR Fallback Rate Adjustments Rule Book ("Bloomberg Rule Book"), providing clarity on future terms of the numerous derivative contracts which incorporate the fallbacks set out in the IBOR Supplement and ISDA Protocol.[4]

[1] FCA, Announcements on the end of LIBOR (March 5, 2021), *available at* https://www.fca.org.uk/news/press-releases/announcements-end-libor

[2] IBA, ICE Benchmark Administration Publishes Feedback Statement for the Consultation on Its Intention to Cease the Publication of LIBOR Settings (March 5, 2021), *available at* https://ir.theice.com/press/news-details/2021/ICE-Benchmark-Administration-Publishes-Feedback-Statement-for-the-Consultation-on-Its-Intention-to-Cease-the-Publication-of-LIBOR-Settings/default.aspx.

[3] ARRC has provided a helpful Frequently Asked Questions guide, *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Benchmark_Transition_Event_FAQs.pdf.

[4] *See* ISDA, ISDA Statement on UK FCA LIBOR Announcement (March 5, 2020), *available at* https://www.isda.org/2021/03/05/isda-statement-on-uk-fca-libor-announcement; ISDA, IBOR Fallbacks Supplement (published on January 25, 2021), *available at* http://assets.isda.org/media/3062e7b4/23aa1658-pdf/; ISDA, ISDA 2020 IBOR Fallbacks Protocol (published on October 23, 2020), *available at* http://assets.isda.org/media/3062e7b4/08268161-pdf/; and Bloomberg, IBOR Fallback Rate Adjustments Rule Book (last updated October 8, 2020), *available at* http://assets.isda.org/media/34b2ba47/c5347611-pdf/.

- ARRC has stated that it will match ISDA's spread adjustment values for non-consumer products so cash market transactions that incorporate ARRC spread adjustments in their hardwired fallback language will also use the spread adjustment values (five-year historic median average for each tenor) set by Bloomberg.[5]
- Therefore, for transactions that incorporate ARRC hardwired fallback language or the IBOR Supplement/ISDA Protocol, (i) the transition to the Secured Overnight Financing Rate ("SOFR") occurs when the applicable LIBOR setting actually stops or becomes non-representative, and (ii) the spread, set on March 5, 2021, will never include any non-representative LIBOR data.

- The FCA has indicated that it will compel the IBA to publish "synthetic LIBOR" for certain tenors, for a certain period of time.
  - A synthetic LIBOR will no longer be considered "representative" and is not for use in new contracts. It is intended solely for use in certain tough legacy contracts (to be decided in Q2 2021 by the FCA after a consultation). The FCA statements explain its intention to propose using a forward-looking term rate version of the relevant risk-free rate plus a fixed spread aligned with the spreads in the IBOR Supplement and ISDA Protocol as a methodology for any synthetic LIBOR.
  - There is now even further emphasis on the previously-articulated guidance that entry into any new contracts referencing USD LIBOR after December 31, 2021, at least without robust fallback language, is strongly discouraged by US regulators.[6]

The Road Ahead for USD LIBOR

As of March 5, 2021:

- Index Cessation Event under IBOR Supplement and ISDA Protocol.
- Spread Adjustment Fixing Date under the Bloomberg Rule Book, causing spread adjustments referenced in fallback language used by ISDA and ARRC hardwired approaches to be set by Bloomberg.
- Trigger Event/Benchmark Transition Event (confirmed by ARRC)[7] in ARRC fallback language (amendment and hardwired approaches),[8] and in many other variants of fallback language in credit agreements and indentures.
  - For ARRC hardwired fallback language (the current recommendation for business loans and securitizations),[9] the only thing that is "triggered" on this date is perhaps an agent/sole lender notice requirement in the case of business loans.
  - For ARRC amendment fallback language, a Trigger Event will likely require notice of such event by the agent/sole lender and would allow for the amendment process to begin. The

[5] Bloomberg, IBOR Fallbacks – Technical Notice – Spread Fixing Event for LIBOR (March 5, 2021), *available at* https://assets.bbhub.io/professional/sites/10/IBOR-Fallbacks-LIBOR-Cessation_Announcement_20210305.pdf.

[6] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of Currency, Statement on LIBOR Transition (November 30, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf.

[7] ARRC, ARRC Confirms a "Benchmark Transition Event" has occurred under ARRC Fallback Language (March 8, 2021), *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Benchmark_Transition_Event_Statement.pdf.

[8] ARRC, Fallback Contract Language Library, *available at* https://www.newyorkfed.org/arrc/fallbacks-contract-language.

[9] ARRC, ARRC Recommended Best Practices for Completing the Transition from LIBOR, *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Best-Practices.pdf.

Loan Syndication Trading Association (the "LSTA") has provided its members with a form of notice for this purpose.[10]

  - Note that under the ARRC language, an amendment could not take effect until the window (typically 90 days) opens (so, April 1, 2023 for most USD LIBOR settings, *i.e.* 90 day prior to June 30, 2023).

- All USD LIBOR settings continue to be representative until (i) in the case of 1-week and 2-month USD LIBOR, December 31, 2021 and (ii) in the case of all other remaining USD LIBOR settings, June 30, 2023.

Between April 1, 2021 and September 1, 2021:

- FCA to consult on using proposed new powers granted to it under the Benchmarks Regulation[11] to require the IBA to continue publishing one-month, three-month and six-month USD LIBOR on a non-representative, synthetic basis for a further period after June 30, 2023.

Immediately after December 31, 2021:

- One-week and two-month USD LIBOR settings will either cease to be provided by any administrator or will no longer be representative.
  - Agents under syndicated loans may elect to "turn off" these tenors as available options at this time so long as the facility offers borrowings under other tenors.

Between December 31, 2021 and June 30, 2023:

- All USD LIBOR settings will continue:
  - Overnight, one-month, three-month, six-month and twelve-month settings will continue to be provided.
  - Under the ISDA fallbacks approach (discussed further below), the rate for the one-week and two-month USD LIBOR settings will be computed by each calculation agent using linear interpolation (using the other, still-published, USD LIBOR settings).
- Under ARRC's amendment approach (or variations thereof), decisions to amend a rate will become effective once the window (typically 90 days) to do so opens (so, April 1, 2023, *i.e.* 90 day prior to June 30, 2023).

Immediately after June 30, 2023:

- All remaining USD LIBOR settings (overnight, one-month, three-month, six-month and twelve-months) will either cease to be provided by any administrator or will no longer be representative.
- It will no longer be possible to calculate the one-week and two-month USD LIBOR settings using linear interpolation.
- The fallbacks (to the adjusted risk-free rate plus spread) will automatically occur for all outstanding derivatives contracts that (i) reference any USD LIBOR settings and (ii) incorporate the IBOR Supplement or are subject to the ISDA Protocol.
- Depending on the outcome of the FCA consultations, publication of non-representative, synthetic one-month, three-month and six-month USD LIBOR settings may continue.

The Fallback Approaches

ARRC has released variants of two approaches for fallback language – the amendment approach and the hardwired approach.

[10] LSTA, Form of Notice of IBA Announcement; FCA Announcement on Future LIBOR Cessation and Loss of Representativeness, *available to LSTA members only* at https://www.lsta.org/content/notice-of-iba-and-fca-announcements/.

[11] FCA, UK Benchmarks Regulation, *available at* https://www.fca.org.uk/markets/benchmarks/regulation.

The ARRC amendment approach is not ARRC's preferred methodology but is often found in existing loan facilities and reasonably often (for the time being) in new transactions. This approach relies upon the borrower and administrative agent to select a successor rate, subject to prevailing regulatory guidance, market practice and lender consent provisions. Under the ARRC recommended language for the amendment approach, a Trigger Event (a Benchmark Transition Event in ARRC terminology) will have occurred based on the March 5, 2021 announcements – however, in certain cases where parties choose variations on the amendment approach, the Trigger Event does not occur until the actual cessation of availability of the relevant LIBOR tenor. Under the amendment approach, the borrower and administrative agent may select any alternate benchmark rate and related conventions (expected in most cases to be Term SOFR[12], Daily Simple SOFR[13] or Daily Compounded SOFR[14]), subject to the negative consent of the facility's required lenders. Finally, under the ARRC amendment approach, a borrower and the administrative agent select a spread adjustment or calculation method after considering recommendations of relevant government authorities or prevailing market conventions.

The ARRC hardwired approach is the preferred methodology and is likely to appear in more new loan facilities or amended legacy transactions going forward. This approach mechanically identifies a successor rate in accordance with a clearly set out waterfall of alternative rates. Under the ARRC recommended language for the hardwired approach, a Trigger Event (a Benchmark Transition Event in ARRC terminology) will have occurred based on the March 5, 2021 announcements. Under the hardwired approach, the waterfall will generally place Term SOFR as the preferred rate, followed by Daily Simple or Daily Compounded SOFR at the next step down the waterfall. As mentioned above, under the hardwired approach, ARRC stated that it intends to match ISDA's spreads, which were set on March 5, 2021 by Bloomberg.

Both ARRC approaches grant the administrative agent broad authority to determine rate conventions, taking into consideration both ARRC recommendations and market conventions where administratively possible.

ISDA's fallback approach utilizes, as discussed in further detail below, the IBOR Supplement and the ISDA Protocol. ISDA has confirmed that the March 5, 2021 announcements constituted an "Index Cessation Event" under the IBOR Supplement and the ISDA Protocol. This triggers a "Spread Adjustment Fixing Date" under the Bloomberg Rule Book, fixing the spread to be used across standard derivative contracts once LIBOR ceases to be published at the end of June 2023. The Bloomberg Rule Book also sets out detailed conventions to be used for calculating the relevant replacement rate when the time comes. For example, the Bloomberg Rule Book specifies that interest is to be compounded over a lookback period that begins two business days prior to the relevant floating rate payment period and ends two business days prior to the relevant payment date.

The spreads now set for derivative contracts pursuant to the IBOR Supplement, as well as the detailed calculation methodologies spelled out in the Bloomberg Rule Book, will be relevant for cash products as well, as they will likely serve as the standard for agents and others who need to select and calculate a replacement rate (under either the amendment or hardwired approach).

[12] "Term SOFR" is not yet available – it will be a forward-looking term rate based on SOFR.

[13] "Daily Simple SOFR" is a backward-looking overnight rate based on SOFR, averaged over the duration of the applicable tenor, with no compounding.

[14] "Daily Compounded SOFR", or SOFR compounded in arrears, is a backward-looking overnight rate based on SOFR, with compounding accrued unpaid interest over the applicable calculation period. The methodology for compounding may be based on the rate (which is the methodology used for the SOFR index published by the Federal Reserve Bank of New York, *available at* https://apps.newyorkfed.org/markets/autorates/sofr-avg-ind, and in the ISDA documents), or based on the balance – which is the more economically accurate approach in situations where the principal amounts may change.

Implications and Market Observations

Market participants should now all be on notice that the end of LIBOR and the other IBORs is certain, and that steps to make this process as smooth as possible should be taken immediately, if they have not already been taken. Our observations about certain transaction types are below, but these will continue to evolve over the next two years. Many of the necessary changes will be operational in nature; to this end, the ARRC Operations & Infrastructure Working Group is planning to release a number of documents related to the transition away from LIBOR and towards SOFR and has already released Internal Systems & Processes: Transition Aid for SOFR Adoption,[15] which covers transition activities across 10 categories and 50 sub-categories.

Derivatives

All new derivatives that reference the 2006 ISDA Definitions entered into on or after January 25, 2021 already incorporate the IBOR Supplement (unless the parties to the transaction have agreed not to incorporate the IBOR Supplement). Market participants are encouraged to adhere to the ISDA Protocol, which enables market participants to incorporate the amendments made by the IBOR Supplement into their legacy non-cleared derivatives with counterparties that also opt to adhere to the ISDA Protocol (as all major derivatives dealers have done). Alternatively, market participants may also agree to incorporate the new LIBOR fallbacks by bilaterally amending their legacy non-cleared derivatives.[16] Both the IBOR Supplement and ISDA Protocol became effective on January 25, 2021.[17]

The IBOR Supplement amends the 2006 ISDA Definitions or other Covered ISDA Definitions Booklet (which includes the 2006 ISDA Definitions and the 2000 ISDA Definitions, among others) to incorporate new interbank offered rates fallbacks, which are adjusted versions of certain risk-free rates ("RFRs"). These amendments apply to cleared and non-cleared derivatives referencing the relevant Covered ISDA Definitions Booklet that were executed on or after January 25, 2021. Under the 2006 ISDA Definitions as amended by the IBOR Supplement, the RFRs that replace the relevant IBORs for each applicable currency and tenor will be compounded over the relevant period for such tenor and a spread adjustment will be added to the compounded rate. In the case of USD LIBOR, the adjusted RFR will be a combination of a) Daily Compounded SOFR, compounded in arrears over such period and b) the spread adjustments, published by Bloomberg on March 5, 2021, which are based on the median over a five-year lookback period of the historical differences between LIBOR and SOFR for the relevant tenor.

Leveraged Finance – Broadly Syndicated Corporate Loans

Whether they incorporate the ARRC amendment approach or the hardwired approach, most broadly syndicated corporate loans referencing LIBOR call for its replacement to begin upon the occurrence of a Benchmark Transition Event,[18] which, under the ARRC language, would occur upon the earlier of to occur of:

> (1) a public statement by the administrator announcing that it has ceased or will cease to provide the relevant benchmark rate;

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[15] *Available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Internal-Systems-Processes-Transition-Aid.pdf.

[16] ISDA, Outline of Bilateral Forms for IBOR Fallbacks, *available at* http://assets.isda.org/media/3062e7b4/bf8c96ca-pdf/.

[17] ISDA, New IBOR Fallbacks Take Effect for Derivatives, *available at* https://www.isda.org/2021/01/25/new-ibor-fallbacks-take-effect-for-derivatives/.

[18] ARRC, ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans (June 30, 2020), *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/Updated-Final-Recommended-Language-June-30-2020.pdf.

(2) a public statement by a relevant regulator that the administrator of such Benchmark (or such component) has ceased or will cease to provide the relevant benchmark rate;[19] or
(3) a public statement by a relevant regulator announcing that the relevant benchmark is no longer representative.[20]

As the IBA's and the FCA's March 5th announcements constitute Benchmark Transition Events under prongs (1) and (2), respectively, a Benchmark Transition Event will have occurred under most broadly syndicated corporate loans, (as well as under the terms of standard derivatives).

With respect to replacement rates, most syndicated loans issued since the fourth quarter of 2020 rely on some version of hardwired fallback language. The ARRC formulation, which is increasingly prevalent, provides for the following fallbacks:

Step 1: Term SOFR + Spread Adjustment

Step 2: Daily Simple SOFR + Spread Adjustment

Step 3: Borrower and Administrative Agent Selected Rate + Spread Adjustment

Depending on the circumstances, parties may choose to vary certain of the above steps – for example, certain banks are choosing to loop back to Term SOFR if it becomes the recommended rate by a governmental authority even after dropping down the waterfall to Step 2 or 3 above. Other parties are choosing to eliminate Step 1 entirely, or to replace Daily Simple SOFR in Step 2 with Daily Compounded SOFR + Spread Adjustment or SOFR Average (*i.e.*, Compounded in Advance) + Spread Adjustment.

Loans with Related Hedges

In situations in which borrowers are hedging all or part of the relevant loans, banks often allow for modification of the benchmark replacement language to ensure that the replacement rate for the loan can track that of the hedge, which, for any hedge executed on market-standard terms, will be SOFR compounded in arrears, calculated pursuant to the provisions of the Bloomberg Rule Book. Providing for the benchmark rate under the loan to fallback to Daily Compounded SOFR allows basis between the loan and the hedge to be reduced.

While many bank loan origination desks do not have policies permitting them simply to incorporate by reference in their loan documents the fallback rate applicable to the related hedges, adjustments to the bank's standard replacement rate fallback waterfall are commonly permitted. This includes the ability to eliminate references to Term SOFR rates in loan fallbacks to allow the loan to fall back to Daily Compounded SOFR in order to match the derivative. While this rate is not defined with the precision articulated for derivatives in the Bloomberg Rule Book, the typical ARRC language allows the agent enough discretion in calculating the replacement rates to allow it to follow the calculation conventions used for the derivatives.

Another option – likely only applicable in special situations in which the related loan agreements are not being amended - is to approach mitigation of the basis risk by amending the derivative rather than the loan. ISDA has published templates[21] to allow parties to modify the terms of the IBOR Supplement and ISDA Protocol as they apply to the derivative – including templates to exclude existing or new

[19] Triggers (1) and (2), also called the "Permanent Cessation Triggers", are intended to align with the triggers included in the IBOR Supplement and, according to the definition of "Benchmark Replacement Date", do not lead to a move away from LIBOR until the date that LIBOR ceases to be published.

[20] Trigger (3), also called a "Pre-cessation Trigger", institutes a transition to an alternative rate upon a determination by a regulatory supervisor that the quality of the Benchmark has deteriorated such that it would likely have a significant negative impact on its liquidity and usefulness to market participants.

[21] ISDA, Outline of Bilateral Forms for IBOR Fallbacks, *available at* http://assets.isda.org/media/3062e7b4/bf8c96ca-pdf/.

agreements from the ISDA Protocol and apply separate trigger events/fallback rates to such agreements, or provide that the triggers and fallbacks match those under a related hedged product.

Collateralized Loan/Bond Obligations ("CLOs")

Most CLO indentures utilize the ARRC hardwired fallback language,[22] with the same Benchmark Transition Events as those in broadly syndicated corporate loans, except that the following fourth trigger (a second Pre-cessation Trigger) is often included:

> (4) the Asset Replacement Percentage is greater than [50]%, as reported in the most recent servicer report.

This trigger is intended to minimize basis risk between the CLO issuer's debt securities and the assets underlying these securities by providing that if a certain percentage of the underlying assets have converted to the replacement benchmark rate or have been replaced by assets bearing interest based on the replacement benchmark rate, the securities will convert to the replacement benchmark rate as well. However, since the IBA's and the FCA's March 5th announcements constitute Benchmark Transition Events under prongs (1) and (2) above, respectively, a Benchmark Transition Event will have occurred under most CLOs and this fourth prong will not be activated.

A plurality of CLO indentures incorporate some variant of the ARRC-recommended hardwired language for fallbacks (set out as (a) below), whereby the first step of the below waterfall that **also** satisfies the criteria in (b) will be used as the replacement benchmark rate.

(a) Waterfall:

Step 1: Term SOFR + Spread Adjustment

Step 2: Compounded SOFR [or Daily Simple SOFR] + Spread Adjustment

Step 3: Relevant Governmental Body Selected Rate [*e.g.* Base Rate] + Adjustment

Step 4: ISDA Fallback Rate + Adjustment

Step 5: Transaction Specific Fallback Rate + Adjustment

and

(b) [in the sole discretion of the manager], the rate being used by either (1) at least 50% of the [underlying floating rate assets] or (2) at least 50% of the collateralized loan obligation transactions which have (x) priced or closed a new issuance of securities and/or (y) amended their rate, in each case within [three] months from the later of (i) the date on which the Benchmark Transition Event occurs or (ii) such date of determination.

We do not currently see consistent alignment of fallback provisions across CLOs and their underlying assets. While newly issued loan obligations generally include the ARRC hardwired fallbacks (or reference SOFR directly), legacy loans often will not. This leaves CLO managers having to assess their existing loan portfolios in more detail. With the timeline and the spreads now providing far more certainty, we will likely see a trend toward more legacy loans relying on the ARRC hardwired language, which will help in providing alignment.

It is worth keeping in mind that some legacy loans will mature or will be refinanced prior to June 30, 2023. While some larger asset managers have organized multiple workstreams to assess the moving pieces within their portfolios, others have decided for the time being to wait and see how much natural portfolio

[22] ARRC, ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Securitizations (May 31, 2019), *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Securitization_Fallback_Language.pdf.

churn addresses the issues. In the meantime, it is crucial to remain educated on differing LIBOR exposures, external market developments, and to prepare operational systems to handle the changes that will be required. Flexibility is important because as new data is available and markets shift, firms need to be able to accommodate new infrastructure or market practice as it becomes available.

Derivatives Contacts

New York | 55 Hudson Yards, New York, NY 10001-2163

John Williams	jwilliams@milbank.com	+1 212.530.5537

Leveraged Finance Contacts

New York | 55 Hudson Yards, New York, NY 10001-2163

Michael J. Bellucci	mbellucci@milbank.com	+1 212.530.5410
Lauren Hanrahan	lhanrahan@milbank.com	+1 212.530.5339

CLO Contacts

New York | 55 Hudson Yards, New York, NY 10001-2163

Deborah M. Festa	dfesta@milbank.com	+1 212.530.5540
Jay D. Grushkin	jgrushkin@milbank.com	+1 212.530.5346
Sean M. Solis	ssolis@milbank.com	+1 212.530.5898

Los Angeles | 2029 Century Park East, 33rd Floor Los Angeles, CA 90067-3019

Deborah M. Festa	dfesta@milbank.com	+1 424.386.4400

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