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ALERT

Real Estate ▪ Finance

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New York Fed's New Benchmarks May Provide Further Guidance on LIBOR Phase-Out

Overview

As reported in a previous alert, the UK Financial Conduct Authority (FCA) announced on July 27, 2017 that, by 2021, it intends to replace the London Interbank Offered Rate (LIBOR), the key benchmark rate underlying hundreds of trillions of dollars in lending and other financial transactions, with new benchmarks that are more reliable. The FCA urged market participants to begin planning a transition to replacement rates, and in response, borrowers and lenders have devised various approaches for determining a substitute benchmark rate in their financing documentation.

On April 3, 2018, the Federal Reserve Bank of New York (New York Fed), in cooperation with the Treasury Department's Office of Financial Research (OFR), began publishing three index rates based on overnight repurchase agreement (repo) transactions collateralized by US Treasury securities to potentially replace LIBOR. The New York Fed's actions may help to provide further clarity regarding the appropriate alternative approach to LIBOR that market participations may wish to use to address the LIBOR phase-out.

Current Market Approaches

Since the FCA's announcement, borrowers and lenders have been negotiating a variety of alternatives to determining the reference rate in LIBOR-based financing transactions. One key consideration is the manner in which LIBOR converts to an alternative rate if LIBOR is determined to be unavailable. Most loan agreements contemplate either an alternative rate determined by the lender or an automatic conversion from LIBOR to the prime or base rate, the latter of which is traditionally higher than LIBOR. Certain borrowers, however, have been pushing for several different protections in anticipation of the LIBOR phase-out, including the following:

- A Borrower consultation right in connection with determining the replacement rate;
- A most-favored nations provision requiring the replacement rate be based on the then-prevailing market convention for the reference rate for floating-rate commercial loans in the U.S. substantially similar to such borrower's loan and made to similarly situated borrowers of similar loans, and a requirement that the lender uniformly apply this conversion for such similarly situated borrowers;
- A spread adjustment for all post-conversion interest periods to approximate the total pricing rate prior to the conversion, and prepayment rights without penalty or premium after a conversion event so that borrowers can test the market for the reference rate then being generally utilized; and/or
- A cap on the replacement rate such that the replacement rate will never exceed the average of the "all-in" interest rate during the life of the loan.

Borrowers may also wish to consider requesting additional leveling mechanics to maintain existing covenants tied to the interest rate, such as not requiring parallel increases in interest reserves due to an increased replacement rate, as well as requiring adjustments to debt yield and debt service coverage ratio tests to offset increased rates in order to maintain pre-conversion rates, as the market may evolve in this direction.

New York Fed Announcement

On April 3, 2018, the New York Fed announced that it had begun publishing three reference rates based on actual overnight repo transactions collateralized by Treasury securities, one of which may eventually become the "market convention" referenced above. The three reference rates are as follows:

- Secured Overnight Financing Rate (SOFR): SOFR is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities, which was identified by the Alternative Reference Rates Committee in June 2017 as its recommended alternative to LIBOR for use in certain new U.S. dollar derivatives and other financial contracts. The SOFR includes all trades in the BGCR (as defined below) plus bilateral Treasury repurchase repo transactions cleared through the Delivery-versus-Payment (DVP) service offered by the Fixed Income Clearing Corporation (FICC).
- Broad General Collateral Rate (BGCR): BGCR is a measure of rates on overnight Treasury general collateral repo transactions (i.e., repo transactions for which the specific securities provided as collateral are not identified until after other terms of the trade are agreed). The BGCR also includes all trades in the TGCR (as defined below) and under the FICC's GCF Repo Service, a channel for securities dealers to execute repo trades involving certain types of government-backed collateral.
- Tri-Party General Collateral Rate (TGCR): TGCR is a measure of rates on overnight, specific-counterparty, tri-party general collateral repo transactions secured by Treasury securities.

The New York Fed had previously published indicative historical rates for these three Treasury repo reference rates for the period extending from August 2014 to October 2017, and expects to publish historical data for these reference rates through the end of March 2018 in the coming weeks.

Conclusion

Time will tell whether market participants will embrace any of these three new reference rates as the generally accepted replacement for LIBOR, and potential users can subscribe here for updates from the New York Fed.

For more information regarding the LIBOR phase-out or to discuss potential approaches to determine reference rates in LIBOR-based loans, please feel free to contact a member of Ropes & Gray's leading real estate and finance teams.