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LIBOR Transition Update: Publication of Most LIBOR Settings to Cease by End of 2021

The transition away from LIBOR took a major step forward on March 5, 2021, with announcements by the U.K. Financial Conduct Authority (FCA) and ICE Benchmark Administration (IBA) in response to the results of a consultation conducted by IBA on its intention to cease the publication of LIBOR settings. As a result of these announcements, market participants now have more certainty regarding the timing of LIBOR's endgame and the implementation of fallback rates in derivatives, loans and other instruments that reference LIBOR. Global efforts to transition away from LIBOR to risk-free rates (RFRs) before LIBOR ceases to be published or becomes "non-representative" have accelerated this year. Regulators including the U.S. Securities and Exchange Commission (SEC) have identified preparedness for the LIBOR transition as an area of focus in 2021.

In this Alert, we summarize and consider the implications of these announcements regarding LIBOR's cessation. We also highlight some challenges and risks that asset managers may face in connection with the transition.

FCA/IBA Announcements

The first key takeaway from the March 5 announcements is that the dates on which certain LIBOR settings will cease to be published are now known. For many contracts that currently reference LIBOR, the occurrence of these designation dates will trigger the application of contractual fallbacks to alternative RFRs.

The IBA will cease publication of the following LIBOR settings in their current form immediately following the publication on December 31, 2021:

- GBP LIBOR – all settings (overnight, 1-week, 1-month, 2-month, 3-month, 6-month and 12-month;
- EUR LIBOR – all settings (overnight, 1-week, 1-month, 2-month, 3-month, 6-month and 12-month);
- CHF LIBOR – all settings (spot next, 1-week, 1-month, 2-month, 3-month, 6-month and 12-month);
- JPY LIBOR – all settings (spot next, 1-month, 2-month, 3-month, 6-month and 12-month); and
- USD LIBOR – 1-week and 2-month.

The IBA will cease publication of the following LIBOR settings in their current form immediately following the publication on June 30, 2023:

- USD LIBOR – overnight, 1-month, 3-month, 6-month and 12-month.

While most of the LIBOR tenors will cease publication permanently, the FCA announced that it will consult (or consider consulting) on compelling the publication of a subset of LIBOR settings for a period of time following the dates noted above on a changed methodology (also known as "synthetic" LIBOR).[1] The FCA notes that the changed methodology

[1] The FCA's authority to require IBA to publish synthetic LIBOR settings is currently pending legislative approval by Parliament. The FCA has indicated that synthetic LIBOR would be based on a forward-looking term rate version of the relevant RFR plus the same fixed spread credit adjustment prescribed by the ISDA IBOR Fallbacks Protocol and Supplement.

will provide a "fair approximation of what panel bank LIBOR would have been beyond the end-dates for each of the panels" but that synthetic LIBOR will "no longer be representative of the underlying market and economic reality the setting is intended to measure." Accordingly, the FCA announcement states that immediately after December 31, 2021, the 1-month, 3-month and 6-month JPY LIBOR settings and the 1-month, 3-month and 6-month GBP LIBOR settings will no longer be representative and representativeness will not be restored. Additionally, immediately after June 30, 2023, the 1-month, 3-month and 6-month US dollar LIBOR settings will no longer be representative and representativeness will not be restored.

The FCA notes in its announcement that the purpose of continuing some LIBOR settings on a synthetic basis is "intended to protect consumers and market integrity by reducing disruption in markets where it is unlikely to be feasible to convert certain outstanding contracts that reference LIBOR to alternative reference rates." Regulators have indicated that any synthetic LIBOR publications will only be available for use with "tough legacy" transactions (*e.g.*, transactions that are not capable of being amended to reference a fallback or alternative reference rate).

The second key takeaway from the March 5 announcements is that the credit spread adjustment that will be added to fallback RFRs in contracts governed by International Swaps and Derivatives Association (ISDA) and other industry documentation is now known. This credit spread adjustment was developed to minimize the economic impact on a contract when its reference rate is switched from LIBOR to the applicable RFR, as LIBOR is a historically higher unsecured lending rate reflecting a credit risk component. The credit spread adjustment is, in short, equal to the median of the difference between the relevant LIBOR setting and the corresponding RFR compounded over a five-year lookback period. The announcements have the effect of setting the end of that five-year lookback period and as a result, Bloomberg has published the amount of the credit spread adjustment for each of the relevant LIBOR settings. Note, however, that the credit spread adjustment itself will not be applied in a contract until the point at which the applicable fallback RFR is applied to the contract.

Impact on the OTC Derivatives and U.S. Loan Markets

In both the OTC derivatives and U.S. loan markets, the designated fallback RFR for USD LIBOR is the Secured Overnight Financing Rate (SOFR), which is published by the Federal Reserve Bank of New York based on information received from the repo market. To the extent fallback provisions have been adopted by market participants or have been deemed to apply, references to USD LIBOR will be replaced with SOFR and the credit spread adjustment will be applied upon the occurrence of the designated triggering events. In many cases, these fallbacks will be implemented via language that has been developed by the Alternative Reference Rates Committee (ARRC) for the U.S. loan market and by ISDA for the OTC derivatives market. While there are similarities between the ARRC and ISDA methodologies, there are a number of key differences. Below we describe some of these differences and the impact of the announcements on the U.S. loan market and OTC derivatives market.

Impact on the OTC Derivatives Market

The ISDA fallbacks are set forth in Supplement 70 to the 2006 ISDA Definitions (Supplement) and the ISDA 2020 IBOR Fallbacks Protocol (Protocol). The Supplement took effect on January 25, 2021, and amends the terms of new transactions entered into from that date that incorporate the 2006 ISDA Definitions. The Protocol amends the terms of legacy transactions entered into prior to that date that incorporate the Definitions, but only if both parties to the applicable transaction have adhered to the Protocol.[2] In addition to activating fallbacks upon LIBOR's cessation, the ISDA Protocol and Supplement also provide for fallbacks to be activated in respect of certain rates, including USD LIBOR, if the rate is deemed to be non-representative prior to its cessation. ISDA has published bilateral templates that may be used to customize the application of the changes covered by the Protocol and the Supplement, including the

[2] A list of entities that have adhered to the Protocol is publicly available on ISDA's website.

scope of agreements covered, opting out of the non-representativeness trigger, and adding provisions that address related underlying hedges or cash instruments.

As a result of the announcements, the transition for (i) all OTC derivative contracts that reference USD LIBOR and that have been amended by the Protocol and (ii) all OTC derivative contracts that were entered into after January 25, 2021, and incorporate the 2006 ISDA Definitions, is expected to happen on July 1, 2023.[3]

Impact on the U.S. Loan Market

The March 5 announcements have helped to clarify the landscape for transitioning from LIBOR to SOFR in the U.S. loan market. Under the ARRC's prior guidance issued in June 2020, the ARRC recommended that all existing loan contracts be amended to incorporate "robust" fallback language by the end of 2021. Agent banks have generally interpreted this to refer to the "hardwired" version of the ARRC-recommended language, which provides for the automatic transition from LIBOR to SOFR upon the occurrence of one or more triggers, without the need for a subsequent amendment. The ARRC also recommended that new loans originated after June 30, 2021, be issued on SOFR from the outset, and U.S. banking regulators have effectively mandated that new loans originated after December 31, 2021, be issued on SOFR.

In order to facilitate implementation of the ARRC recommendations, the Loan Syndications and Trading Association (LSTA) has published model provisions for loans based on SOFR. As regulated banks and other lenders are increasingly pressured to include hardwired fallback language in credit agreements, borrowers have been seeking to retain some measure of control with respect to the timing and details of the transition from LIBOR to SOFR. For borrowers, a downside to an early transition would be the loss of the ability to fix its interest cost in advance at the start of the applicable interest period. This results from the fact that daily SOFR is likely to be the only SOFR-based rate that will be widely available and administratively feasible for agent banks at the time of transition.[4] In order to mitigate this risk, borrowers have been seeking the ability to subsequently transition to forward-looking SOFR (or Term SOFR) if and when it becomes available, without having to seek additional consents from lenders.

The practical impact of the March 5 announcements on existing loans depends on the form of fallback language in the underlying loan documentation. A significant majority of existing syndicated loans—tracking an earlier version of the ARRC's recommended language—require parties to amend the loan in order to effectuate the replacement of LIBOR with SOFR following the occurrence of a trigger event. Under the "amendment" approach, the March 5 announcements will merely trigger a requirement that the agent notify the borrower of the occurrence of a trigger event, but no change would actually occur until the parties agree to amend the loan agreement. If the loan documentation has adopted the "hardwired" approach, the transition to SOFR will automatically occur upon the permanent cessation of publication or non-representativeness of the relevant LIBOR settings, which, as noted above, will not occur until December 31, 2021 or June 30, 2023 (depending on the setting). However, under either approach, the loan document may permit the agent and the borrower to elect an earlier transition date under an "early opt-in" trigger. Regardless of the effective date of the

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[3] Although the one-week and two-month USD LIBOR setting will permanently cease after December 31, 2021, the ISDA fallback methodology prescribes that those rates will be calculated using linear interpolation from the nearest USD LIBOR settings still available until June 30, 2023, at which point all USD LIBOR settings will fall back to SOFR plus the credit spread fixed on March 5, 2021. Additionally, while not expected, if a subsequent triggering event occurs (*e.g.*, a "non-representativeness" announcement is made prior to the permanent cessation of a setting or an earlier permanent cessation date is announced), the fallbacks could apply at an earlier time. In such cases, however, the credit spread adjustment that was set on March 5th will not change but will instead apply on the date of the earlier effective date of the triggering event.

[4] Under the ISDA fallback methodology, SOFR will be calculated on a compounded basis in arrears at the end of the relevant interest period. By contrast, the loan market will rely on daily SOFR, in part due to the difficulty of calculating a compounded interest rate in the context of loans, where principal can vary daily due to prepayments, amortization, or incremental borrowings.

transition, the credit spread adjustment for each relevant LIBOR setting will be the credit spread adjustment as calculated on March 5 and published on Bloomberg.

It should be noted that the March 5 announcements do not address the potential impact of the differences between the ARRC and ISDA approaches on borrowers that hedge their interest rate exposure. Under the ARRC approach, assuming that forward-looking Term SOFR is not yet available, the fallback rate will be Daily Simple SOFR, which will be calculated on a daily non-compounded basis. In contrast, ISDA-governed swaps and hedges will calculate interest using Compounded SOFR in Arrears, which results in a small but measurable difference in interest calculations. Borrowers are eager to understand the potential impact of that discrepancy on their ability to effectively hedge their interest rate exposure, as well as any accounting implications. In addition, it is possible that there will be a timing gap between the effective date of transition under the loan agreement and its corresponding interest rate hedge agreement. Under either the "amendment" or "hardwired" approach, it is possible that a loan may fall back to Daily Simple SOFR prior to the end of 2021. However, under the ISDA Supplement and Protocol, the corresponding hedge may not fall back to SOFR until July 1, 2023. Borrowers that hedge their interest rate exposure should be preparing to engage with their counterparties in order to minimize any gap in the effective date of transition.

Next Steps for Asset Managers

As asset managers work towards transitioning away from LIBOR, the importance of planning and preparation cannot be understated. LIBOR cessation will have wide-ranging impacts on an asset manager's business, including on trading and investments, operations, risk, investor relations, marketing, compliance and legal functions.

In a 2020 Risk Alert, the SEC's Office of Compliance Inspections and Examinations (now the Division of Examinations) provided a list of sample examination questions focused on LIBOR transition preparedness by registered investment advisers. The Risk Alert highlights five areas of focus related to the LIBOR transition:

- The manager's and investors' exposure to LIBOR-linked contracts that extend past the current expected discontinuation date;
- The manager's operational readiness, including any enhancements or modifications to systems, controls, processes, and risk or valuation models;
- The manager's disclosures, representations, and/or reporting to investors regarding its efforts in respect of the LIBOR transition;
- Identifying and addressing any potential conflicts of interest; and
- Efforts undertaken to replace LIBOR with an appropriate alternative reference rate.

With these areas of focus in mind, managers should consider taking the following steps to prepare for LIBOR's cessation if they have not already done so:

- Form a committee of key stakeholders from the investment, operations, legal, compliance, risk, tax, accounting, investor relations and other relevant teams to assess firm-wide LIBOR exposures and prepare a plan and timeline for the transition;
- Conduct a comprehensive review of any documentation and internal and vendor-provided systems and functions that include or refer to LIBOR, including disclosures; fund and investor agreements; trading and investment agreements; vendor contracts; marketing materials; performance composites; information technology systems; and accounting, investor reporting, risk, valuation and trading systems and functions;

- In the OTC derivatives space, market participants should familiarize themselves with and consider the implications of the contractual fallbacks in the ISDA Supplement and Protocol;
- Consider incorporating fallbacks in other financial instruments used by the adviser and its clients, including credit agreements, loans, securitized products, and floating rate notes;
- Consider implications of any mismatch between LIBOR fallbacks used in hedging arrangements and underlying hedged products, such as loans. Asset managers should consult with applicable stakeholders on how to address mismatch issues. Please see our recent Podcast for more information on this topic and steps asset managers can take to address these issues;
- Review and remediate performance composites and performance advertisements that use LIBOR;
- Review and update fund and investor disclosures and fund documentation;
- Assess and remediate use of LIBOR-based risk or valuation models (internal and vendor-provided systems);
- Update information technology systems (including accounting, investor reporting, risk, valuation and trading) and compliance procedures and controls;
- Communicate with boards, investors, clients, vendors and other service providers; and
- Document steps taken to prepare for LIBOR transition in order to respond to investor and client inquiries and SEC examination requests.

Ropes & Gray attorneys have been involved with and closely following all aspects of the LIBOR transition and are well positioned to advise clients as they navigate through the transition. Please consult our LIBOR Transition Page for more information. As always, please also reach out to your Ropes & Gray client team to discuss any questions and ways we can be of assistance.