

THE GLOBAL TRANSITION AWAY FROM LIBOR TOOK A MAJOR STEP FORWARD last week when the Alternative Reference Rate Committee (“ARRC”) endorsed a forward-looking term version of the Secured Overnight Funding Rate (“SOFR”) for use in place of LIBOR. The ARRC, an industry group convened by the Federal Reserve Board of New York, previously recommended Daily Simple SOFR as the presumptive replacement rate for LIBOR. However, market participants have struggled to find an alternative version of SOFR that would be a suitable replacement rate for commercial loans, which currently allow the borrower to select among various LIBOR interest period options. Loan market participants, especially borrowers, have been focused on replacing LIBOR with another term rate that would allow them to lock in a known-in-advance rate for the selected interest period. As an overnight rate, Daily Simple SOFR was not well suited as a replacement for LIBOR interest periods used in the vast majority of commercial loans.

The over-the-counter derivatives market, on the other hand, has adopted a backward-looking version of SOFR, SOFR Compounded in Arrears, as a replacement rate for LIBOR-based derivatives products. The selection of different replacement rates by the derivatives market and loan market has raised concerns about the inability of borrowers to create a “perfect hedge” for their loans when entering into an interest rate swap in the over-the-counter market.

On March 5, 2021, the U.K. Financial Conduct Authority and ICE Benchmark Administration (the administrator of LIBOR) issued announcements that clarified the timing of the cessation of publication of widely used LIBOR settings. While the announcements allowed legacy contracts to continue to use U.S. dollar LIBOR through June 2023, they stressed the importance of moving new loans away from LIBOR as soon as possible. Market participants

interpreted the announcements and related regulatory guidance as effectively requiring that, by the end of 2021, all contracts, existing and new, should either include the ARRC’s “hardwired” fallback language or incorporate a non-LIBOR-based rate at the outset. Immediately after the announcements, the ARRC announced the fixed spread adjustments to be used to transition existing LIBOR-based contracts to SOFR in order to reflect historical differences between the two rates. The spread adjustments were calculated based on a five-year trailing average difference between LIBOR and SOFR. Loan market participants have noted that because the difference between LIBOR and SOFR is currently less than the ARRC-recommended spread adjustment, using the ARRC-recommended adjustment will likely result in an immediate increase in the overall interest rate for many borrowers. It remains to be seen whether borrowers will ask lenders to offset this increase with a reduction in the interest rate margins on their loans.

Following the March 5 announcements, many loan market participants became more vocal about the need for a forward-looking term rate to replace LIBOR. *Bloomberg* and others published forward-looking credit sensitive rates (“CSRs”), and the Loan Syndicated Trading Association (“LSTA”) published a rider to the ARRC’s hardwired language providing for incorporation of CSRs as an alternative to LIBOR. Regulators expressed some discomfort that CSRs had similar vulnerabilities to LIBOR since they lacked the depth and liquidity of the SOFR market. Around the same time, CME Group, which operates one of the world’s largest derivatives exchanges, began publishing a forward-looking version of SOFR (“CME Term SOFR”). On July 26, 2021, the Commodity Futures Trading Commission (the primary regulator for swap dealers) launched a “SOFR First” initiative to encourage a transition to SOFR for U.S. dollar interest rate swaps, cross-currency swaps and other exchange-traded derivatives. The first phase of the

initiative was immediately successful in expanding the use of SOFR in the inter-dealer over-the-counter derivatives market. Since the calculation of CME Term SOFR is based on SOFR futures trading, the increase in SOFR derivatives volume gave a much-needed impetus to CME Term SOFR. On July 28, 2021, the ARRC formally recommended the use of CME Term SOFR for commercial loans and other financial products. The ARRC also approved CME Term SOFR for use in end user-facing derivatives. Although this provides a means for borrowers to effectively hedge their interest rate exposure for loans that originate on or fallback

to CME Term SOFR, the standard documentation used for hedging will need to be amended. There is currently some uncertainty about how this will be accomplished. The LSTA is currently working on a concept credit agreement reflecting the adoption of CME Term SOFR, which is expected to be distributed shortly. As a result of these developments, loan market participants should soon have the option of a forward-looking SOFR-based term rate that operates similarly to the way LIBOR does now. This should greatly accelerate the loan market's transition away from LIBOR.

ROPES & GRAY

ropesgray.com

NEW YORK | WASHINGTON, D.C. | BOSTON | LONDON
CHICAGO | SAN FRANCISCO | SILICON VALLEY
HONG KONG | SEOUL | SHANGHAI | TOKYO