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Derivatives

One Year to Go: The State of Play in LIBOR Transition

By Anne E. Beaumont, *Friedman Kaplan Seiler & Adelman LLP*

As of December 31, 2021, two U.S. dollar (USD) London Interbank Offered Rate (LIBOR) rates ceased to be published. One year from now – as of June 30, 2023 – the remaining USD LIBOR rates will follow suit, and the rate once hailed as "the world's most important number" will cease to exist. Although much has been accomplished in the nearly five years since the planned demise of LIBOR was first announced in 2017, fund managers and their counterparties have substantial work remaining to do in the coming year as the final June 30, 2023, LIBOR end date approaches.

This article explains how the end of LIBOR began, how the transition away from LIBOR is going and what steps managers need to take next to ensure a smooth transition.

For more on the LIBOR transition, see "How Advisers Can Prepare for OCIE Exams on the Transition From LIBOR" (Jul. 9, 2020); and "The SEC Weighs In on LIBOR Transition" (Aug. 8, 2019).

How It Started

In July 2017, Andrew Bailey, then-CEO of the U.K. Financial Conduct Authority, which regulates LIBOR, announced that the LIBOR panel banks would not be compelled to continue making submissions after the end of 2021, with the obvious consequence that those banks would stop making submissions and LIBOR would cease to be published. The stated rationale for ending LIBOR was financial stability: for regulatory reasons, there has been a massive decrease in the types of short-term, unsecured interbank lending transactions that underlie USD LIBOR relative to the hundreds of trillions of dollars of transactions that use or depend on the rate. Nonetheless, allegations of large-scale manipulation of USD LIBOR and other "IBOR" rates are widely perceived as an equally important justification for LIBOR's demise.

After Bailey's announcement, market participants, led in the U.S. by the Alternative Reference Rates Committee (ARRC), turned to the tasks of finding suitable replacement rates for LIBOR and transitioning contracts and transactions that reference LIBOR to those replacements. Although ample progress was made on those tasks in the years that followed, various factors, including the coron-

avirus pandemic, eventually led to a partial extension of Bailey's original December 31, 2021, deadline. In November 2020, it was announced that two of the least-used USD LIBOR rates would cease to be published as planned at the end of 2021, while the others would continue to be published through the end of June 2023.

For discussion of the history of LIBOR, see "Hedge Fund Managers Must Prepare for Benchmark Regulation" (Feb. 11, 2016).

How It Is Going

In the five years since LIBOR's end originally was announced, substantial work has occurred throughout the financial markets to transition away from widespread LIBOR use and smooth the way for that transition. Several major milestones have already been achieved, including the following:

- In 2017, the ARRC selected the Secured Overnight Financing Rate (SOFR) as its preferred alternative to LIBOR. In 2021, the ARRC formally recommended SOFR Term Rates from the Chicago Mercantile Exchange (CME) for use.
- The ARRC developed and recommended contract provisions – known as "fallbacks" – that address the consequences of a permanent LIBOR cessation. Previously, most fallback provisions addressed only a temporary unavailability of LIBOR, and many contracts had no fallback language at all.
- In 2020, the International Swaps and Derivatives Association (ISDA) launched the IBOR Fallbacks Protocol and the IBOR Fallbacks Supplement to the 2006 ISDA Definitions to amend both existing transactions (known as "legacy" transactions) and new transactions to incorporate robust fallback provisions into transactions linked to various IBOR rates. The changes in the Protocol and the Supplement began to take effect in January 2021.
- ISDA and others also have developed "spread adjustments" for use with SOFR and other risk-free rates to address the fact that such rates do not reflect bank credit risk as LIBOR did. ISDA's spread adjustments were fixed as of March 5, 2021.
- In 2021, New York enacted a statute to amend the terms of so-called "tough legacy" transactions, which are existing contracts that terminate after June 30, 2023; lack adequate (or any) fallbacks; and cannot practicably be amended. The statute allows for USD LIBOR to be replaced with SOFR plus a spread adjustment and also provides certain liability protections that are intended to minimize litigation resulting from such changes. Several other states have followed suit with similar statutes.
- In 2022, the federal government enacted the Adjustable Interest Rate (LIBOR) Act to amend the terms of tough legacy transactions. The federal statute largely mirrors the New York

tough legacy statute and also amends the Trust Indenture Act to address certain perceived conflicts between that law and the New York statute.

See "Recent Developments in the Loan and Derivatives Markets and Litigation Risks Pertaining to the End of LIBOR" (Dec. 17, 2020).

Notwithstanding the substantial legal and operational progress in transitioning away from LIBOR, market participants have moved away from widespread LIBOR usage very gradually and only when forced to do so. As a consequence of that reluctance, in November 2020, the Federal Reserve Board, Office of the Comptroller of the Currency and FDIC announced that they "believe entering into new contracts that use USD LIBOR as a reference rate after December 31, 2021, would create safety and soundness risks and will examine bank practices accordingly." Although that guidance does not specifically apply to non-bank market participants, an end to widespread usage of USD LIBOR by banks has had the intended practical effect of substantially reducing that usage throughout the markets.

Undoubtedly as a result of that regulatory pressure, in the first six months of 2022, SOFR-based market activity has accelerated substantially. For example, in April 2022, the CME announced that for the first time, more SOFR futures contracts were traded than LIBOR-based Eurodollar futures.

Another important market development is that competitors to the ARRC's chosen successor SOFR have emerged in the form of so-called "credit-sensitive rates" (CSRs). The CSRs are designed to replicate more closely the characteristics and behavior of LIBOR, which itself is a CSR and not a risk-free rate like SOFR. The major CSRs that have emerged so far are:

- AMERIBOR;
- the Bloomberg Short-Term Bank Yield Index (commonly known as "BSBY"); and
- the ICE Bank Yield Index.

Both U.S. regulators, such as the Federal Housing Finance Agency and the SEC, and international bodies, such as IOSCO, have strongly discouraged the use of CSRs. Nonetheless, the federal tough legacy statute includes a provision stating that no federal supervisory agency may take enforcement or other similar action against a bank solely because it uses a LIBOR-replacement benchmark that is not SOFR, such as a CSR.

See "Recent Developments in the Loan and Derivatives Markets and Litigation Risks Pertaining to the End of LIBOR" (Dec. 17, 2020); and "How Hedge Fund Managers Can Prepare for the Anticipated 'End' of LIBOR" (Aug. 24, 2017).

What to Do Next

As the June 30, 2023, deadline for the termination of the remaining USD LIBOR rates approaches, private fund managers still have substantial work remaining to ensure a smooth transition.

For coverage of the SEC's risk alert on the LIBOR transition, see "Compliance Corner Q3-2020: Regulatory Filings and Other Considerations That Hedge Fund Managers Should Note in the Coming Quarter" (Jul. 23, 2020).

Finalize Fallbacks

At this point, every manager already should have confirmed that any LIBOR-based positions, transactions or contracts in their portfolios contain fallback language that is designed to address a permanent cessation of LIBOR. Those fallback provisions generally use one of two approaches:

1. "Hardwired" fallback provisions contain all of the features required for a fallback to operate when triggered.
2. Amendment-approach fallback provisions, which are used in a limited universe of transactions such as syndicated loans, allow market participants to negotiate the specifics of the LIBOR replacement rate at a future date. Thus, to the extent a transaction uses that approach, it still is necessary to negotiate a final fallback provision before June 30, 2023.

Determine How Tough Legacy Positions Have Been Amended

Managers also should identify tough legacy transactions in their portfolios that may have been amended by federal legislation or another legal or regulatory regime. For those transactions, it may be worthwhile to communicate with other parties – such as an indenture trustee, servicer or other holders – to confirm there is agreement about which regime applies and the impact of any amendments. This is particularly critical for situations in which, for example, transaction parties are located in multiple jurisdictions; parties are subject to multiple regulatory or legal regimes; or the law applicable to a transaction is not specified. In those cases, which legislation or regulation applies and how a transaction may be impacted or amended may not be clear, and legal advice may be necessary.

Operationalize Fallbacks

With respect to both legislatively amended tough legacy transactions and any transaction that uses LIBOR and contains a fallback provision, it will be necessary after Friday, June 30, 2023, to "operationalize" the amendments or fallback provisions, as the case may be. That means that as of – or possibly before – Monday, July 3, 2023, any cash flows, calculations or actions that use USD LIBOR will need to be changed to use a replacement rate and, when applicable, an appropriate spread adjustment.

For that process to go smoothly, all operational systems that use LIBOR will need to be prepared and tested well ahead of time. Managers should already be working closely with their own teams, as well as with service providers, such as prime brokers, data providers, administrators, auditors and others, to ensure operational readiness and work out any problems before June 30, 2023, arrives.

Update Valuation Policies and Procedures

Managers that have positions using LIBOR should also ensure that their valuation policies and procedures take into account the impact of LIBOR cessation on those valuations, particularly as the deadline approaches. For example, LIBOR cessation may be expected to impact the liquidity and pricing of some positions, and a dramatic change in a position's valuation at or after June 30, 2023, may well draw attention from investors or regulators.

Replace the Benchmark and Update Models

Managers that use LIBOR as a performance benchmark or in models and other analytic systems (*e.g.*, as a discount rate) should have a plan in place to replace LIBOR. They may want to begin using the replacement rate prior to June 30, 2023.

Trade Out of LIBOR

Managers also should consider the possibility of trading or closing out of LIBOR-based positions well before June 30, 2023. Obviously, as that date approaches, doing so is likely to become more difficult and costly, so any such action should be taken promptly to avoid negative economic consequences.

See "Debtwire/SRS Acquiom Study: Hedge Funds Largely Prepared for LIBOR's End; SOFR the Likely Replacement Rate" (Oct. 28, 2021); "Advisers Should Be Planning Now for the End of LIBOR" (Oct. 29, 2020); and "What Private Fund Advisers Need to Know About Transitioning Away From LIBOR" (Aug. 13, 2020).

Anne E. Beaumont is a litigation partner in the New York office of Friedman Kaplan Seiler & Adelman LLP. Her practice focuses on representation of investment and asset management firms and their managers and investors, as well as financial services firms in litigation matters and disputes involving complex financial products and transactions. Beaumont also counsels and trains financial services industry clients, investment managers and asset management firms on legal compliance, due diligence and other issues, and she advises investment and asset management firms and their professionals on employment and separation issues and disputes.

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