Morgan Lewis

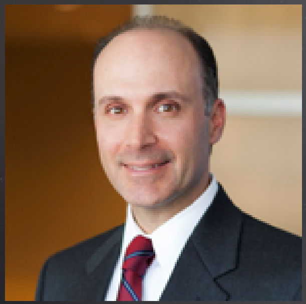
BANKING BULLETIN

USD LIBOR TRANSITION: THE END GAME

May 20, 2021

Presenters

David Chang



Thomas D'Ambrosio

Bruce Johnston

Jon Roellke

John Rosenthal

Morgan Lewis

Today's Discussion

- Antitrust Reminders
- Transition Complexities
- Supervisory Guidance
- Rate Options
- Transition Tools
- Other Jurisdictions
- Operational Readiness

USD LIBOR Basics

- **LIBOR**: Calculated for five currencies in seven different "tenors," intended to represent the average cost of short-term, wholesale, unsecured borrowing by major banks. ***Aggregate gross exposure to transactions tied to USD LIBOR is estimated at more than $200 trillion annually***.
- **IOSCO Principles for Financial Benchmarks:** Principles regarding benchmark governance, quality, and accountability promulgated by the International Organization of Securities Commissions in 2013.
- **RFR Working Groups**: Because actual bank borrowing transactions on which to quote LIBOR are limited, global regulators set up national working groups like the Federal Reserve's Alternative Reference Rates Committee (ARRC) in the US - ***to identify robust alternative "risk-free" interest rate benchmarks based on more active markets***.
- **LIBOR Cessation**: The Ice Benchmark Administrator (IBA) has confirmed that the overnight and 1, 3, 6 and 12 months USD LIBOR settings ***will end on June 30, 2023***. ***All other LIBOR settings***, including the ***1 week and 2 month USD LIBOR settings***, will no longer be published ***after the end of 2021***.
- **US Regulators:** Markets must ***stop writing new contracts*** tied to USD LIBOR ***by the end of 2021*****.**
- **SOFR**: Secured Overnight Financing Rate, selected in June 2017 by the ARRC as its preferred alternative to USD LIBOR. SOFR is a broad measure of ***the cost of borrowing cash overnight in the repo market, collateralized by US Treasury securities***. Published daily by the New York Fed.

Complexity of the LIBOR Transition

The ARRC: Over 300 member and nonmember institutions (banks, asset managers, insurers, and industry and consumer groups) and every major US financial regulator.

ARRC Product Groups: Securitizations, business loans, consumer products, and floating-rate notes.

Other ARRC Working Groups: Legal, tax, accounting, operations and infrastructure, regulatory issues, legislative affairs, and education and outreach.

ISDA: Working in parallel with the ARRC and other RFR working groups to address LIBOR transition for derivatives.

Supervisory Guidance

- US regulators (the Federal Reserve Board, FDIC, and OCC) issued supervisory guidance encouraging "banks to cease entering into new contracts that use USD LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021."

- The guidance further noted that entering into new contracts that reference LIBOR after December 31, 2021 would "create safety and soundness risks" for firms and for the financial system.

- On March 9, 2021 the Fed issued SR 21-7, a Supervision and Regulation Letter "to assist examiners in assessing supervised firms' progress in preparing for the transition," with 'examination work tailored to the size and complexity of the firms' LIBOR exposure.

- SR 21-7 notes that "examiners should consider issuing supervisory findings and other supervisory actions if a firm is not ready to stop issuing LIBOR-based contracts by December 31, 2021."

Why SOFR?

1 **Deep and Liquid Underlying Markets**: SOFR is a fully transaction-based, nearly risk-free reference rate. It is a broad measure of the cost of borrowing cash overnight, collateralized by US Treasury securities. Daily transaction repo volume underlying SOFR has averaged more than $980 billion.

2 **Official Sector Administration**: The New York Fed publishes SOFR daily in cooperation with Treasury's Office of Financial Research (OFR). It also publishes 30-, 90-, and 180-day SOFR Averages and a SOFR Index to support a successful transition away from USD LIBOR.

3 **Strong Oversight/IOSCO Compliant**: An internal New York Fed Oversight Committee periodically reviews the rate production process which is conducted consistent with best practices for financial benchmarks, including the IOSCO Principles for Financial Benchmarks.

4 **Versatile**: SOFR is suitable to be used across a broad range of financial products including, but not limited to, derivatives (listed, cleared, and bilateral-OTC), many variable-rate cash products that have historically referenced LIBOR, and as a general proxy for interest rates in a range of business processes (accounting, valuation, and financial modeling).

The Term Rate Issue

- LIBOR is a "term rate" expressed in different maturities (e.g., 1 month, 3 months, a year).
- SOFR is, as its name suggests, an overnight rate.
- The "fallback waterfall": Fall back to term SOFR if any such rate is recommended by the ARRC by the time LIBOR ceases; if not, fall back to some version of SOFR averages.
- The ARRC is working on developing a SOFR term rate, and it is expected to have one published before the end of the year, when some tenors of USD LIBOR will no longer be published.

ARRC Term Rate Progress

- ARRC's list of "market indicators" that would support a robust SOFR term-rate recommendation:
  - Continued growth in overnight SOFR-linked derivatives volumes.
  - Visible progress to deepen SOFR derivatives liquidity.
  - Visible growth in offerings of cash products, including loans, linked to averages of SOFR, either in advance or in arrears.
- ARRC seeks to ensure a sufficient track record of SOFR-based futures contracts with enough liquidity to develop a term rate derived from SOFR.
- Scope of Use: ARRC has indicated that its recommendation will have some limitation on how it suggests that SOFR term be used.

The "Spread Adjustment"

- LIBOR is an unsecured rate; SOFR is a "risk-free" rate. Implicitly, LIBOR rates embed a credit-risk component.
- So, a "SOFR fallback" needs to be adjusted to approximate cash flows comparable to those tied to LIBOR.
- ARRC: Recommended a one-time "spread adjustment" applied to SOFR in a contract that transitions to a recommended SOFR rate.
- Referred to as "spread-adjusted SOFR."
- Modeled after the same spread adjustment that ISDA adopted for derivatives.
- The IBA's March 5 announcement about the cessation of LIBOR was a "transition event" which triggered the one-time setting of the spread adjustment for all tenors.

Other Rates

- ARRC and the Fed have both stated that they support other market innovations toward reference rates that are robust, IOSCO-compliant, and available for use before the end of 2021.
- The ARRC's recommendations have always been voluntary, and it recognizes that market participants may choose other rates, but any solutions must be robust.
- Other term rates have been developed and published by private entities, most notably "credit-sensitive rates" that try to reflect the costs of borrowing by major lenders.
- Policymakers have emphasized that market participants, in selecting a rate, should "know their rate" and understand the differences between RFRs and any available credit-sensitive rates. The FSB has advised that most products should use risk-free rates.

Using SOFR in the LIBOR Transition

- Fallback Contracts: Contracts tied to LIBOR that anticipate LIBOR cessation and provide for a "fallback" rate. ARRC's product groups developed model provisions that designate some version of SOFR as the fallback when LIBOR stops. ISDA modified definitions for derivatives.
- "Tough Legacy" Contracts: Existing contracts that did not anticipate LIBOR cessation or provide for an untenable or unascertainable alternative rate (e.g., "last LIBOR"), and are difficult to amend. NY State Legislation provides for safe-harbor options to transition to SOFR.
- New Originations: New contracts that have stopped using LIBOR altogether and rely on SOFR, SOFR averages, or some other rate. Derivatives maturing after June 2023 are SOFR-based as per the ISDA protocol. GSE-backed ARMS are SOFR-based. Some corporates have started issuing SOFR-based bonds. Loan market still evolving.

Fallbacks

- "Fallback language" refers to the legal provisions in a contract that apply if the underlying reference rate in the product (e.g., LIBOR) is discontinued, nonrepresentative, or unavailable.
- The Official Sector Steering Group of the FSB advised that market participants ensure that their fallback arrangements are robust enough to prevent potentially serious market disruptions in a LIBOR cessation event.
- ARRC's product groups developed model provisions that designate some version of SOFR as the fallback for cash products when LIBOR stops.
- Fallbacks for derivatives are covered by the ISDA protocols for all adherents to the Master Agreement amendments.

Baseline ARRC-Recommended Fallbacks

To date, the ARRC has released recommended fallback language for six different cash products—for adjustable-rate mortgages, bilateral business loans, floating-rate notes, securitizations, syndicated loans, and variable rate private student loans.

Bilateral Business Loans	FRNs	Securitizations	Syndicated Loans
Term SOFR	Term SOFR	Term SOFR	Term SOFR
Daily Simple SOFR	Compounded SOFR	Compounded SOFR	Daily Simple SOFR

Updated ISDA Fallbacks for Derivatives

Previous ISDA Documentation	In the case of USD-LIBOR-BBA, if such rate does not appear on the Screen LIBOR01 Page, then, as a fallback, the Calculation Agent will request the principal London office of each of the Reference Banks to provide a quotation of its rate. If at least two such quotations are provided, the rate for that Reset Date will be the arithmetic mean of the quotations. If fewer than two quotations are provided, the rate is determined by seeking quotations from NY banks for USD loans to leading European banks. Working assumption was that quotations would be available.
Updated ISDA Definitions	Amend ISDA and other covered agreements to include the concept of an Index Cessation Event (i.e., when a rate will no longer be available or will no longer be representative), the date of effectiveness for such cessation, the fallback reference rate structure for the particular reference rate experiencing an Index Cessation Event, and further fallbacks to the original replacement reference rate.

The ISDA Protocol

- The ISDA 2020 IBOR Fallbacks Protocol was finalized on October 23, 2020 and became effective on January 25, 2021. It was created to enable parties to covered documents to amend the documents to:
  - in respect of a covered document which incorporates, or references a rate that is defined in an ISDA definitions booklet, include the terms of, or a particular defined term included in, the IBOR Fallback Supplement to the 2006 ISDA Definitions
  - in respect of a covered document which otherwise references a relevant IBOR, include in the terms of such document new fallbacks for that relevant IBOR.
  - IBORS: Sterling LIBOR, Swiss Franc LIBOR, USD LIBOR, Euro LIBOR, EURIBOR, Yen LIBOR, Yen Tokyo IBOR, Euroyen TIBOR, Australian Dollar Bank Bill-Swap Rate, Canadian IBOR, Hong Kong IBOR, Singapore Dollar-Swap Offer Rate and the Thai Baht Interest Rate Fixing.

ISDA IBOR Fallbacks for USD LIBOR

- USD LIBOR Fallback rates
  - Fallback Rate (SOFR): a term-adjusted SOFR rate plus spread published by Bloomberg
  - SOFR: as published by the Federal Reserve with calculation agent adjusted spread
  - Federal Reserve Recommended Rate with calculation agent adjusted spread
  - Overnight Bank Funding Rate provided by NY Federal Reserve
  - FOMC Target Rate: A short-term interest rate target set by the Federal Open Market Committee and published on the Federal Reserve's website (or an average of such published rates)
- FCA's statement in March was an Index Cessation Event, which, when the cessation event becomes effective, will trigger the fallbacks. The March statement also had the effect of fixing the spread that will be used when converting LIBOR to the relevant IBOR.

Tough Legacy

- What about all the LIBOR-based contracts that do not have adequate fallbacks that address a permanent cessation of LIBOR.
- Some contracts become fixed at the "last LIBOR" rate quoted, defying the parties' expectation of a variable rate. Others involve securities holders, whose identities are unknown, or consumers, and are therefore difficult or impossible to amend.
- The June 30, 2023 cessation date for the frequently used USD LIBOR tenors "would allow most legacy USD LIBOR contracts to mature before LIBOR experiences disruptions." But there will still be a significant minority of outstanding legacy LIBOR will remain after that date.
- This is the "Tough Legacy" problem.

Tough Legacy Solutions

- Negotiate amendments with your counterparties.
- Legislate to fill gaps and provide safe harbors.
- Ask a court what you should do.

New York Legislation

- While the June 30, 2023 cessation date for the most popular USD LIBORs will address a substantial portion of legacy contracts, there will still be a significant portion of contracts that use USD LIBOR and would mature after that time.
  - Some of these contracts have no effective means to replace USD LIBOR upon its cessation.
- In April 2021, New York Governor Andrew Cuomo signed into law a bill addressing fallback language in existing contracts governed by NY law that do not have effective fallbacks.

How the NY Legislation Works

- Newly enacted Article 18-C of the New York General Obligations Law
  - Statutory solution for legacy contracts that do not have appropriate fallbacks
  - If a contract references USD LIBOR with no fallback provisions (or fallbacks referencing LIBOR), then the replacement SOFR rate, including the applicable spread adjustments that are necessary to convert the USD LIBOR rate to SOFR, that is recommended by the Federal Reserve Board, Federal Reserve Bank of New York, or the Alternative Reference Rates Committee will be the replacement rate for the contract
  - Fallbacks referencing LIBOR in any way are invalidated (including "Last LIBOR")
  - Fallbacks requiring "polling" of bank or other rate quotations are voided
  - Technical/operational amendments necessary to reflect the rate change are not deemed to be amendments
  - No liability for parties implementing these changes
  - Contracts not voided, no right to terminate, no excuse for nonperformance

How the NY Legislation Works

Key Components	Legislation Structure
"Mandatory" v. "Permissive" Application of the Statute	• **Mandatory**: If the legacy contract is *silent* as to fallbacks. • **Mandatory**: If the legacy language falls back to a *LIBOR based rate* (such as last-quoted LIBOR). • **Permissive**: If the legacy language gives a party the right to exercise *discretion or judgment* regarding the fallback, that party can decide whether to avail itself of the statutory safe harbor.
Degree of Override of Legacy Contract Fallback Provisions	• **Override**: Where the legacy language falls back to a LIBOR-*based rate* (such as last quoted Libor). • **Override**: If the legacy language includes a fallback to *polling for LIBOR or other interbank funding rate*, the statute mandates that the polling not occur. • **No Override**: Where the legacy language is *silent* as to fallbacks or gives a party the right to exercise *judgment or discretion* regarding the fallback. *In these instances, there is nothing to override.* • **No Override**: The statute would not override legacy language that falls back to an express *non-LIBOR based rate* (such as Prime).
Mutual "Opt-Out"	• Parties are permitted to mutually opt out of the application of the statute, in writing, at any time *before or after* the occurrence of the trigger event.

Trigger Events	• The statute would become applicable or available (as described in "Mandatory" v. "Permissive" above) upon the occurrence of statutory trigger events.
	    • **Cash Products**: The statutory trigger events for cash products would be based on the ARRC permanent cessation and pre-cessation trigger events.
	    • **Derivatives**: The statutory trigger events for derivatives would be based on what ISDA does.

"All Products"	• **No Exclusions**: No product is categorically excluded from the statute. Parties can opt-out as described above.
Conforming Changes	• The statute provides safe-harbor protection for parties who add conforming changes to their documents to accommodate administrative/operational adjustments for the statutory endorsed benchmark rate.

Federal Legislation

- Is pending in Congress (Adjustable Interest Rate (LIBOR) Act of 2021).
- Purpose:
  - to establish a clear and uniform process, on a nationwide basis, for replacing LIBOR in existing contracts that do not provide for the use of a clearly defined fallback benchmark rate
  - to preclude litigation
  - to allow existing contracts that reference LIBOR but provide for the use of a clearly defined fallback benchmark rate to operate according to their terms
- Modeled largely after the NY State legislation: automatic replacement of rate, contract continues, no deemed amendment, no liability.

Federal Legislation

- Would preempt all state laws (including the NY statute)
- Amends the Trust Indenture Act of 1939: "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security shall not be deemed to be impaired or affected by any change occurring by the application of section 4 of the Adjustable Interest Rate (LIBOR) Act of 2021 to any indenture security"
- Provides for possible rulemaking by the Board of Governors of the Federal Reserve System
- LIBOR-related changes are not treated as a taxable event

What about the other “LIBORs”?

- London was the home of Libor and most of the claims around its susceptibility to manipulation have been dealt with in London
- Lots of currencies have Libor rates: US dollars, pounds sterling (GBP), Japanese Yen, the euro, and the Swiss franc
- Multicurrency tough-legacy contracts are common and are still being written even though market participants have been told to stop doing so by regulators
- Although SONIA is gaining significant traction, it has similar issues to SOFR as an overnight rate; it is also only published mid-morning in respect of the prior day
- The Bank of England Base Rate is proving popular in trade finance and mid-market transactions.

Operational Readiness: ARRC Resources

User's Guide to SOFR

Practical Implementation Checklist for SOFR Adoption

Buy-Side Checklist

Internal Systems & Processes: Transition Aid for SOFR Adoption

OCC's "LIBOR Self-Assessment Tool"

"Given the expectation for banks to cease entering into new contracts that use Libor as a reference rate by December 31, 2021, bank management should assess whether the bank's progress with preparedness is sufficient. For example, in 2021, LIBOR exposure and risk assessments and cessation preparedness plans should be at least near completion with appropriate management oversight and reporting in place. Most banks should be working toward resolving replacement rate issues while communicating with affected customers and third parties, as applicable."

- Exposure assessment and planning
- Replacement-rate methodologies
- Fallback language
- Progress and oversight

Resources

- “There must be 50 ways to leave your [LIBOR].”
- No shortage of literature, doomsday pundits, critics, and advocates.
- Seminars, symposiums, trade group task forces everywhere.
- But don’t get lost trying to figure this out-we’ve got you covered.
- Portfolio evaluation resources; substantive and practical know-how.

Coronavirus COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

Morgan Lewis

To help keep you on top of developments as they unfold, we also have launched a resource page on our website at **www.morganlewis.com/topics/coronavirus-covid-19**

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to **subscribe** using the purple "Stay Up to Date" button.

Biography

David V. Chang
Los Angeles
+1.213.612.1372
david.chang@morganlewis.com

David V. Chang represents leading financial institutions, direct lenders, and corporate borrowers in a broad range of complex debt financing transactions across a variety of industries and business sectors. David focuses his practice on domestic and cross-border syndicated and bilateral credit facilities, cash-flow and asset-based loans, acquisition and leveraged buyout financings, first- and second-lien debt financings, project financings, public and private debt issuances, workouts, and restructurings.

Biography

Thomas V. D’Ambrosio
New York
+1.212.309.6964
thomas.dambrosio@morganlewis.com

Thomas V. D’Ambrosio concentrates his practice on structured and complex derivative transactions, including related insolvency and regulatory issues. Thomas helps clients structure, negotiate, and analyze the risk inherent in a wide range of cleared and uncleared derivative and futures products. He represents clients in all asset classes, including equity, debt, credit, commodity, interest rate, currency, and exotic derivatives. His clients include Fortune 500 corporations, private companies, investment managers, hedge funds, financial institutions, pension funds, and high net-worth individuals.

Biography

Bruce Johnston
London
+44.20.3201.5592
bruce.johnston@morganlewis.com

Bruce Johnston advises both lenders and borrowers on banking and finance transactions in Europe, the Middle East, and Africa, including acquisition finance, leveraged finance, project finance, structured finance, trade finance, asset-backed lending, private placements and asset finance. Head of the firm's international finance practice, he also handles energy and infrastructure transactions and workouts and restructurings.

Biography

Jon R. Roellke
Washington, D.C.
+1.202.739.5754
jon.roellke@morganlewis.com

Jon Roellke focuses on antitrust, trade regulation, and other commercial litigation, primarily counseling clients in the financial services and high technology industries. He handles class action and other complex litigation, advises clients on enforcement matters before state and federal agencies, and regularly counsels on competition issues, including his work as outside antitrust counsel to the ARRC.

Biography

John M. Rosenthal
San Francisco
+1.415.442.1346
john.rosenthal@morganlewis.com

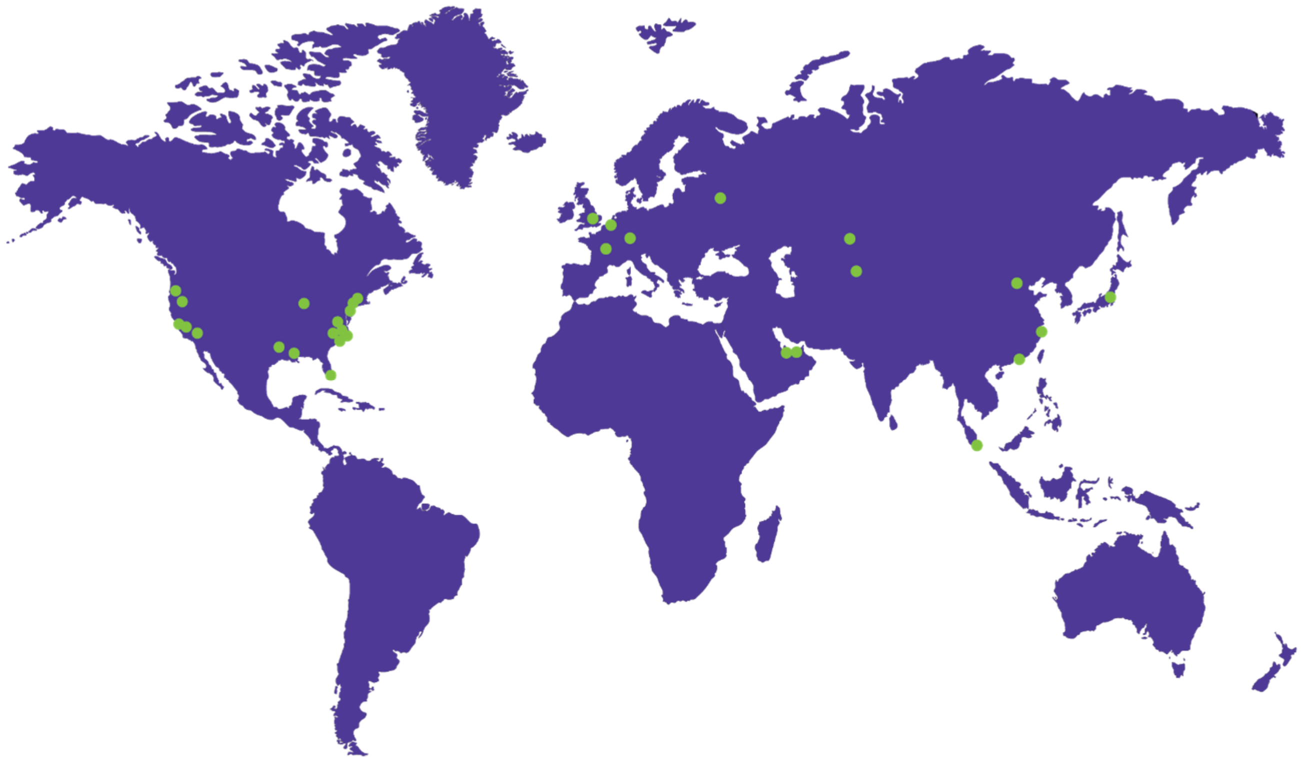
John M. Rosenthal advises clients in structured, project, corporate, and public finance debt matters. He also counsels banks on institutional risk management (including operational, regulatory, and litigation risk) and restructurings. Working with issuers, lenders, borrowers, indenture trustees, and other participants, John structures, negotiates, and documents complex financing transactions and workouts/restructurings of such transactions. These include secured transactions, asset-backed financings, securitized receivables financing, syndicated lending, credit enhancement, and public finance.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Nur-Sultan
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore*
Tokyo
Washington, DC
Wilmington



Morgan Lewis

*Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan, Lewis & Bockius is a separate Hong Kong general partnership registered with The Law Society of Hong Kong. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

THANK YOU