

Preparing for LIBOR Substitution-Commercial and Consumer Lending Considerations

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1. Introduction

As of December 31, 2021 (the “Effective Date”), the use of LIBOR as an index for commercial and consumer loans will likely cease—which presents lenders and other industry participants with the challenges to address: (a) the process for replacing LIBOR as an index for commercial and consumer loans outstanding as of the Effective Date that employ LIBOR as an index; and (b) how to proactively anticipate the end of LIBOR by beginning to substitute a new index for LIBOR between now and the Effective Date.

This Alert will provide a short background on the developments that have led up to the decision to replace LIBOR, as well as some metrics estimating the scope of commercial and consumer financing transactions that may be affected as of the Effective Date. In addition, this Alert will provide an analysis of factors to be considered when reviewing loan documents using LIBOR as an index, as well as risk-related approaches for drafting provisions to include in current and future loan documents.

2. Background

LIBOR—which stands for the “London Interbank Offered Rate”—is a calculation announced each morning by the ICE Benchmark Administration (the “ICE”), and is calculated each day based on the representations of panel banks as to the rates at which they could each borrow on the London interbank lending market.¹ Unfortunately, over the years the calculation of LIBOR was regularly manipulated by traders, with the result that over the course of the last decade certain large money-center banks and other trading organizations paid over \$9 billion in fines and penalties.²

Ultimately, the determination by U.S. and EU governmental and private organizations was to phase out the use of LIBOR, and to cease announcing LIBOR daily values rates as of December 31, 2021.

Following this decision, several governmental and trade association groups have been

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analyzing replacement indices for LIBOR, including the following:

- SOFR—The Secured Overnight Financing Rate (the “SOFR”)
- SONIA—The Reformed Sterling Overnight Index Average
- TONAR—The Tokyo Overnight Average Rate
- SARON—The Swiss Average Rate Overnight
- EONIA—The Euro Overnight Index Average
- A Modified Version of LIBOR (as calculated by ICE)

In June of 2017, the “Alternative Reference Rates Committee” or “ARRC,” which was created by the Federal Reserve Board to identify an alternative, transaction-based reference rate to replace LIBOR, designated the SOFR as its preferred substitute for USD LIBOR.³ Since that time, the ARRC has issued numerous studies and analyses regarding the use of the SOFR,⁴ and has issued draft language not only for use by the swaps and derivatives markets, but also draft commercial loan language and proposed recommended language to be used for residential mortgage instruments.⁵ On September 19th, the ARRC issued a draft project plan approach, discussed below, to assist financial institutions in the implementation of a LIBOR substitution process.

The task of addressing the elimination and replacement of LIBOR as an index is daunting—for the swaps and derivatives markets the notational amount of LIBOR-based instruments as of the Effective Date is estimated to exceed \$180 trillion dollars; for commercial and consumer loans the principal amount may exceeds \$20 trillion. Moreover, since in all markets there will be transaction documents outstanding on the Effective Date that will continue to employ LIBOR as the designated index, counterparties will be faced with literally trillions of dollars of instruments requiring modification. Since no replacement index can be certain to track LIBOR values identically, winners and losers in any replacement scenario may experience gain or loss when a new index is substituted. This may or may not be addressed by changes in margins used in conjunction with a LIBOR value to determine a transaction’s rate of interest (discussed in greater detail below).

3. The Components of an Index Replacement Event

When considering the replacement of LIBOR, several questions need to be answered to determine a course of action—both as to current instruments that employ LIBOR as an index and for new loans originated between now and the Effective Date:

- **What is the Triggering Event?** A triggering event refers to an event that requires the replacement of one index with another. In this context, the event is the cessation of announcing a current LIBOR value.
- **Is there a Contractual Methodology to be Followed?** Assuming that a triggering event occurs, does the current instrument being analyzed provide a procedure to be followed with respect to the replacement of LIBOR with another index?
- **Can the Margin also be Replaced/Adjusted?** Usually expressed in terms of basis points, does the instrument being analyzed address whether the spread over (or under) the chosen index (*i.e.*, the “margin”) may be adjusted to align with the interest rate immediately prior to the LIBOR substitution?

- **What is the Index that will be the Substituted Index?** This is the selected reference rate that will be used to set the interest rate for adjustable rate transactions, which will adjust from time to time.

4. Replacement Factors Considerations

The following are several significant considerations that impact each of the four factors identified above.

A. Triggering Event

Because the administration of credit transactions is typically handled by an originating lender, an administrative agent or a servicer, a decision to declare that a triggering event has occurred creates potential risk of objections being raised by borrowers against creditors and their agents.

Although it might seem that the cessation of the use of LIBOR is straightforward, applying the applicable contract language may not be. For example, frequently triggering events are described when an index is no longer “available.” (e.g., daily LIBOR values are no longer printed in the Wall Street Journal or another designated authoritative source.) Similarly, disputes may arise if the calculation of LIBOR becomes so unreliable that its continued use is inconsistent with the intent of the counterparties. (e.g., ICE elects to modify its calculation of LIBOR in a manner that no longer reflects the methodology or movement of the current/original calculation methodology of LIBOR.)

B. Fallback and Replacement Methodology

Contractual language describing index replacement methodology is frequently deficient when describing the process and procedure how LIBOR may be replaced. In many cases, the authority to make the replacement is solely held by the creditor or holder of the promissory obligation.

Ignoring for a moment the presence or absence of contractual authority to adjust the margin at the same time that a LIBOR index is replaced, discussed below, in the absence of clear rules, replacement of an index could be objected to due to: (i) the authority of a lender to select a replacement index that is detrimental to a borrower; and (ii) the timing and value of the index actually selected.

For example, loan contract language may authorize a lender or holder to select a replacement index that is “based upon comparable information.” Because the SOFR is a *secured* index rate (as compared to LIBOR, which is an unsecured index rate and includes a credit risk component), and therefore likely to be lower than LIBOR, a lender may not want to substitute SOFR for LIBOR unless it can simultaneously adjust the margin to reflect the difference. A borrower may object to the lender’s choice of an alternate index, particularly if SOFR becomes the new “market standard.” Where the lender has the authority to adjust the margin, a borrower may object to the margin adjustment as not properly reflecting the likely variance between SOFR and what LIBOR would have been.

Similarly, the timing and related procedure by which LIBOR is replaced may be a source of dispute. Since the SOFR has been shown to experience short-term spikes in value, a selection of the substituted SOFR index value within a short time period might benefit or harm each respective counterparty.⁶ For example, if the SOFR is chosen as the replacement index and it varies to any significant degree within a 30-day period, the SOFR value on the date being used to substitute for the LIBOR index may not be deemed to be “comparable” with LIBOR as of the date computed.⁷

In addition, the actual authorization of the creditor to select and substitute a replacement index might be challenged, particularly in instances in which contract language is imprecise or unclear. In such circumstances, parties might be required to agree to an independent person or entity to direct the substitution and replacement of a LIBOR index value.

C. Margin Replacement/Adjustment

When evaluating the elimination of LIBOR, the issue of margin adjustment may create the most significant legal risk for litigation, based upon several factors.

First, due to drafters’ inability to anticipate future developments, many credit documents, such as numerous standard residential mortgage documents, do not address the authority to adjust the margin value when a substitute for LIBOR is selected. Unless the timing for the substitution is fortuitous, in the absence of the contractually stated ability to adjust the margin (to reflect as closely as possible the value of LIBOR plus the margin immediately prior to the substitution), either the creditor or the borrower may suffer an adverse interest rate result. For example, in the instance in which a securitization has occurred involving variable rate instruments, the holder of securities might incur significant loss of expected income if an underlying loan pool substitutes a SOFR index for a LIBOR value without a concomitant adjustment to the margin.

Similarly, in the same manner that timing issues may affect the substituted index value, the date from which a margin is calculated may also create disputes. For example, consumer mortgage notes frequently require that an index value used to adjust the interest rate be the index value 45 or more days prior to the effective date of an interest rate change. If a substituted index value is adopted that looks back to a date for resetting a margin—yet the substituted index moves between the calculation date and the effective date of the adjusted interest rate—an change in the index that might affect the resetting of the margin might also be challenged.

Finally, industry participants and ARRC members have indicated that a “margin adjustment” might be calculated as a component of a LIBOR replacement process. While this approach is meritorious in concept, in the absence of contractual language authorizing the use of a margin adjustment legal risk is presented.

D. The Substituted Index

Although the ARRC is viewed as taking the lead adopting a consensus approach for a

substitute for US dollar LIBOR (*i.e.*, it appears to be the SOFR), the policy perspectives of many members of the ARRC may differ from those of the commercial and consumer lending industry. Stated another way, ARRC and the parties with the power to substitute indexes may disagree about whether the SOFR is an appropriate choice for a substituted index.⁸ Moreover, the ARRC's announced substitution language has been criticized as being too complicated for many categories of commercial and consumer credit transactions.⁹

As this replacement process moves forward, assuming SOFR remains the preferred alternative of the ARRC, commercial and consumer lenders not involved in the swaps and derivatives markets might consider whether other announced indices may be more suitable for their lending products and management of their cost of funds.

5. The ARRC Project Plan Checklist

As noted above, on September 19th, the ARRC released a checklist, entitled "Practical Implementation Checklist for SOFR" (the "Checklist") that might be used as part of a project plan for implementing a LIBOR substitution strategy.¹⁰ The Checklist includes the following steps a financial intermediary might consider as part of an implementation strategy:

- Establish Program Governance
- Develop Transition Management Program
- Implement Communication Strategy
- Identify and Validate Exposure
- Develop Product Strategy
- Risk Management
- Assess Contractual Remediation Impact and Design Plan
- Develop Operational and Technology Readiness Plan
- Accounting and Reporting
- Taxation and Regulation

While the Checklist may be a useful starting point for those institutions that are at the early stages of developing a LIBOR substitution plan, we note that, in our view, the Checklist is deficient in its approach. First, it appears to have been written by consultants and largely ignores the fact that the LIBOR issue itself requires a legal analysis of existing and proposed financing documents and the legal risk presented to a financial institution. Stated another way, we believe that, as an initial step in the substitution process, an institution must identify and categorize its varying degrees of litigation risk (*e.g.*, based upon the content of its financing documents) and develop a substitution strategy that addresses litigation exposure. Second, the Checklist indicates that it is focused on "banking institutions," whereas non-bank and consumer lenders are equally exposed to LIBOR-related litigation risk. Finally, as analyzed in this Alert, larger financing transactions may involve multiple layers of LIBOR-related risk, and the Checklist maybe too simplistic as an effective tool for financial intermediaries to employ.

6. Loan Document Modification

Regardless of the status of the replacement factors and the selection of a substitution index, we offer the following observations.

First, while most commercial loans (particularly non-real-estate secured credits) are of shorter term and will begin to run off sooner than other classes of commercial and consumer loans, it may be prudent to look for opportunities to clarify the index substitution provisions set forth in loan documents. In the instance in which a renegotiation would support adequate consideration for the adoption by counterparties of fulsome substitution language, from a risk perspective such a strategy might be advisable. Addressing the margin adjustment concern should be a high priority.¹¹

Second, on a go-forward basis, we suggest that a lender draft index replacement provisions that are reflective of their customer base. By this we mean that one size does not fit all. For example, the ARRC has promulgated an extensive set of commercial contract provisions—which may be appropriate for large syndicated loans but not bilateral portfolioed commercial credits. Similarly, the ARRC has recently issued language for mortgage documents—but ultimately most lenders will adopt mortgage contract modifications as issued and required by Fannie Mae and Freddie Mac.¹²

Third, several segments of the commercial and consumer loan market continue to use LIBOR as the chosen index value. Unless a lender is comfortable with the index replacement language contained in its lending documents, and particularly for longer-term transactions where the runoff period (and therefore the impact of an index substitution) may be substantial, it may be prudent to adopt a new index prior to the Effective Date to minimize the risk presented.

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Please note that this Alert is intended to reflect recent developments in the efforts by commercial and consumer lenders to address the impending elimination of LIBOR. We have not focused on the parallel developments in the derivatives market, where other considerations may predominate.

The LIBOR substitution developments discussed herein are anticipated to accelerate in the coming months; members of Dorsey's Finance and Restructuring Group are available to discuss any questions or concerns that may arise.

¹ LIBOR is calculated and announced in five currencies (CHF, EUR, GBP, JPY and USD) and seven tenors (Overnight/Spot Next, 1 Week, 1 Month, 2 Months, 3 Months, 6 Months and 12 Months) based on submissions from a reference panel of between 11 and 16 banks for each currency, resulting in the publication of 35 rates every applicable London business day. See, https://www.theice.com/iba/libor?utm_source=website&utm_medium=search&utm_campaign=spotlight.

² Among other things, the use of estimates rather than actual LIBOR transactions

diminished the market's confidence in LIBOR as a reliable baseline of interbank short-term borrowing costs.

³ <https://www.newyorkfed.org/arrc/about>. For transactions denominated in pound sterling, the SONIA has been designated as the announced replacement index. (Whether a UK-based index will experience unanticipated fluctuations in value caused by Brexit is a source of concern.)

⁴ The ARRC has issued a graphic presentation of its "Paced Transition Plan" at <https://www.newyorkfed.org/arrc/sofr-transition>.

⁵ See, <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-May-31-2019-announcement.pdf>;
<https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-Consultation-Paper-Fallback-Language-Consumer-ARM-announcement.pdf>.

⁶ It should be noted that complex syndication and securitization transactions require an analysis to correctly identify the entity (or entities) authorized to direct substitution of index procedures, including the degree to which security holders or syndicate members are required to be consulted or otherwise hold voting rights. (Further, related transaction documents such as hedge positions create the possibility that multiple index substitutions may be required.)

⁷ For example, several Fannie Mae and Freddie Mac variable rate mortgage instruments require the use of an index value in effect 45 days prior to the date an interest rate change date is scheduled to occur.

⁸ As an example of difficulties presented, this matter, the ARRC has indicated that variations in the value of the SOFR have yet to be developed and announced on a regular basis, such as weekly, monthly and yearly SOFR values.

⁹ While beyond the scope of this Alert, it should be noted that the ARRC's suggested replacement language may only be appropriate for use in very large and complicated financing transactions. For smaller dollar amount or less complicated loans, this presents lenders with a business decision whether to draft replacement language deemed acceptable to a particular market segment and transaction category.

¹⁰ See, <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-SOFR-Checklist-Press-Release-20190919.pdf>.

¹¹ In the case of the syndicated commercial loan market, the Loan Syndications and Trading Association has issued several useful interpretative and guidance documents addressing alternative approaches to index substitution language. See, <https://www.lsta.org/content/the-great-migration-away-from-libor/>.

¹² As of the date of this Alert, both Fannie Mae and Freddie Mac have not ceased purchasing Libor-based variable rate mortgage loans, and their standard LIBOR mortgage notes do not include a margin substitution provision.