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CLOs and LIBOR Transition


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Introduction

Trillions of dollars in derivatives and financial products refer to the London interbank offered rate ("LIBOR") as a benchmark rate for the calculation of floating rates of interest. LIBOR is based on an average of the rates at which selected banks, often referred to as "panel banks", determine they may borrow funds in wholesale unsecured transactions. The selection of panel banks is made every year by the Intercontinental Exchange's Benchmark Administration ("IBA"). Currently, LIBOR is calculated for seven different maturities and for five different currencies, including the U.S. dollar, the British pound sterling, the euro, the Japanese yen and the Swiss franc. A panel is made up for each currency and consists of at least 11 and a maximum of 16[1] contributor banks which are deemed to be representative of the London finance market. The time periods for which LIBOR is currently quoted are: overnight, one week, one month, two months, three months, six months, and one year.

On each business day, the panel banks submit to the administrator information as to what they expect their interest rates would be if they were to borrow funds for each maturity and for each currency in wholesale unsecured borrowings. The information is provided based on a waterfall approach generally summarised as: (1) first, submissions of weighted averages based upon actual transaction data for unsecured deposits, commercial paper and certificates of deposit satisfying criteria approved by the administrator; (2) second, if actual transaction data is not sufficient to satisfy the administrator's criteria, then submissions based on data derived from transactions, including time-weighted historical transactions adjusted for market movements and linear interpolation; and (3) third, if information is not available to satisfy the first and second levels of the waterfall, then the bank submits information based upon how it would fund itself, subject to procedures it has agreed to with the IBA.[2] After the administrator has collected the rates, the highest and the lowest submissions are eliminated (the number of eliminated submissions depends on the number of banks making submissions) and LIBOR is then calculated using the remaining middle values.[3] The value calculated is then published for use as a benchmark, or a floor interest rate, for various transactions. Because LIBOR is an unsecured benchmark rate reflecting the credit of the panel banks, in order to account for the risk component of a transaction with a less creditworthy borrower (among other factors), a lender will require the borrower to pay an additional "spread", or an additional interest amount, over LIBOR to account for, among other things, its perceived risk in providing financing and its desired rate of return. In a collateralised loan obligation ("CLO") transaction, for example, where multiple tranches of notes are issued, the spread over LIBOR will vary depending on the level of risk associated with each tranche of notes. A higher risk will warrant higher returns and, thus, a larger spread.

Where LIBOR is Used

The gross notional value of all financial products tied to the U.S. dollar LIBOR is approximately $200 trillion – or approximately 10 times the U.S. gross domestic product. That includes $3.4 trillion of business loans, $1.8 trillion of floating-rate notes and bonds, another $1.8 trillion of securitisations and $1.3 trillion of consumer loans held by about four million individual retail consumers, including approximately $1.2 trillion of residential mortgage loans. The remaining 95% of exposures are derivative contracts.[4] The figure is not surprising because LIBOR is used worldwide in a wide variety of financial products, standard interbank products like forward rate agreements, interest rate swaps, interest rate futures/options and swap options (swaptions), commercial products like floating rate certificates of deposit and notes, syndicated loans and variable rate mortgages. LIBOR is also used in hybrid products like collateralised debt obligations, collateralised mortgage obligations and a wide variety of accrual notes, callable notes and perpetual notes. Many derivative products are created, launched and traded with LIBOR as the reference rate. Finally, many types of floating rate consumer loan-related products, like individual mortgages and student loans, also use LIBOR as their reference rate. Since LIBOR was implemented, it has generally been a reliable (despite a financial crisis-era scandal discussed below) and convenient rate for market participants throughout the world to use as an interest rate benchmark. However, LIBOR-based interest rates are no longer dependably rooted in actual transactions, simply because recent trends have been towards there being relatively fewer and fewer transactions in the unsecured wholesale market.[5] Because LIBOR is based less and less on actual transactions, there is a potential for error or, even apart from error, a lack of a connection to the market which each LIBOR rate is intended to represent.

Why LIBOR is Going Away

During the financial crisis of the late 2000s, some banks were alleged to have been involved in misreporting their borrowing costs in an attempt to keep LIBOR low. Many banks reached monetary settlements with their regulators relating to the alleged manipulation of LIBOR without admissions of guilt. After the scandal, the regulators implemented certain reforms to strengthen LIBOR's credibility. One of such reforms was to replace the then-current LIBOR administrator with the IBA. The U.K. government asked the body that had been administering the benchmark during the scandal years to step aside

and introduced regulations requiring an oversight committee. The transfer of the administration of LIBOR to the IBA was completed on February 1, 2014, following authorisation by the Financial Conduct Authority ("FCA").[6]

After the financial crisis, several regulatory authorities proposed the development of alternatives to LIBOR benchmark rates. The stated reasons were not directly tied to the allegations of manipulation during the financial crisis, but, rather, based on the view that the method of calculating LIBOR was not based on actual transactions, at least not for all of the tenors and currencies for which LIBOR is quoted. To help spur the market into action, in July 2017, the Chief Executive of the FCA in the United Kingdom, Andrew Bailey, gave a speech on "[t]he Future of LIBOR" and announced the FCA's intention to cease sustaining LIBOR after 2021.[7] In that speech, Mr. Bailey indicated that the FCA's intention is not to require the panel banks to submit information for the calculation of LIBOR after the end of 2021. Without a mandate to make submissions, banks are expected to choose not to disclose their cost of borrowing, in particular to avoid liability for submitting information about rates that lack sufficient underlying transactions. Assuming that several, if not all, panel banks opt out of making information submissions after 2021, LIBOR will fail to comply with relevant International Organization of Securities Commissions ("IOSCO") principles, particularly regarding representativeness. However, the regulators understood that given the importance and substantial presence of LIBOR in the financial markets, the transition to a replacement would take time.

Proposed LIBOR Successors

In a 2019 speech, the president and chief executive officer of the Federal Reserve Bank of New York, John Williams, said "[s]ome say only two things in life are guaranteed: death and taxes. But I say there are actually three: death, taxes, and the end of LIBOR".[8] After Andrew Bailey stated that the markets should not expect LIBOR to be available beyond the end of 2021, governments and financial institutions began working to identify alternatives to LIBOR. The Financial Stability Board ("FSB")[9] and the IOSCO[10] published roadmaps for reform. Their shared principle is that benchmarks should be based on observable, arms-length transactions rather than estimates.[11]

In April 2017, a working group of the Bank of England recommended the Sterling Overnight Index Average ("SONIA") as its preferred replacement for LIBOR (sterling). SONIA is the rate that banks pay to borrow sterling overnight from other financial institutions. The Bank of England serves as the administrator for the SONIA benchmark and publishes SONIA for each business day. As of this writing, the European financial markets are working SONIA into financial contracts as a replacement for LIBOR.[12]

In the United States, the Federal Reserve convened a working group called the Alternative Reference Rates Committee ("ARRC"), tasked with facilitating the transition away from LIBOR and developing possible alternative benchmark rates. The ARRC is comprised of a diverse set of private sector entities and official sector entities. The ARRC worked with the International Swaps and Derivatives Association ("ISDA") to determine an appropriate replacement for LIBOR in derivative contracts. In June 2017, the ARRC recommended the Secured Overnight Financing Rate ("SOFR") as the appropriate replacement index for derivative contracts and other financial contracts.[13] The ARRC also published a transition plan to promote the transition to SOFR on a voluntary basis. In April 2018, the New York Federal Reserve ("New York Fed") began publishing overnight SOFR rates, and in 2019 the ARRC released recommended contract fallback language for replacement benchmark rates to replace LIBOR in certain types of transactions. The recommended language addressed floating rate notes (published in April 2019),[14] syndicated loans (published in April 2019),[15] securitisations (published in May 2019)[16] and bilateral business loans (published in May 2019).[17] Adoption of the ARRC's recommended language is voluntary, but regulators have suggested that firms begin addressing the transition away from LIBOR as early as possible.

LIBOR v. SOFR

Shifting from LIBOR to the alternative reference rates will not be a simple conversion because the alternative reference rates will not necessarily be reported in the same way that LIBOR is reported. Therefore, the transition will be very challenging and will have important long-term implications for financial products and risk management. Using the U.S. proposed alternative rate, SOFR, as an example, some of the potential challenges that the market will have to overcome include that: (a) LIBOR is a forward-looking, unsecured index that includes a relatively low "panel bank" risk premium; while (b) SOFR is a secured, backward-looking (overnight), risk-free rate (because it is secured by U.S. treasuries) which is based on actual transactions.

SOFR is based on overnight secured transactions (secured by U.S. treasuries in repurchase transactions) which, according to the New York Fed, average close to $800 billion daily. SOFR is a transaction-based rate, reflecting current financial cost. The Federal Reserve does not publish forward-looking term rates to match the terms for which LIBOR is reported, although it has set a goal of seeing an administrator produce a forward-looking term rate based on SOFR derivatives.[18] Due to the lack of a large, developed derivatives market, however, forward-term SOFR is not currently available and may not be an option at the time LIBOR is discontinued. In addition to publishing the overnight SOFR rate, the New York Fed is now publishing three daily compounded averages of SOFR: "30-day Average SOFR"; "90-day Average SOFR"; and "180-day Average SOFR", in addition to a daily index that allows for the calculation of compounded average rates over custom time periods: the "SOFR Index".[19]

The lending and derivatives markets have not yet come to consensus as to how SOFR should be calculated and implemented in loans and derivative instruments. Ideally, the method will be the same, otherwise, there might be a potential mismatch between the lending market and the hedge market. ISDA is working to add SOFR as the replacement index if LIBOR is no longer available. ISDA expects to publish revised definitions, including SOFR and SOFR-compliant language in the first half of 2020, and will also publish a protocol which will allow adherents to amend their existing ISDA contracts to comply with the SOFR standard.

In LIBOR-based financing, the interest rate is typically set at the beginning of each interest accrual period. Under this approach, as of the beginning of the accrual period borrowers know how much they will have to pay, and lenders know what they can expect to receive, at the end of the interest accrual period. ISDA methodology and one of ARRC's proposed methodologies (which, based on recent CLO proposed transition language, appears to be the preferred methodology for CLOs at this date) computes daily compounded SOFR by looking back over the reference period. This method is often referred to as "compounded SOFR in arrears". This generally means that SOFR-based financing will look back at the daily SOFR, compounded, during the reference period, so parties will not know the exact interest payment until a short period of time

before it becomes due. However, the parties should be able to track the amount as it accrues during the interest accrual period. ISDA has found that respondents to its consultations on the matter have overwhelmingly preferred the compounded setting in arrears method. However, banks have reported that significant changes will be required to their operations systems as well as loan documentation to accommodate SOFR compounded in arrears.

Another difference between LIBOR and SOFR is that SOFR is a secured rate, and given that it is secured by U.S. treasuries in overnight repurchase transactions, it is considered to be a risk-free rate. However, the LIBOR reference rate is unsecured and therefore includes an amount reflecting a risk component (which is modest because the panel banks are considered to be among the most creditworthy borrowers). The language proposed by the ARRC to transition from LIBOR as a base rate to SOFR as a base rate allows for the addition of a modifier which would adjust the base rate for the different risks associated with the two rates. In other words, the modifier would make SOFR similar to LIBOR. No modifier is required if a transaction begins with SOFR as the base rate, but, as of this writing, SOFR is typically referenced as a replacement base rate in CLOs, and not as the base rate at the outset, reflecting the reality that leveraged loans and middle-market loans are continuing to use LIBOR as their initial base rate. The ARRC has examined various methods of calculating the risk adjustment modifier; however, market participants have yet to agree on one uniform method to use. The ARRC proposed method is to adjust SOFR by utilising a spread adjustment methodology based on a historical median over a five-year lookback period calculating the difference between U.S. dollar LIBOR and SOFR.[20] It is highly unlikely the two rates can be adjusted to become exactly the same, but ARRC's goal is to level the two rates to avoid potential market disruptions.[21]

Why this Transition is an Issue for CLOs

Typically, the floating rate notes issued by CLOs reference LIBOR (usually three-month LIBOR, but in some cases one-month LIBOR) as the benchmark rate, or the "floating" portion, of the interest rate applicable to such notes. The benchmark rate is reset for each interest period (e.g., every three months if the accrual period is three months) based on the official rate calculated by the administrator and published on each applicable reset date. At the time the floating rate notes are priced, a "spread" based on anticipated risk and other factors is added to the benchmark rate for each class of notes, to establish the actual interest rate for the notes.

Legacy CLOs

CLOs that were issued prior to the announcement of the discontinuation of LIBOR typically have LIBOR fallback provisions that were intended to address the situation of a temporary problem with the reporting of LIBOR. If LIBOR is not available on the requisite screen from the administrator, then the calculation agent is required to request quotations from leading banks in the market and use the mean of the quotations obtained. If quotations cannot be obtained then LIBOR for the prior interest period shall be used for the current interest period. Therefore, if LIBOR were to cease to be available in the market, floating rate notes issued by CLOs would essentially be converted to fixed-rate notes earning interest at the last rate determined for the period prior to LIBOR ceasing to exist. In order to transition these CLOs to a base rate other than LIBOR, an amendment would be required, which would likely require 100% approval by affected noteholders. Another option for such CLOs may be to refinance all notes that use LIBOR as a base rate and to provide for a transition rate applicable to the notes that are issued in the refinancing.

LIBOR fallback during the early stages following the discontinuation announcement

CLOs issued shortly after the announcement of the discontinuation of LIBOR often added provisions to CLO indentures to address the permanent nature of LIBOR going away. Many CLOs permitted the collateral manager to select a market replacement rate with the consent of certain holders of the notes – typically, a majority of the controlling class and/or a majority of the equity class; and, in some cases, permitting the collateral manager to select a fallback rate based on either the prevailing base rate used in the underlying assets, or the prevailing base rate used in recent (e.g., preceding three months) new issue or refinanced CLO transactions. This approach would avoid the problem of having to either use the last LIBOR rate determined as discussed above under *Legacy CLOs* and also avoid the problem of having to obtain consent from all affected noteholders to change the interest rate on the notes.

ARRC-tailored approach as applied to recent CLO transactions

Among several proposed ARRC replacement language approaches, the "hardwired" approach with some variations seems to be the approach a majority of CLOs are currently adopting. The original "hardwired" approach specifies a fallback waterfall of particular replacement rates that can be implemented in the CLO without investor consent. However, most CLOs using this approach allow collateral managers, with the consent of the majority of the controlling class and/or a majority of the equity, to implement a replacement rate other than the rate produced by the fallback waterfall. On the one hand, such hybrid approach provides for a level of certainty in the future. Because the "hardwired" approach serves as a basis for this method, the CLO manager can always fall back on the waterfall and pick the rate determined by such waterfall. On the other hand, such hybrid approach still allows for some flexibility on the part of collateral managers to choose, with the consent of certain investors, a different base rate. Such flexibility minimises the potential for basis risk.

Basis risk

For CLOs, the underlying floating rate collateral assets/loans which use LIBOR as a benchmark rate typically follow a procedure to set LIBOR at the beginning of each accrual period similar to the one described for CLO notes, although the tenor may be different, and fallback rates typically follow a different convention if LIBOR is not available. The current convention in U.S. loan documentation is likely to replace LIBOR with the higher of the prime rate referenced in the loan documents or the federal funds rate. In some loans there may also be an adjustment to the spread based upon which alternative base rate applies to the underlying loan when LIBOR is not available. If LIBOR is discontinued as a benchmark rate, it is uncertain whether broad replacement conventions in the leveraged loan markets will develop and, if conventions do develop, what those conventions will be and whether they will create adverse

consequences for CLO issuers or holders of CLO notes. The risk that there will be a difference between the benchmark rate payable on a CLO's liabilities and the benchmark rate received on the CLO's assets is commonly referred to as "basis risk". Basis risk may negatively affect a CLO manager's ability to effectively mitigate interest rate risks.

Given the expected move away from LIBOR at the end of 2021, new-issue CLOs have started including the hard-wired fallback language published by the ARRC as described above. However, equity investors and portfolio managers have been concerned with the potential for basis risk. Even if the loan market and the CLO market were in perfect sync and produced the same replacement rates, a difference in the timing of such implementation could still produce basis risk during the transition period. To avoid the possibility of a basis rate mismatch between the rate used to calculate interest on CLO notes and the rate used for determining interest on CLO assets, some new-issue CLOs have included the option to switch to a base rate which is utilised by at least 50% of such CLO's collateral obligations. The fallback options for such CLOs include the usual base rates (i.e., Term SOFR, Compound SOFR, etc.), but also the rate that either satisfies the 50% threshold for the collateral obligations or the rate that is used by the majority of recent newly issued or recently amended CLOs.

Potential for Litigation

Michael Held, executive vice president and general counsel of the Federal Reserve Bank of New York, has recently called the LIBOR transition a situation that invites litigation or more precisely a "DEFCON 1 litigation event".[22] Held warned market participants of an upcoming litigation tornado in connection with trillions of dollars in existing contracts being forced to switch over to alternative base rates. It is essential for market participants to be aware of the litigation risks associated with the LIBOR transition. Finding an appropriate fallback rate is half the battle. The transition should also involve a careful review of all relevant contractual provisions.

Parties adversely affected by the LIBOR transition may attempt to avoid or modify their contracts using an equitable defence of impracticability or *force majeure*. The discontinuation of LIBOR may not fit neatly within the category of impracticability or *force majeure*, but if a fallback rate results in an unintended value transfer to a party at the expense of another after LIBOR is discontinued, the harmed party may argue that the discontinuation of LIBOR rises to the threshold of impracticability or *force majeure* because it interferes with interest rates, expected returns on investment or, in the case of borrowers, their financial obligations on a loan.

Proposed legislative solution

On March 6, 2020, the ARRC published a potential legislative response to the LIBOR transition titled "Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR transition".[23] The ARRC reiterated that most contracts relying on LIBOR either do not have robust alternatives built into the contract or include the fallback rates that might dramatically change the economics of the particular transaction. Despite the development of several flexible approaches to amending financial contracts, such amendment process may still be challenging and lead to value transfer and potential litigation, as described above. Because the vast majority of financial contracts are governed by New York law, the ARRC is proposing that New York State legislators adopt a legislative response to the discontinuation of LIBOR and possible transition options.

The ARRC stated in its proposal that the legislation will need to: (1) prohibit a party from refusing to perform its contractual obligations or declaring a breach of contract as a result of the discontinuance of LIBOR or the use of the statute's recommended benchmark replacement; (2) definitively establish that the recommended benchmark replacement is a commercially reasonable substitute for and a commercially substantial equivalent to LIBOR; and (3) provide a safe harbour from litigation for the use of the recommended benchmark replacement. The proposed legislation would achieve these goals by requiring the use of the recommended benchmark replacement where the contract language is silent or the fallback provisions prescribe the use of LIBOR. Where the fallback provisions are discretionary, the proposed legislation's safe harbour is intended to encourage the selection of the recommended benchmark replacement.

The proposed legislation, however, would not impact legacy contracts that have fallback provisions to a non-LIBOR replacement rate (such as the prime rate).[24] Therefore, the legislation would not affect loan contracts that, for example, default to the prime rate or federal funds rate if LIBOR is not available. The legislation will, however, on a mandatory basis, override any legacy language falling back to a LIBOR-based rate (such as last-quoted LIBOR), unless all parties opt out of the application of the statute, in writing, at any time before or after the occurrence of a trigger event. Moreover, if a contract allows parties to exercise discretion in choosing an alternative rate, the parties may avail themselves of the statute or select the fallback rate proposed by the legislators. The legislative proposal might bring more certainty and clarity into the contract that lacks the replacement language or still rely on LIBOR-based rates.

The ARRC's proposal will be most beneficial for the financial contracts which currently do not have any benchmark replacement provisions (typically, contracts executed before 2018).

There are several potential obstacles that the proposed legislation may face in the future. Section 316(b) of the Trust Indenture Act of 1939[25] prohibits any impairment to a holder's right to "receive payment of the principal of and interest on such indenture security, […] without the consent of such holder". The legislation proposed by the ARRC will arguably violate that right and mandate an interest rate that will diminish the interest payments. Moreover, the ARRC legislative proposal will most likely suggest a SOFR-based benchmark, which might be ill-suited for certain types of financial products as discussed above, at which point parties will be able to opt out of the statute and negotiate a new rate. There are no guarantees that such new rate will not lead to the very issues the ARRC proposal is designed to address: adverse economic impact on some investors; and legal uncertainty.

The ARRC legislation proposal would not apply to recent CLO indentures which include the ARRC hardwired approach or "hybrid" approach described above. However, the ARRC proposal may be helpful for legacy CLOs which do not have a non-LIBOR-based fallback.

Conclusion

Since the FCA's announcement that it would not take action to sustain LIBOR after 2021, regulatory groups and market participants have proposed measures to address the transition to a replacement base rate. For transactions in British pound sterling and the U.S. dollar, SONIA and SOFR, respectively, have been proposed as replacement base rates. As of the date of writing this chapter, the transition to SONIA appears to be further along than the transition to SOFR. For the U.S. CLO market, the transition will be facilitated if the leveraged loan market implements SOFR as a standard base rate.

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Aviation Law
Business Crime
Cartels & Leniency
Class & Group Actions
Competition Litigation
Construction & Engineering Law
Consumer Protection
Copyright
Corporate Governance
Corporate Immigration
Corporate Investigations
Corporate Tax
Cybersecurity
Data Protection
Derivatives
Designs
Digital Business
Digital Health
Drug & Medical Device Litigation
Employment & Labour Law
Enforcement of Foreign Judgments
Environment & Climate Change Law
Family Law
Financial Services Disputes
Fintech
Foreign Direct Investment Regimes
Franchise
Gambling
Insurance & Reinsurance
International Arbitration
Investor-State Arbitration
Lending & Secured Finance
Litigation & Dispute Resolution
Merger Control
Mergers & Acquisitions
Mining Law
Oil & Gas Regulation
Outsourcing
Patents
Pharmaceutical Advertising
Private Client
Private Equity
Product Liability
Project Finance
Public Investment Funds
Public Procurement
Real Estate
Renewable Energy
Restructuring & Insolvency
Sanctions
Securitisation
Shipping Law
Telecoms, Media & Internet
Trade Marks
Vertical Agreements and Dominant Firms
Workplace Pensions

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