SUCCESSOR RATE PROVISIONS FOR LIBOR IN U.S. CREDIT AGREEMENTS

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Legal Briefings – By **Gabrielle Wong and Ahu Yalgin**

DISCONTINUATION OF LIBOR

It has been well documented that the Financial Conduct Authority will be phasing LIBOR out by 2021. Yet despite this being first announced in 2017, the market continues to be in flux on the preferred approach for LIBOR successor rate provisions.

In the U.S., the Loan Syndications and Trading Association (LSTA) is still consulting on the relevant replacement language. To date, it has not landed on a single preferred convention for establishing rules for pricing loans at successor rates. We note, however, that the U.S. syndicated loan market is more reliant on agreed precedents and bank forms rather than the equivalent of the form documentation published by the Loan Market Association.

The Alternative Reference Rates Committee (ARRC) Business Loans Working Group, co-chaired by the LSTA and the American Bar Association, is currently engaging with its members as it develops a LIBOR successor recommendation for U.S. dollar syndicated loans. Two approaches have been suggested. The first is an "amendment" approach (providing an efficient amendment mechanism for negotiating a replacement benchmark) and the second is a "hardwired" approach in that it does not rely on amendments, but provides more clarity upfront by setting out a specified waterfall of replacement benchmark rates starting with a forward looking term Secured Overnight Financing Rate (SOFR) plus a spread adjustment.

SOFR – HOW SIMILAR IS IT TO LIBOR?

SOFR, as a recommended alternative to LIBOR, measures the cost of overnight cash borrowing, using U.S. Treasury Securities as collateral. There are a few features to SOFR which are challenging for the existing loan pricing framework, outlined as follows:

i. as SOFR is designed to be relatively risk-free (because of the security aspect), it is lower than LIBOR (which is unsecured);

ii. it is an overnight rate and is backward-looking rather than forward-looking (which is the case for LIBOR);

iii. it is not a term rate whereas LIBOR offers rate quotes for various durations;

iv. LIBOR reflects banks' credit risk and cost of funds whereas SOFR does not reflect cost of funds; and

v. in periods of credit stress, SOFR narrows whereas LIBOR widens.

LIBOR and SOFR may behave very differently but there is an expectation in the market that SOFR will be further developed to address these challenges, with market participants cognizant of the price differentials that the use of SOFR may lead to.

MARKET'S POSITION ON THE SELECTION OF REPLACEMENT RATES

Prior to the announcement of the phasing out of LIBOR, credit agreements in the U.S. syndicated loan market had an established fall-back pricing at an alternative base rate to manage the risk of LIBOR becoming temporarily unavailable. However, the alternative base rate is more expensive than LIBOR and is only intended to address a temporary situation. This means borrowers will find it unappealing as a permanent solution and it is unlikely that any borrower would agree to permanently default to this solution without seeking amendments.

With this in mind, a number of alternative approaches on the selection of LIBOR replacement rates have been seen in loan documentation:

i. Agent, alone, selects the successor rate: this option is the least preferred by both borrowers and lenders as neither party would be able to approve the successor rate.

ii. Agent chooses the successor rate in consultation with the borrower without any lender consent required: this approach is not popular with the lenders as they would have no control over the LIBOR replacement rate. Borrowers also oppose this approach as they would only have consultation rights rather than being able to veto the LIBOR replacement rate suggested by the agent.

iii. Agent and borrower together approve the successor rate without further input from the lenders: seen on strong sponsor deals, this approach is equally opposed by the lenders as option (ii) above.

iv. Agent and borrower determine the successor rate, with "Required Lenders" being given negative consent rights (and the Required Lenders would be deemed to have agreed to such successor rate if they do not object within a certain period of time): some lenders may feel uncomfortable with this approach arguing that unanimous lender consent should be required for amending LIBOR. However, a 100% lender vote requirement would, in practice, likely be unworkable.

WHAT DOES THIS MEAN?

It is evident that LIBOR will not continue post 2021. In the immediate term banks are increasingly reluctant to submit LIBOR rates as they are unwilling to reveal their cost of funds. SOFR is a combination of 3 overnight U.S. Treasury rates, with a large volume of trading – so, it is more liquid, robust and difficult to manipulate (unlike LIBOR).

Whilst the market remains unsettled, the definitions and amendment sections of syndicated credit agreements warrant careful review by the lenders and investors, as well as the borrowers who need to be wary of these provisions when negotiating them. The market is constantly evolving so lenders and borrowers should be vigilant, keeping abreast of the developments to be able to choose the most appropriate successor rate provisions as the time draws near. It may be even be more efficient and wiser to start hardwiring some alternatives in new credit agreements as developments become more concrete rather than go through a burdensome amendment process post 2021 when LIBOR ceases to exist.

For further information on the ever-evolving LIBOR landscape and the effect this will have on New York law-governed financings please contact Gabrielle Wong or Ahu Yalgin.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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