Leaving LIBOR

How to draft a credit agreement in the Latin American loan market before LIBOR's replacement is available

With calls to phase out the scandal-ridden LIBOR by the end of 2021 and the potential size of the disruption this will cause, loan market participants should be prepared. **Sabrena Silver**, partner, and **Simon Cassell**, associate, of global law firm White & Case, explain.

Regulators, banks and other market participants are grappling with the many challenging questions that transitioning to alternative benchmarks brings about: What will be the consequence of the London Interbank Offered Rate (LIBOR) discontinuation in the context of credit agreements both in the Latin American loan market and in the New York loan market? What will be the proposed replacement benchmark rate? And how will the current trends in loan documentation and in the New York market address this change as they apply to loans in the Latin American market?

What is LIBOR, and why are we leaving it?

LIBOR is the most widely used benchmark for short-term interest rates, including for US-dollar loans in the New York market, and among the most widely used for short-term interest rates in the Latin American market. LIBOR rates are published for US-dollars, British pounds sterling, Euros, Japanese yen, and Swiss francs at seven different maturities ranging from overnight to one year. LIBOR is an indicative average interest rate at which a panel of 11 to 18 banks (chosen by the ICE Benchmark Administration, which has responsibility for administering LIBOR) indicate that they are prepared to lend funds on an unsecured basis to one another in the London money market.

US$350tn

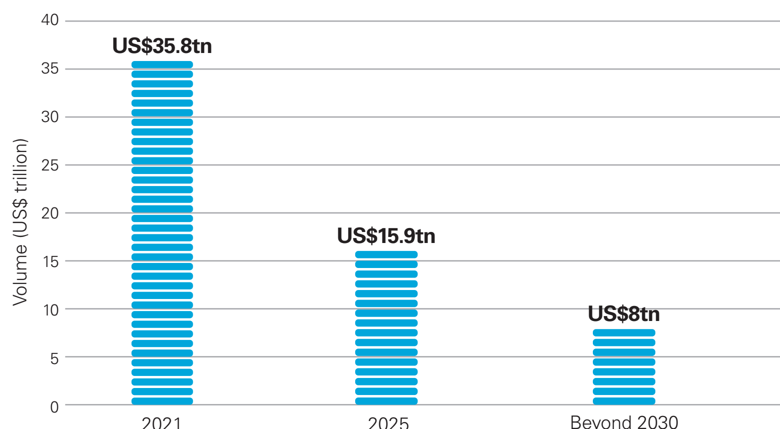
LIBOR underpins an estimated US$350 trillion worth of financial contracts worldwide

Source: Various market estimates, PwC

In 2012, it came to light that certain of the panel banks had been manipulating LIBOR rates by adjusting the rate they reported to the British Banker's Association (ICE Benchmark Administration's predecessor) in order to achieve an advantage in their trading positions or to improve the perception of their creditworthiness. Since then, the current method of determining LIBOR, based on indicative quotes, has been widely criticized for being without a basis in actual transactions, and there has been extensive discussion of a replacement benchmark. Unfortunately, basing LIBOR on actual transactions has proven difficult, because there are insufficient transactions at each panel bank for each maturity in each currency on each day. As a result, the LIBOR panel banks are still forced to exercise considerable judgment when submitting their rates.

In a speech on July 27, 2017, Andrew Bailey, chief executive of the Financial Conduct Authority (the UK governmental agency charged with regulating LIBOR), publicly called for LIBOR to be discontinued and replaced by the end of 2021. In particular, he acknowledged the panel banks' reluctance to continue to quote LIBOR, as banks have become weary of the potential legal risk and liability in quoting

US$ LIBOR-related notional outstanding 2021 and beyond (as of 2016)



Source: BlackRock calculations, NYFRB, Second Report of The Alternative Reference Rates Committee, March 2018

LIBOR. The Financial Conduct Authority has persuaded the panel banks to continue their roles through the end of 2021, with the goal of completing a transition from LIBOR to a replacement benchmark rate by that date.

SOFR: Another fish in the sea?
For US-dollar loans, currently the most-commonly proposed replacement for LIBOR is the SOFR (Secured Overnight Financing Rate), which is published by the New York Federal Reserve and is a measure of the cost of borrowing cash overnight secured by US Treasury securities. SOFR addresses two concerns with LIBOR. One, it is based on actual and abundant transactions, currently approximately US$800 billion in transactions. Two, the rate is provided by the New York Federal Reserve, removing the ability of panel banks to manipulate the rate and obviating the dependence on the willingness of a panel of banks to participate.

Unfortunately, however, SOFR raises challenges as a potential replacement of LIBOR due to two fundamental differences between SOFR and LIBOR. First, SOFR is an overnight rate only. It does not provide an indicative fixed rate for the longer LIBOR maturities. Second, SOFR is a secured rate and does not include the spread related to bank credit risk that is currently built into LIBOR, which is the rate at which banks will lend to each other on an unsecured basis. Given these fundamental differences between SOFR and LIBOR, market participants are concerned that the replacement of LIBOR with SOFR will ultimately cause potentially economically significant changes in the interest rates payable on loans for which LIBOR currently functions as a benchmark rate.

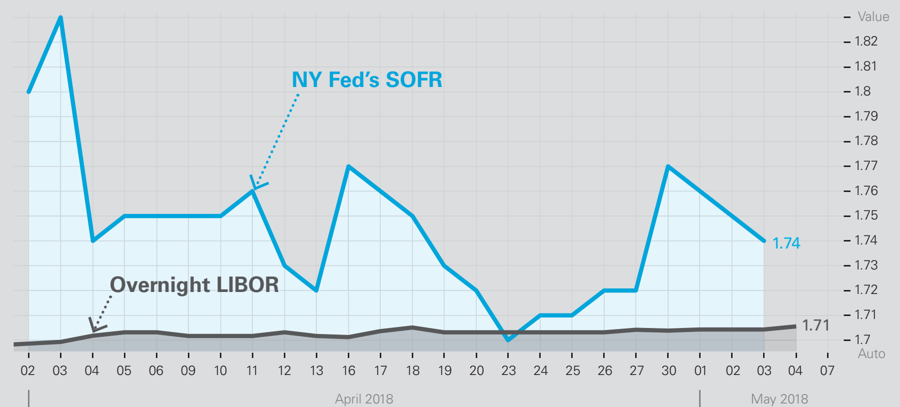
The Alternative Reference Rates Committee ("ARRC," a working group convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York) has set itself the goal of the development of forward-looking term rates based on SOFR derivative markets, but no such rates have been proposed as yet.

Other alternatives have been proposed for different currencies, such as SONIA (Sterling Overnight Index Average) for British pounds sterling, and TONAR (Tokyo Overnight Average Rate) for Japanese yen, and they all have similar concerns.

A potential suitor hiding in plain sight?
Almost every loan agreement in the New York market—and some, but not all in the Latin American market—provides that a base rate, a daily floating rate that is typically the highest of either the Federal Funds Rate plus a spread, one-month LIBOR plus a spread, and a "prime" rate, would be available in the absence of LIBOR. Unfortunately, the use of a base rate is not an adequate solution because it is usually a higher rate than LIBOR, and a base rate does not allow the borrower to fix the interest rate for a given period of time, as it is a daily floating rate.

In loan agreements that include the base rate option, the base rate could potentially function as a temporary safety valve in the event that LIBOR is discontinued, providing a well-established and orderly

New reference rate has a choppy start



Source: *Thomson Reuters*

Given the uncertainty surrounding a benchmark rate that will replace LIBOR, there is still no clear market standard for addressing the anticipated disappearance of LIBOR or its replacement in loan documentation.

mechanism for determining the interest rate at least on a temporary basis while the borrower, the administrative agent and the lenders negotiate a LIBOR alternative.

Unfortunately, due to a difference in market practice from the broader New York loan market, many LatAm loans do not typically have a "base rate" option, so this safety valve may not be available in those financings. As a result, many LatAm loans may not have a clear mechanism for even a temporary solution in the event that LIBOR is discontinued (rather than just temporarily unavailable). As such, particular attention should be applied to this issue in Latin America.

Loan documentation: Keeping our options open

Given the uncertainty surrounding what benchmark rate will replace LIBOR and the related economics, there has not yet emerged a clear market standard or practice for addressing the anticipated disappearance of LIBOR or its replacement in loan documentation.

Four key documentation trends to be considered in all new loans and in significant amendments to existing loans

1 Who determines that a new rate is necessary and on what basis?

The first element that must be addressed is who determines, and on what basis, that LIBOR should be replaced with a successor rate. According to a survey done by *Practical Law Finance*, 66 percent of credit agreements specified that the administrative agent determined when a successor rate should be used, with the remaining 34 percent specifying that the administrative agent should make such determination with the borrower and/or the required lenders.

There are a number of formulations for the basis on which such determination should be made, but they usually rely on a combination of some or all of the following triggers:

a. The administrative agent being unable to ascertain LIBOR due to circumstances that are unlikely to be temporary

b. A public statement by a relevant regulatory authority that LIBOR shall no longer be used

c. Syndicated loans are no longer being executed that refer to LIBOR, but instead a new benchmark interest rate is being used

2 Who determines what the new rate should be?

Given the uncertainty surrounding the replacement rate, and the inability at this time to describe the replacement rate, the credit agreement should specify which parties to the agreement should select the new rate once the necessity of the new rate has been determined. The US loan market seems to be settling on the new rate being chosen by the administrative agent and the borrower (occasionally formulated instead as "by the administrative agent with the consent of the borrower").

3 Is lender approval required?

As changing the benchmark rate will affect, and potentially lower, the interest rate paid by the borrower, this kind of amendment would normally require the consent of every affected lender. To avoid the administrative obstacle and ensure that the parties will be able to implement a replacement rate, the approach being taken in most deals is to make clear that an amendment implementing a replacement rate does not require the consent of every affected lender and to provide a negative consent right, where at least a majority or super-majority of lenders must object to the change within a specified period of time to prevent implementation of the replacement rate.

4 Are the lenders' economics protected?

Some credit agreements also build in protections around loan economics to provide comfort to the lenders that the economics of the loan will not change fundamentally upon LIBOR replacement. Typically this at least includes a floor to the replacement index, and we have also seen in two deals from the first quarter of 2018 a prohibition on the reduction of the margin that is applied on top of the new index benchmark.

However, certain key documentation trends appear frequently, which we discuss below.

On September 24th of this year, ARRC released for public consultation two proposed documentation approaches. The first is an 'amendment approach' that lays out a framework for expediting an amendment in response to the replacement of LIBOR. The second is a 'hardwired approach' that, upon the replacement of LIBOR, sets up a waterfall of different SOFR-based benchmarks that would be used depending on whether they are available at that time. The 'amendment approach' is based on current market practice and broadly addresses the same issues as the key documentation trends that we identify . The 'hardwired approach', in contrast, does not seem to have been adopted by the market, but perhaps suggests a potential direction when there is more certainty around the replacement benchmarks.

US$9bn

Approximate cost incurred by banks in LIBOR-related penalties globally

Source:
The Financial Times

Bouncing back from the breakup

At this stage, it is not possible to predict the effects of replacing LIBOR as the benchmark rate, or where the market will settle once it happens. But 2021 is fast approaching, and given the potential size of the disruption this will cause, loan market participants should be prepared. Best practice, and the current direction of market standards, is to maintain flexibility in the solution while providing clarity on the process of implementing a replacement. Implementing now clear mechanisms and procedures for who determines when LIBOR must be replaced and on what basis, who determines what the new rate will be, whether lender consent is required and what fundamental protections on economics are included will greatly facilitate an orderly transition to our new benchmark rate partner. ■

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