SYNDICATED LOANS AND LIBOR FAQs - MAY 2018

What is the "problem" with LIBOR?

During the financial crisis, allegations of manipulation of LIBOR led to banks paying billions of dollars of fines and people going to jail. Since then, banks have reduced their interbank funding (LIBOR) borrowings. As a result, there is only about $500 ***million*** of daily three-month interbank (e.g., LIBOR) trading. These trades are the informational foundation of the LIBOR quotes submitted by banks. These quotes, in turn, are used to create the LIBOR curve – and this LIBOR curve is used to price $200 ***trillion*** of contracts. If something were to happen to LIBOR – like it suddenly ceased – there potentially could be significant issues for those $200 trillion of contracts.

Is LIBOR "going away" after the end of 2021?

It's possible. Due to potential legal liability and the small number of actual interbank trades, banks don't particularly like providing LIBOR submissions. For now, the panel banks have agreed to continue their LIBOR submissions through 2021, but the UK Financial Conduct Authority (FCA) has said they would not compel banks to submit LIBOR thereafter. At that point, banks may or may not submit LIBOR and LIBOR may or may not continue.

What might replace LIBOR?

In the U.S., the Alternative Reference Rates Committee ("ARRC") has identified the Secured Overnight Financing Rate ("SOFR") as the LIBOR replacement for derivatives. SOFR is the combination of three overnight treasury repo rates. It is very liquid and very deep, with more than $700 billion of trading on a daily basis. This means that it will likely be robust, durable and hard to manipulate – all alleged shortcomings of LIBOR. It is quite possible that SOFR may become the replacement rate for cash products, like syndicated loans and CLOs.

How are SOFR and LIBOR different?

SOFR and LIBOR are quite different. SOFR is an overnight, secured risk-free rate, while LIBOR is an unsecured rate with a term curve (overnight, one week, one month, two months, three months, six months and one year). Because LIBOR is unsecured and includes an element of bank credit risk, it will be higher than SOFR and prone to widen when there is severe credit market stress. In contrast, because SOFR is secured and risk-free, it should be lower than LIBOR and may stay flat (or potentially even tighten) in periods of severe credit stress. Thus, the two rates may behave differently.

Will a SOFR "term curve" be developed?

Yes. SOFR futures began trading in May 2018, and a term SOFR curve should develop quickly. In addition, ARRC expects a "SOFR term reference rate" to develop before the end of 2021. Thus, both

lenders and borrowers would be able to use a forward looking curve when pricing loans and CLO notes.

Will SOFR be adjusted to behave more like LIBOR?

Because SOFR is a secured, risk-free rate, it may never behave exactly like LIBOR. However, market participants are working to develop a “credit spread adjustment” (“CSA”), which would look to bridge the gap between LIBOR and SOFR. There are three different potential types of CSAs being discussed. The first is simply a static CSA, which would try to measure the difference between LIBOR and SOFR either at cessation, for a period of time before cessation, or on a forward looking basis. Once calculated – probably around the time of LIBOR cessation – the static CSA wouldn’t change. Another approach under discussion is a “dynamic CSA”, which would attempt to measure the difference between LIBOR and SOFR on an ongoing basis. (While likely more accurate, a dynamic CSA is very complicated and may also have some of LIBOR’s shortcomings.) The third option is a static CSA with a “break the glass” component; in effect, if there is considerable credit market stress – as measured by an external variable – a temporary additional spread could be added to the CSA to account for the credit stress.

How should loan documents evolve for a potential cessation of LIBOR?

Loans tend to be relatively short-lived, are easily refinanced or amended, and already have a “fallback” to Prime if LIBOR were to cease to be published. For this reason, syndicated loans are in better shape than many other asset classes (many of which have longer tenors, limited fallbacks and are hard to amend). However, loans and CLOs still have their work cut out for them.

First, all legacy documents should be reviewed to understand existing fallback language and amendment flexibility. Second, new or amended documents should contemplate the transition to a new benchmark should that be necessary. The existence of Prime as an ultimate fallback means that, unlike other asset classes, the loan market would not seize up if LIBOR were to cease. However, the Prime Rate is more than 200 bps above LIBOR, so it could become a hardship for borrowers.

Recognizing that falling back to Prime may be a non-optimal outcome – but also realizing that it is currently challenging to fall back to a SOFR-based rate – borrowers and lenders currently are structuring language that will more easily facilitate a transition to a new reference rate. This language typically permits the agent or the borrower to identify a new reference rate (sometimes with a credit spread adjustment) and shift to the new rate (often with an objection right for the lenders). While this will be more efficient than a 100% lender vote, it may still be unwieldy if thousands of credit agreements must go through this process simultaneously.

Once the prerequisites – such as term SOFR and a CSA – are in place, it may be more effective to “hardwire” a transition to a new reference rate. A hardwired approach could have the documents identify: i) a trigger event (like the cessation of LIBOR), ii) a new reference rate (potentially SOFR) and iii) a credit spread adjustment. If the trigger event occurred, then the reference rate in the credit agreement would automatically flip to SOFR+CSA. If structured appropriately, there should be

minimal value transfer – and the process would be automatic and would forestall any disruption in the loan market.

What else does the loan market need to do to prepare for a potential cessation of LIBOR?

In reality, the loan market does not exist in isolation. Many loans have embedded hedges and are held in CLOs. In an ideal world, any transition from LIBOR to a new reference rate might occur simultaneously for the loan, hedge and CLO. In reality, the transition will likely be messier; however, market participants should consider the impact on other nearby markets and seek to minimize disruption.

Making the language of credit agreements (and CLOs) work in a potential LIBOR cessation environment is critical. However, market participants also have to consider other issues, like tax and accounting ramifications and operational challenges. Once a new reference rate (and potential credit spread adjustment) is identified and published, agent systems need to be recoded to calculate interest payments based on the new rates. The way the loan market calculates delayed compensation will also change as the reference rate changes. In addition, issues like multicurrency facilities will be particularly challenging.

Is this process only happening in the U.S.?

No. Several jurisdictions are undertaking similar transitions away from their relevant currency IBOR to an overnight risk free rate. In the UK, Reformed SONIA (Sterling Overnight Interbank Average Rate) has been identified as the appropriate replacement for GBP LIBOR. In Switzerland, SARON (Swiss Average Overnight Rate) has replaced the TOIS benchmark. In Japan, TONAR (Tokyo Overnight Average Rate) has been selected as the alternative to yen Libor. Finally, the European Central Bank is developing a daily euro unsecured overnight index rate. Some of these risk free rates, such as SONIA, are unsecured, while others, such as U.S.'s SOFR, are secured. In the context of multicurrency facilities, market participants should recognize that different currencies may transition to alternative rates at different times and the different alternative rates may require different adjustments.

To facilitate an orderly transition, a number of global financial trade associations are collaborating to help ensure that there is coordination across jurisdictions and across asset classes.

In conclusion…Onward!

There are a number of challenges to transitioning to a new reference rate and there is relatively little time to do it. Importantly, the transition will be a market-driven process. We firmly believe that if market participants recognize the challenges and mobilize now an orderly transition is doable. We encourage you to join our efforts. For more information, please contact LIBORinformation@lsta.org. LSTA LIBOR team leaders are Meredith Coffey (mcoffey@lsta.org) for policy, Tess Virmani (tvirmani@lsta.org) for documentation and Ellen Hefferan (ehefferan@lsta.org) for accounting and operations.