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CLIENT MEMORANDUM

Fed Panel Floats New Floater Fallback Language to Address Future Loss of LIBOR

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Proposal addresses financial industry concerns over current fallback language when LIBOR is discontinued

The US dollar London Interbank Offered Rate, known as LIBOR, is today the most common reference rate or benchmark used to set interest rates on floating-rate notes (FRNs) issued in the US capital markets. As originally conceived, LIBOR was set through a survey of prime banks for the interest rates at which they could borrow in the London interbank market, and as such was intended to approximate major lending banks' average cost of funds. The British Bankers Association (BBA) took responsibility for calculating LIBOR in the mid-1980's, and over the following three decades use of the benchmark proliferated throughout the US financial system, becoming embedded not only in capital markets debt, but also in syndicated loans, mortgages, credit cards, securitizations and swaps, options and other derivatives. During the 2007-2008 financial crisis, however, LIBOR began to behave unexpectedly compared to other market benchmarks, and UK and US regulators and prosecutors began to scrutinize the benchmark and how it was calculated, ultimately concluding that it was subject to manipulation. In 2012, UK financial regulators decided that responsibility for calculating LIBOR should be transferred from BBA to an independent third party, and after a competitive tender process, ICE Benchmark Administration (IBA) assumed responsibility for LIBOR in 2014. US and UK regulators remained concerned that LIBOR was not a reliable benchmark given the relative lack of underlying transactions in the interbank lending market that LIBOR was meant to measure. Accordingly, in July 2017, the UK Financial Conduct Authority (FCA), the UK benchmark regulator, announced that it would no longer "persuade, or compel" banks to submit LIBOR quotations after 2021, which is expected to result in the permanent cessation of LIBOR.

Meanwhile, US corporates have continued to issue FRNs that use LIBOR as the base rate, with the actual interest rate determined by adding a fixed spread to the prevailing LIBOR base rate. The language most commonly used in FRN indentures contemplates the potential unavailability of LIBOR for this purpose, but relies on a fallback procedure that many market participants fear will not work well when put to the test—a process of manually soliciting rate quotes from a handful of banks in the London market and then relying on the judgment of the issuer, a calculation agent or both to formulate the base rate. Even if this process were to work as intended, it would be likely to produce base rates that differ from issuer to issuer, causing confusion in the market, and would also likely create a mismatch between rates paid by an issuer on its FRNs and rates received by the same issuer under any related hedges. However, if LIBOR has been discontinued, many market participants believe that it will be difficult or impossible to obtain these quotes from banks in the London market. If this manual process does not yield a rate, most FRN indentures simply stipulate that the previously applicable LIBOR rate continues. In effect, the current fallback would turn a floating-rate instrument into a fixed-rate instrument, a result that market participants view with concern.

Seeking to head off any market disruption that might occur when LIBOR becomes unavailable, on April 25 the Alternative Reference Rates Committee (ARRC), an industry-wide panel convened by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York, published its **Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Floating Rate Notes**, a proposal with model FRN indenture language intended to dovetail with corresponding recommendations for syndicated loans, bilateral business loans, securitizations and ISDA derivatives. Adoption of the model fallback language contained in ARRC's recommendations is voluntary

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and will be decided on an issuer-by-issuer, deal-by-deal basis, although within a few days of the proposal's release, the language appeared in a fixed-to-floating issue offered by **JPMorgan Chase & Co**.

ARRC FRN Fallback Language

The ARRC fallback language for FRNs is based on a reference rate that ARRC announced as its recommended alternative to US dollar LIBOR in 2017, the Secured Overnight Financing Rate, or SOFR. SOFR is intended to be a broad measure of the cost of borrowing cash overnight collateralized by US treasuries and, as such, looks to interest rates charged in the overnight US treasury repo market, as calculated each business day by the New York Fed. Because SOFR is a secured, overnight rate but LIBOR is an unsecured rate and FRNs typically reset on a one, three or six-month basis, the ARRC language contemplates an adjustment to SOFR to make it more comparable to the rates market participants would have relied on when setting interest periods using one, three or six-month LIBOR, and addressing the fact that LIBOR is an unsecured bank rate and not a secured government rate.

The ARRC fallback language establishes a waterfall of LIBOR replacement options that would be triggered by a "benchmark transition event"—essentially a public statement by IBA, FCA, the Fed or a court that the cessation of LIBOR has occurred or is expected to occur, or a public statement by FCA that LIBOR is no longer "representative," which is a determination that FCA is charged with making under the EU Benchmarks Regulation. On the effective date of the benchmark transition event, all references to LIBOR in FRNs that contain the model fallback language would instead refer to the "benchmark replacement," which would then govern the relevant FRNs to maturity, unless the replacement itself later needed to be replaced.

The first step in the waterfall contemplates a partial discontinuation of LIBOR, where some but not all LIBOR tenors are affected by the initial benchmark transition event. In that case, the benchmark replacement is simply interpolated between the nearest LIBOR tenors that have not been affected. If interpolation is not possible, the waterfall continues through the following steps, in turn:

- term SOFR + adjustment
- compounded SOFR + adjustment
- other benchmark rate recommended by the Federal Reserve or New York Fed + adjustment
- ISDA fallback rate + adjustment
- other benchmark rate selected by the issuer, "giving due consideration" to any industry-accepted replacement rate + adjustment

Term SOFR, which is under development but expected to be available prior to LIBOR's discontinuance, is intended to be a forward-looking term rate based on SOFR for the applicable interest period that is announced daily by the New York Fed, and compounded SOFR is a compound average of SOFR rates over the applicable interest period. The adjustment is the spread recommended by the New York Fed to adjust term or compounded SOFR in connection with the transition from LIBOR; if the New York Fed fails to make a recommendation, the model adjustment language also contains a waterfall. Detailed descriptions of term SOFR, compounded SOFR, the adjustment and the other constructs in the replacement waterfall can be found in the ARRC's **recommendations**.

Next Steps

A company contemplating an FRN issuance in the near future will need to monitor the market to see whether ARRC's proposal begins to gain widespread acceptance, and if so whether the company's existing LIBOR replacement language has begun to look off-market and should be switched to the ARRC model in order to ensure smooth deal execution. Timely consultation with bankers and counsel should help minimize any delays to the deal timetable caused by needing to revise language in prospectuses,

term sheets, indentures and forms of notes necessary to reflect the ARRC recommendations, and should help in the process of bringing senior management up-to-speed on the impact of the changes.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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