PENSFORD

SOFR Transition FAQs

February 2021

Executive Summary

London Inter-bank Offered Rate (LIBOR) based interest rate caps and swaps are generally governed by the International Swaps and Derivatives Association (ISDA). The 2006 ISDA Definitions published by ISDA governing hedges executed before 1/25/2021 currently do not include fallback language sufficient for the discontinuation of LIBOR.

In October 2020, ISDA released a Supplement which revises the 2006 Definitions to include robust fallback language in preparation for the transition to SOFR. In order for the Supplement to apply to legacy LIBOR contracts, counterparties will need to adhere to the 2020 IBOR Fallbacks Protocol via the ISDA website. The Supplement became effective on 1/25/2021, so counterparties to all trades entered prior to that date will need to adhere for the new fallback language to apply.

Upon the discontinuation of LIBOR, hedges incorporating the new fallback language will transition to SOFR. Prior to adhering, borrowers should review their loan documents and consult with the respective lenders to determine how such lender plans to address the interest rate fallbacks on the related loans.

Per a December 2020 announcement, now only one-week and two-month LIBOR will be discontinued at the end of 2021. All other remaining tenors will be around until at least June 30, 2023.

For a more in-depth overview, please continue to the next page. We're here to help so please don't hesitate to reach out with any questions.

1300 South Mint Street, Suite 410 (704) 887-9880
Charlotte, NC 28203 Pensford.com

Updated Timeline for LIBOR's Discontinuation

In 2017, Andrew Bailey announced administrators of LIBOR intended to cease publication of all USD LIBOR tenors on December 31, 2021.

However, in December 2020 regulators announced changes to the initial timeline. Now only one-week and two-month LIBOR are to be discontinued on December 31, 2021 and all other remaining tenors are expected to cease publication on June 30, 2023.

In addition to buying more time, we believe that the timeline was pushed out another 18 months simply to allow most existing contracts to mature without disruption. Approximately 60% of all outstanding USD LIBOR contracts are set to mature by this date.

In their recent statement, the regulators have encouraged banks to cease entering new LIBOR contracts as soon as practicable, with an outside date of December 31, 2021, and to ensure any new contracts use a reference rate other than LIBOR or include robust fallback language to ensure a smooth transition.

Click here to read the recent announcement

Many existing LIBOR based contracts do not contain robust fallback language or only have fallback language which covers a temporary, not permanent, unavailability of LIBOR.

What happens to legacy LIBOR contracts?

Most trade confirmations will not specifically outline what happens in the event LIBOR is unavailable and instead rely on the provisions contained in the 2006 ISDA Definitions.

Interest Rate Swaps
Most borrowers execute a 1992 or 2002 ISDA Master and Schedule, which is subject to the 2006 ISDA Definitions, prior to locking a swap. The trade is then documented on a standard confirmation which outlines economic terms such as the notional amount, fixed rate, floating rate index, key dates, accrual periods, etc.

Interest Rate Caps
Most caps are documented on a long form confirmation which functions as both the transaction confirmation and ISDA Schedule. Often outlined in the first few paragraphs, long form confirmations are subject to the terms of the 1992 or 2002 ISDA Master Agreement, as amended to incorporate the items outlined in the confirmation as part of the Schedule, and incorporates the 2006 ISDA Definitions.

In either case, the existing 2006 ISDA Definitions outlined steps that must be taken by a bank in the event LIBOR was unavailable. However, the definitions' existing fallback language was not practicable and did not address what happened in the event LIBOR is discontinued, since that wasn't something being contemplated at the time.

Recent Developments – Robust Fallback Language

On 10/23/2020 ISDA released (i) the Supplement to the 2006 Definitions, and (ii) the 2020 IBOR Fallbacks Protocol.

Supplement
The Supplement is the amendment to the definitions which adds new IBOR Fallbacks and became effective 1/25/2021. The Supplement is forward looking, so all contracts entered after the effective date which reference the 2006 Definitions will incorporate the new robust fallback language by default.

Click here to access the Supplement

Protocol
The Protocol is the standardized approach for amending contracts entered before the 1/25/2021 Supplement effective date. Amendments made to the Definitions by adhering to the Protocol are effective on the later of (i) 1/25/2021, or (ii) the date the second party adheres.

Click here to access the Protocol

Punchline
The Protocol is the mechanism whereby parties incorporate the Supplement, modifying the definitions their existing trades are subject to. At some point in the future, counterparties to LIBOR based derivatives will need to adhere to the Protocol, or enter into a bilateral agreement with their provider, in order for their hedges to transition to the successor index.

Keep in mind, in either case LIBOR remains in place until a borrower opts in early to a fallback benchmark, or a specified trigger event occurs.

Trigger Events

Below we've outlined some of the Trigger Events, also known as Index Cessation Events, to fallback to SOFR. The Supplement has these outlined in greater detail.

Permanent Triggers (Fallback)
- Permanent Cessation
  - Announcement that the administrator will cease or has ceased to provide the IBOR is made by among others:
    - The administration of the IBOR (ICE)
    - The regulatory supervisor (the UK FCA) for ICE
    - The central bank for the currency of the IBOR
- Pre-Cessation
  - Would occur in the case LIBOR were announced that it is "non representative" as of a specific date. The idea is that an announcement would be used to trigger a forward looking date where the relevant fallbacks would be implemented.

What is the standard fallback rate for LIBOR hedges in the Supplement?

Upon the occurrence of an Index Cessation Event, references to USD-LIBOR in trade confirmations will become references to "Fallback Rate (SOFR)" which is term adjusted SOFR plus a spread.

The spread adjustment will be the historical five year median between the two indices. It's worth noting since LIBOR and SOFR are quoted in various tenors (e.g. 1 month or 3 month), there will be different spread adjustments for each respective term.

Since SOFR is a risk free rate and LIBOR is not, the goal of the spread adjustment is to make up for the lack of the bank credit premium and leave parties to existing contracts economically indifferent.

What steps should I take today?

Prior to adhering, we suggest reviewing the fallback language in your loan documents and speaking with your lender about their plans for the transition. It has been strongly advised that counterparties to LIBOR based hedges adhere to the Protocol as soon as possible to ensure a smooth transition, but there's nothing that says counterparties must do so today.

The ideal scenario from our perspective would be for lenders to follow what ISDA does (as far as fallbacks and timing) so that loans and hedges all roll over to the same index at the same time. However, we understand that each deal, lender, and borrower is different, so that may not be possible in some cases.

There's no "magic bullet" as far as solutions go since many lenders are still trying to determine what they're going to do. Per the December 2020 LIBOR transition playbook, even the various banking regulators and agencies are still working on laying out their plan for the transition of legacy LIBOR products. Therefore, if there's ambiguity or uncertainty around plans, it could make sense to hold off for further clarity prior to adhering to ensure you don't agree to fallback language prematurely.

Where do I adhere?

When you're ready, adherence to the Protocol can be done through the ISDA website, or in some cases, through the execution of a bilateral agreement with your hedge provider.

In the event the hedge provider doesn't offer a bilateral form, the cost to Adhere through the ISDA website is $500/entity. We've included links to the ISDA website and step-by-step instructions on how to adhere below.

Click here to access the 2020 IBOR Fallbacks Protocol

Click here for instructions on how to adhere

1300 South Mint Street, Suite 410

Charlotte, NC 28203

(704) 887-9880

Pensford.com

Conclusion

Given that there are over $200 trillion in LIBOR based contracts, the regulators are working to make the transition as smooth as possible in addition to making all parties feel indifferent economically after the switch.

If you need assistance or have any questions as you take the necessary steps to adhere, please don't hesitate to reach out.

For the latest update on Agency SOFR caps, please click **here**.

Other Resources

https://www.newyorkfed.org/arrc/sofr-transition

http://www.freddiemac.com/about/pdf/LIBOR_transition_faqs.pdf

https://www.isda.org/a/YZQTE/Understanding-Benchmarks-Factsheet.pdf

1300 South Mint Street, Suite 410 (704) 887-9880

Charlotte, NC 28203 Pensford.com