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Q1 2022 Update on LIBOR Transition Developments: McGuireWoods

Since passing the December 31, 2021 "no new LIBOR" line-in-the-sand drawn by regulators, the pace of new developments in LIBOR transition has slowed as various markets have adapted to pricing transactions at SOFR or some other alternative to LIBOR. As we close out Q1 2022, here are some of the highlights in events and trends we've seen since our last post.

Federal LIBOR Legislation: On March 15, 2022, President Biden signed the Consolidated Appropriations Act, 2022, which contains as part of its many provisions the Adjustable Interest Rate (LIBOR) Act. The LIBOR Act is largely unchanged from the legislation passed by the U.S. House of Representatives in December 2021, which the U.S. Senate also passed earlier this month as part its approval of The Consolidated Appropriations Act. Some of the highlights:

- As discussed in a previous post on the House bill, the LIBOR Act is intended to provide a transition from LIBOR to a SOFR based rate for "tough" legacy contracts which lack adequate fallback provisions and would be difficult to amend.
- The LIBOR Act does not affect contracts which already contain benchmark replacement or alternate interest rate provisions, so the work in the business loan market (which typically contain some version of fallback language even in credit documents that pre-date LIBOR sunset announcements) will need to continue apace.
- The LIBOR Act also amends the Trust Indenture Act of 1939 to resolve potential conflicts between the provisions of that legislation and changes authorized under the LIBOR Act.
- The Board of Governors of the Federal Reserve System (the Fed) is charged with adopting regulations to implement the LIBOR Act and establish a replacement rate based on SOFR (including establishing spread adjustments for the one, three and six month interest period tenors).
- Perhaps most importantly, the LIBOR Act establishes safe harbor from claims and liability for administrators, trustees or agents which utilize Fed selected benchmark replacements and procedures.

The LIBOR Act will provide important relief for CLOs, bonds and similar widely held and difficult to amend debt instruments, and protection for the trustees and agents which administer those products in dealing with LIBOR transition, but will have little direct impact for the business loan market.

No New LIBOR and its Nuances: As to business loans, throughout the end of Q42021 and early Q12022, we've seen banks methodically implementing the joint OCC and Fed regulatory guidance dictating "no new LIBOR" after December 31, 2021. This has been clearly understood to mean no new LIBOR deals or facility size increases for LIBOR deals after that date, and no extensions of maturity for existing LIBOR deals beyond June 30, 2023 (the final termination date for the publication of LIBOR). The meaning of "no new LIBOR" for other credit actions on and after January 1, 2022 is less clear and much discussed: For instance:

- *Committed delayed draw term loans:* like a committed revolver, probably OK to fund at LIBOR (but

probably not OK to extend the draw period)
- *Uncommitted facilities:* some credit facilities are "discretionary", and without an ***obligation*** to lend at LIBOR, the weight of interpretation has settled on – move away from LIBOR absent compelling circumstances
- *Material Credit Actions / Waivers:* some banks have decided to use any material credit action as a basis to move away from LIBOR, e.g., a waiver, forbearance or other action requiring credit committee approval

Regulators have avoided issuing specific bright line guidance on these and other "grey area" questions in an effort to push the market away from LIBOR as quickly as possible – if you're uncertain whether a funding or credit action crosses the "no new LIBOR" line, ask your examiner, with a preference for moving off LIBOR wherever possible.

Term SOFR Adoption: An open question early in Q42021 was whether CME Term SOFR would be widely adopted. That questions has been clearly answered "yes", and CME Term SOFR (now expanded to offer twelve month tenors, along with the original one, three and six month tenors), has become commonplace in syndicated loan transactions. Lower middle market bilateral lending transactions have been showing a variety of alternative approaches, including SOFR varieties (e.g., one month SOFR resetting monthly), BSBY, Ameribor and in some cases, "Prime minus" formulations. ARRC and LSTA model SOFR language has been widely adopted particularly in syndicated transactions, with some negotiation around a few topics:

- *Spread Adjustments:* As previously noted, LIBOR-to-SOFR fallback language recommended by ARRC and industry groups (e.g. the LSTA) included a "spread adjustment" to approximate LIBOR values in a SOFR-based rate calculation, i.e., Term SOFR + Spread Adjustment + Applicable Margin, and on March 5, 2021, the ARRC published recommended spread adjustments for one, three and six month tenors based on the average spread between SOFR and LIBOR during the 5 year period leading up to that date. However throughout 2021 Q2 – Q4, the spread between the SOFR and LIBOR spot rates was lower than the 5 year average, leading to frequent negotiation around those spread adjustment values. That dynamic turned around in 2022 Q1, with international and market turmoil driving LIBOR up (recall LIBOR is more sensitive to credit market shocks than SOFR), and pushing the spot spreads back up to, or even slightly above, the ARRC recommended SOFR spreads.
- *Beyond Spread Adjustments:* While spread adjustments made sense for fallback language designed to kick in at a future "Benchmark Replacement Date", a two part calculation (Term SORF + Applicable Margin, with any additional credit risk built into the Applicable Margin) seems like the better approach for new day-one Term SOFR loans. That approach hasn't yet been widely adopted in our experience, and the "Adjusted Term SOFR" three-part construct described above (with the attendant fluid negotiations around the proper spread adjustment) has become something of the norm, at least through February 2022. However we have seen some movement recently toward the simpler two part construct as lenders have become more comfortable with how to price SOFR based loans.
- *Most Favored LIBOR Transition:* We've seen borrowers occasionally ask for, and lenders occasionally agree to, most favored nation treatment on benchmark replacement setting.
- *Break Funding:* We've seen borrowers regularly ask to remove break funding make-whole language on the theory that SOFR loans are not match-funded, so that there should never be any break funding exposure for lenders. There continues to be debate in the market around the practical utility and application of such provisions, but we have generally seen them retained in credit agreements.

Remediation of Existing LIBOR Contracts: While the market evolves around new day-1 SOFR transactions, lenders are actively working to remediate their shrinking, but still very significant, back-book of LIBOR linked business loans. Although new syndicated debt linked to SOFR outpaced LIBOR in January and February, the total outstanding value of debt products linked to LIBOR is still significant, so with only 5 quarters until the last day of LIBOR publication, much remediation work remains.

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