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Flexibility in the financial market in response to major changes

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This year, financial market participants have been subject to many unprecedented changes that have forced them to show a great deal of flexibility. This article highlights two of these events: the cessation of LIBOR and the impact of the COVID-19 pandemic.

The cessation of LIBOR has been anticipated for a number of years and there have been many discussions regarding the potential impact of its termination. However, very little changed in practice prior to 2020, despite the complexity involved for business in adapting to this change. LIBOR is widely used on a global basis in thousands of credit agreements and borrowing arrangements in respect of trillions of dollars of borrowings. Implementing a change of this nature requires widescale agreement across the industry regarding appropriate replacement rates. Equally, a carefully planned approach to implementation of the change is essential.

The laissez-faire attitude towards the LIBOR change leading up to 2020 has given way to a strong push by governmental organizations and market leaders to crystallize a path forward. In 2020, market participants are finally embracing the changes necessary for an orderly transition to a fallback rate and the

transition to an alternative reference rate is gaining some traction. Given the sheer volume of LIBOR-based agreements, these are welcome developments, given that a failure to negotiate and implement an alternate structure, or a fallback structure, prior to LIBOR's cessation in 2021 could have had disastrous consequences for lenders, borrowers and other market participants.

Unlike the cessation of LIBOR, the COVID-19 pandemic took the world by surprise. It had – and continues to have – the potential to create instability and disruption in the credit market. Many businesses were negatively impacted by the pandemic and, as a result, needed to turn to their lenders for flexibility under their credit agreements.

Cessation of LIBOR

The London Interbank Offered Rate (most commonly referred to as LIBOR) is the most widely used interest rate in the world. It is produced in seven tenors (overnight/spot next, one week, one month, two months, three months, six months and 12 months) across five different currencies (including USD, which is the main focus of this article).

LIBOR is generally expected to come to an end by December 31, 2021. As of that date, the Financial Conduct Authority (the FCA), the body that regulates LIBOR, will no longer require panel banks to submit the quotes that LIBOR is based on, thereby rendering LIBOR unusable. In November 2020, ICE Benchmark Administration Limited (IBA), the administrator of LIBOR, announced a plan to begin consultations on its intention to cease the publication of (1) all tenors of GBP LIBOR, EUR LIBOR, CHF LIBOR and JPY LIBOR on December 31, 2020, (2) one week and two month USD LIBOR on December 31, 2020, and (3) all other USD LIBOR tenors on June 30, 2023. The consultations will close by the end of January 2021.

LIBOR is the underlying reference rate for trillions of dollars in borrowings over a wide range of financial instruments and transactions worldwide. This includes corporate loans, bonds, derivatives, futures, mortgages and other financial products. As such, lenders, borrowers and other participants in the global financial markets are faced with the challenge of transitioning away from most LIBOR settings in a little over a year. So far there has been no suggestion that the COVID-19 pandemic will delay LIBOR's end.

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SOFR – the replacement rate

The leading rate expected to replace the U.S. dollar LIBOR rate for many financial products is the secured overnight financing rate (SOFR). SOFR is an overnight rate for repurchase transactions that are secured by U.S. treasuries. There are several different SOFR variants, including forward-looking term SOFR, daily simple SOFR in arrears and daily compounded SOFR in arrears.

Forward-looking term SOFR has a term structure similar to LIBOR and is determined prior to the start of the interest period. To be effective as an alternate to LIBOR, a SOFR futures market would need to be developed. Daily SOFR in arrears uses daily SOFR rates published during the relevant interest period. Unlike forward-looking rates, the rate for the entire interest period would not be known at the beginning of the interest period. Daily simple SOFR

and daily compounded SOFR are differentiated based on whether interest accrues on a simple interest basis or a compound interest basis. SOFR is published on a daily basis by the Federal Reserve Bank of New York.

There are a variety of structural differences between LIBOR and SOFR, including that LIBOR is available in multiple tenors while SOFR is an overnight rate, and that LIBOR incorporates a bank credit risk premium. The two rates also have historical spread differentials. As a result, certain adjustments will need to be applied to SOFR to address these differences as well as the historical spread differential between the rates. Additionally, market participants using SOFR will need to determine whether they will use a simple average or a compound average and whether daily SOFRs are to be observed and averaged in advance or in arrears.

It is not yet clear which specific SOFR rate will be adopted for loans. The leading contenders appear to be forward-looking term SOFR and the daily simple SOFR in arrears. For swaps, the International Swaps and Derivatives Association (ISDA) has announced that it will use term-adjusted SOFR, compounded in arrears.

Recommended fallback language

The Alternative Reference Rates Committee (ARRC) is a committee convened by the Federal Reserve Board and the New York Fed to help ensure a successful transition from USD LIBOR to SOFR. In the spring of 2019, ARRC published recommended fallback language to be included in syndicated and bilateral loan agreements. ARRC's proposed language includes two alternative methods that can be reflected in the applicable agreement as a fallback for the transition from LIBOR. This includes both a "hardwired approach" and an "amendment approach."

The hardwired approach contemplates that the parties will include predetermined terms to transition the loan facility to a successor rate and the spread adjustment. That transition would either occur upon a trigger event that would be agreed to, or earlier due to opt-in. The amendment approach contemplates the parties agreeing to amend the loan agreement upon certain trigger events occurring or upon early opt-in by the parties. ARRC has continuously encouraged the use of the hardwired approach over the amendment approach. In the "ARRC Recommended Best Practices for Completing the Transition from LIBOR," ARRC recommended that all business loans include hardwired language by the end of the third quarter of 2020.

In June 2020, ARRC published revised fallback language, which no longer included the amendment approach. Despite ARRC's insistence that parties should use the hardwired approach, uptake has been slow. This is largely because participants are hesitant to lock-in SOFR when it has not yet been determined to be the definitive market standard. Conversely, the amendment approach has been broadly adopted. ARRC has noted its concern that if all market participants use the amendment approach, it may not be feasible to amend thousands of loans (and many other financial products) in a short period of time upon the cessation of LIBOR.

ARRC also published hardwired fallback language for floating rate notes (FRNs) in April 2019. This hardwired language has been adopted more quickly than in the loan market. This is not surprising given that FRNs are difficult to amend as a result of noteholder consent requirements.

Transitioning to SOFR

A few resources are available to market participants to make it easier to transition to the hardwired approach.

ISDA has been considering the impacts of the cessation of key interbank offered rates (IBORs) for a few years, and has published a supplement to the 2006 ISDA Definitions (the Supplement) and a related protocol (the Protocol) to address the fallback rates for such IBORs (including LIBOR) in derivatives contracts. The Supplement and Protocol will take effect on January 25, 2021. Thereafter, all new derivatives referencing the 2006 ISDA Definitions will automatically include the updated fallbacks for covered IBORs. The changes will apply to legacy derivatives as well if both counterparties have adhered to the protocol or have agreed on similar bilateral amendments. At this stage, more than 1,500 entities have adhered to the Protocol.

The Loan Syndications and Trading Association (LSTA) recently published a concept credit agreement as an educational tool to support the use of hardwired fallback language and to ease the transition to new originations of SOFR-referenced loans. The concept credit agreement describes a term loan referencing daily simple SOFR or daily compounded SOFR. The LSTA notes that the concept credit agreement does not purport to represent or set any standard market practice. As simple SOFR loans have not yet been executed, there is currently no market practice to reflect. Instead, the concept document uses familiar alternate base rate-style provisions and incorporates ARRC conventions as an example of a SOFR loan. The LSTA has indicated that it intends to develop concept credit agreements reflecting other SOFR methodologies as well.

Proposed legislative solution

On March 6, 2020, ARRC released a legislative proposal for New York State to address the discontinuation of LIBOR with a view to mitigating a number of issues that will arise as a result of the cessation. This proposed legislation would, among other things, (1) prohibit a party from refusing to perform its contractual obligations or declaring a breach of contract as a result of the discontinuance of LIBOR or the use of the statute's recommended benchmark replacement; (2) definitively establish that the recommended benchmark replacement is a commercially reasonable substitute for and a commercially substantial equivalent to LIBOR; and (3) provide a safe harbour from litigation for the use of the recommended benchmark replacement.

For contracts that are silent on a LIBOR fallback rate, or that contain fallback provisions that refer to a LIBOR-based rate (such as the last-quoted LIBOR), the legislation requires the use of the recommended benchmark replacement. Where contracts provide for agent or lender discretion to determine the fallback rate, the safe harbour from litigation is meant to encourage adoption of the recommended benchmark replacement. Contracts that have fallback provisions to a non-LIBOR based rate (such as the prime lending rate) would not be affected by the legislation.

LIBOR's end

Although the end of 2021 is a year away, the discontinuation of LIBOR will approach quickly, likely faster than most people realize. It might even be necessary to transition away from LIBOR before it is discontinued if LIBOR ceases to be available at an earlier date. It is critical that market participants begin to implement their transition plans so that they have sufficient time to achieve an orderly replacement of LIBOR, whether through a hardwired approach, a fallback amendment or otherwise. Failing to do so could have significant implications for borrowers. Given the sheer volume of agreements and borrowings with LIBOR-based interest rates, we expect 2021 to be a very busy year as deadlines approach and changes must be implemented. As for new contracts, banks have been encouraged by various regulators to stop using USD LIBOR as soon as practicable, but in any event by the end of 2021.

Osler is the only Canadian law firm that is a member of the ISDA Americas and Europe Benchmarking Working Group, and is the host of the Canadian Legal IBOR Committee for a group of Canadian banks. In that capacity, Osler has been advising numerous banks and other financial market participants with respect to enterprise-wide LIBOR fallback risk assessment, planning and implementation solutions.

Impacts of COVID-19 on credit facilities

As a result of the COVID-19 pandemic, borrowers have faced and are facing a number of challenges relating to their existing credit facilities. These challenges include (1) the inability to meet certain financial covenants and financial reporting requirements; (2) the risk of breaching certain contractual obligations; and (3) the potential for a Material Adverse Effect (MAE).

To date, lenders have generally been quite flexible in response to these issues. Many lenders have entered into amendments to credit agreements and granted waivers for certain covenants and requirements impacted by the pandemic. For example, in some deals, lenders have agreed to accommodate borrowers by adjusting financial ratio requirements, such as allowing COVID-19 related expenses to be added back to EBIDTA and extending reporting deadlines. Lenders have also generally not taken an aggressive interpretation of MAE provisions in loan agreements. It would not have been practical for lenders to enforce their rights on all impacted facilities that could have been triggered by an MAE default during the pandemic.

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As a trade-off for their leniency, lenders have imposed certain additional restrictions. These include (a) anti-cash hoarding provisions; (b) tighter restrictions on asset sales, dividends, distributions and acquisitions; and (c) additional reporting requirements. Lenders should continue to ensure that any carve-outs, waivers, consents and other moderations provided to their borrowers are temporary and fact-specific.

Conclusion

The difficulties that market participants have faced this year will continue to evolve in 2021. Market participants will need to focus on the heavy lifting required to implement the transition away from LIBOR. Borrowers and lenders will need to continue to communicate with each other to find mutually-beneficial

solutions to COVID-19 related issues. Although this is likely to be challenging, market participants have shown great resilience and have worked hard throughout 2020 to equip themselves with the tools to handle these challenges.

It remains to be seen how the overall market will respond to these concerns and the uncertain market landscape. In particular, it will be interesting to see whether ARRC's legislative proposal to address the LIBOR transition is adopted in the U.S. and whether Canada will follow suit with a similar regime.

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