Transitioning From LIBOR In North America: The End of the LIBOR Era Is Not SOFR Away

What is LIBOR?

The era of the London Interbank Offered Rate ("**LIBOR**"), the world's most referenced benchmark for short-term interest rates, is scheduled to end by 2022.

LIBOR's influence cannot be understated – *hundreds of trillions of dollars* of financial contracts in cash and derivatives markets are linked to it.[1] These financial contracts range from interest rates consumers pay for home mortgages and student loans to interest rates that large corporations pay for loans.

LIBOR is reflective of the interest that major banks charge to borrowers in the short-term, based on an array of interest rates. LIBOR is produced for five currencies including the US dollar, and is produced for seven different maturity periods, ranging from daily to one year.[2] These rates are based on submissions from a reference panel of between 11 and 16 major financial institutions for each currency.[3]

The end of LIBOR trails the "LIBOR scandal" where it came to light in 2012 that bankers at many major financial institutions had colluded and manipulated LIBOR since around 2005 for the purposes of profit and making their banks appear financially stronger than they actually were. This scandal led to US and UK regulators handing out large fines to banks, convictions for some traders, and a change in supervision responsibility from the British Bankers Association to the ICE Benchmark Administration by Britain's Financial Conduct Authority. Hence, LIBOR's now commonly referred to as "ICE LIBOR".

What is SOFR and how does it differ from LIBOR?

In the US, the Federal Reserve's Alternative Reference Rates Committee ("**ARRC**") was created to facilitate the transition away from USD LIBOR. The resulting new alternative reference rate in the US is called the Secured Overnight Financing Rate ("**SOFR**").[4]

First, whereas LIBOR is based on quotations and "expert judgment" of large banks, SOFR is derived from the US Treasury repo market[5] and is based on actual reported transaction data of overnight repurchase transactions in US Treasury securities. SOFR is therefore more transparent and representative of short-term lending rates as compared to LIBOR. SOFR is also based on a much larger volume of underlying transactions and meets IOSCO criteria as a reference rate.

Second, LIBOR is a forward-looking rate, whereas SOFR is backward-looking. The possibility of developing a forward-looking term rate for SOFR that could match LIBOR would be advantageous, however this may not happen for a couple of years. This inability to match the terms of each reference rate could create additional uncertainty when using SOFR as a replacement rate.

[1] See: FreddieMac, "LIBOR Transition"; See also: Morgan Stanley, "Transitioning LIBOR: What It Means for Investors" (29 October 2019).
[2] ICE Benchmark Administration, "LIBOR".
[3] *Ibid.*
[4] While a Federal Reserve committee of regulators, banks and asset managers chose SOFR as the official replacement, there is speculation that some smaller financial institutions may opt for a different alternative reference rate such as Ameribor with the belief it manages their needs better than SOFR. There are a number of considerations that market participants interested in using SOFR will need to consider such as whether financial products will use some kind of average of SOFI, or whether lenders will use a simple or compound average of SOFR, and whether users would prefer an *in advance* structure or an *in arrears* structure when referencing an average of SOFR. See: The Alternative Reference Rates Committee, "A User's Guide to SOFR" (April 2019).
[5] The "repo market" in the US financial system is where firms trade trillions of dollars of US debt for cash each day. A "repo" or "repurchase" is where one party sells an asset (e.g. US Treasury) to another party at one price and commits to repurchase the same asset at a different price at a future date (otherwise known as collateralized short-term loans, often made overnight). A "repo rate" or "repurchase rate" is the difference between the selling price and purchase price of the asset.

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Third, unlike SOFR, LIBOR incorporates bank credit risk as well, which results in a higher interest rate. In order to adequately "match" LIBOR in a transition, the ARRC has suggested that SOFR will require an adjustment to be more comparable, which is often referred to as a "spread adjustment".

What about in Canada?

Similar to other jurisdictions, there is a shift in Canada from using an Interbank Offered Rate ("**IBOR**") as a primary reference rate. Canada established the Canadian Alternative Reference Rate Working Group ("**CARR**") to develop a Canadian dollar term risk-free rate benchmark that is robust and reliable, and consistent with IOSCO principles.[6] CARR's purpose is to also explore possible enhancements to the existing Canadian overnight risk-free rate, the Canadian Overnight Repo Rate Average ("**CORRA**").[7]

What does this mean for lawyers?

Many lenders who haven't already addressed the transition away from LIBOR are expected to rely on lawyers to provide strategic advice on credit agreement fallback provisions and any required amendments. With existing credit[8], the typical starting place is assessing credit agreements for exposure to LIBOR as the reference rate. Longer-term rates using LIBOR will be especially common in certain areas such as the project finance sector, where the tenor of an agreement is often greater than five years. Through assessing exposure to LIBOR on a case-by-case basis, lawyers can assess whether there are fallback provisions already in the agreements and then determine what options are available.

There are two main approaches suggested by ARRC to manage the transition from LIBOR for syndicated loans. The first is the "hardwired approach" which consists of clearly specifying which SOFR-based successor rate and spread adjustment will apply to an agreement in the event that LIBOR is no longer usable.[9] The second is the "amendment approach" which would provide a streamlined amendment mechanism for negotiating a benchmark replacement and include standard language with respect to the fallback trigger events.[10]

Conclusion

Many market participants have taken a wait-and-see approach. There are advantages to being proactive and preparing agreements for the end of LIBOR, however. This includes assessing the impact of transitioning away from LIBOR, strategically planning how to adapt to utilizing an alternative reference rate such as SOFR, and overall minimizing transition costs and the transition's impact.

Those market participants who have been proactive have more commonly opted for the "amendment approach", which allows for more flexibility as SOFR and other reference rates are developed. However, as the end of 2021 approaches, it's expected that the "hardwired approach" will become more prevalent, as it could be executed more easily if LIBOR becomes unusable. This is particularly relevant when there are tens of parties involved in a syndicated loan, for example.

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[6] Bank of Canada, "Canadian Alternative Reference Rate Working Group".
[7] The Bank of Canada expects CORRA to become further adopted across a wide range of financial products as a Canadian interest rate benchmark; See: Bank of Canada, "Bank of Canada to become the Administrator of Key Interest Rate Benchmark" (16 July 2019).
[8] New credit agreements will need to be structured to use a new reference rate or account for the transition from LIBOR.
[9] Alternative Reference Rates Committee, "ARRC Releases Recommended Fallback Language for Floating Rate Notes and Syndicated Loans" (25 April 2019). Note: ARRC released updated recommended hardwired fallback language, see: Alternative Reference Rates Committee, "ARRC Releases Updated Recommended Hardwired Fallback Language for Syndicated Loans" (30 June 2020). Note: hardwired fallback language is expected to automatically trigger SOFR-based rates into effect upon a triggering event such as the discontinuation of LIBOR.
[10] Alternative Reference Rates Committee, "ARRC Releases Recommended Fallback Language for Floating Rate Notes and Syndicated Loans" (25 April 2019).

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