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Best Practices for a Transition Away from LIBOR

Legal Update

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This article is the third article published by Fredrikson & Byron related to the ending of LIBOR.

Overview

On September 3, 2019, we published an article addressing the likely end of the London Inter-Bank Offered Rate (LIBOR) and the need for banks and other market participants to prepare to transition to an alternative rate index. Despite the impact of COVID-19, it is safe to assume that LIBOR will still become unusable by the end of 2021.

In preparation for the transition, the Alternative Reference Rates Committee (ARRC) has published its recommended best practices to prepare for the anticipated discontinuation of LIBOR. The recommendations include specific fallbacks and fallback language (i.e., contractual provisions that specify the trigger events for a transition to a replacement rate, the replacement rate, and the spread adjustment to align the replacement rate with the benchmark being replaced — in this case LIBOR). The fallback language in each financial contract will determine how the replacement of the discontinued reference rate, in this case LIBOR, will be handled. Inadequate fallback language could pose a legal risk.

The ARRC has also announced that the Secured Overnight Financing Rate (SOFR) is the recommended alternative to LIBOR. Ultimately, it is critical that banks and other market participants carefully but quickly prepare for the transition away from LIBOR. The ARRC recommendations are not binding guidance but are meant to facilitate strong controls, market integrity, and a smooth transition away from LIBOR.

The ARRC's key recommended guidance is that all LIBOR transactions should include ARRC recommended fallback language and new use of LIBOR should stop, with timing dependent on transaction type. Additionally, it is critical that any third-party technology and operations vendors complete all necessary enhancements to support SOFR by the end of 2020. Lastly, for contracts specifying that a party will select a replacement rate following a transition away from LIBOR, the determining party should disclose their replacement selection to relevant parties at least six months prior to the date the replacement becomes effective.

Key Guidance by Product Type

In addition to general guidance, the ARRC has developed best practices specifically tailored for different product types:

Floating Rate Notes (FRN)

- Issuers should ensure that newly issued FRNs include ARRC recommended LIBOR fallback language prior to June 30, 2020.
- Issuers should ensure that no FRNs using LIBOR and maturing after 2021 should be issued after December 31, 2020.
- All third-party technology and operations vendors should complete all enhancements to support SOFR prior to the end of 2020.
- For FRNs specifying that a party will select a replacement rate for LIBOR, the determining party should disclose their replacement selection at least six months prior to the date the replacement becomes effective.

Business Loans

- Parties should ensure that all new business loans include ARRC recommended fallback language prior to September 30, 2020.
- No business loans using LIBOR and maturing after 2021 should be created after June 30, 2021.
- Third-party technology and operations vendors should complete all enhancements to support SOFR prior to September 30, 2020.
- For any business loans specifying that a party will select a replacement rate for LIBOR, the determining party should disclose their replacement rate and any related adjustment methodology at least six months prior to the date the replacement rate becomes effective.

Consumer Loans

- Parties to consumer loans should ensure that new residential mortgages using LIBOR should include ARRC fallback recommendations prior to June 30, 2020.
- No new residential mortgage applications using LIBOR and maturing after 2021 should be accepted after September 30, 2020.
- Any servicers of any consumer loans using LIBOR and maturing after 2021 should develop comprehensive programs for notifications and consumer education prior to December 31, 2020.

Internal Goals Banks Should Implement

To facilitate a smooth transition from LIBOR to the recommended SOFR rate, banks and market participants must ensure that they have clear internal processes and goals. These goals should include implementing a comprehensive governance

framework accountable for a successful enterprise-wide LIBOR transition, including having senior executives to oversee the implementation and coordination of the LIBOR transition program. Such a program should include creating an approach to monitor LIBOR linked exposures during the transition period, a method to value SOFR based products, and a strategy to transition existing portfolio LIBOR products.

Banks and market participants should also establish an enterprise-wide program to evaluate and mitigate risk and client exposure. Exposure is typically measured by assessing activity and the number of parties or consumers with financial contracts that reference LIBOR across all products. Mitigating risk will require monitoring financial and nonfinancial risks and understanding financial, customer, and legal implications of the transition away from LIBOR. Also, banks and market participants should determine accounting and reporting considerations along with tax and regulatory implications, and they must develop a plan to address technology implications of the transition away from LIBOR.

The transition away from LIBOR will result in a supervisory focus on evaluating preparedness. During examinations and monitoring activities, supervisory staff will inquire about institutional preparedness to effectively transition away from LIBOR. If an institution has exposures to LIBOR-indexed instruments, supervisory staff will discuss transition efforts such as identification and quantification of LIBOR exposure, risk assessment, transition milestones, management's assessment of necessary updates, oversight responsibilities, and progress reporting. Therefore, all institutions should develop a risk management process.

Additional Resources

- For more information regarding the transition away from LIBOR, refer to the ARRC's press release and fact sheet.
- For examples of the ARRC's recommended fallback language, refer to the Summary of ARRC's LIBOR Fallback Language.
- For more information regarding SOFR, refer to the User's Guide to SOFR.