LSTA Adds 'Credit-Sensitive Rate' Rider for LIBOR Fallback Language

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In what may be the first step in a move away from the Secured Overnight Financing Rate (SOFR) as the replacement rate for LIBOR, the Loan Syndications & Trading Association (LSTA) issued a market advisory memo titled, "'Credit-Sensitive Rate' Slot-in Rider for Fallback Language," providing lenders and borrowers with sample credit-sensitive rate language to be used as part of the larger suite of potential LIBOR replacements.[1] The new rider fits into a larger LIBOR fallback framework previously published by the Alternative Reference Rates Committee (ARRC), providing lenders and borrowers with recommended language to more specifically tailor interest rates in loans and related products in the wake of the transition away from LIBOR. When one replacement rate, such as SOFR, might not be ideal, the sample language provides lending institutions with the option of using a single credit-sensitive rate or multiple credit-sensitive rates.

Background

At the end of 2021, the panel banks that submit rates in the London interbank market — these rates being the basis for LIBOR — would no longer be required to do so, effectively ending LIBOR as a viable benchmark interest rate. ARRC has offered guidance on a transition from LIBOR, recommending SOFR as its benchmark replacement rate. Specifically, ARRC recommended putting LIBOR fallback language in loan documents going forward, enabling the transition away from LIBOR in a structured or "hardwired" manner, without parties to loan agreements needing to suddenly amend or terminate when LIBOR ceases to exist.

The push to include LIBOR fallback in loan documentation has been largely successful. ARRC's March 2021 progress report noted the success of various fallback approaches and the adoption of ARRC's hardwired fallback language in the majority of institutional loans during February 2021.

Credit-Sensitive Rates as a LIBOR Alternative

While the push to include LIBOR fallback in loan documentation has been largely successful, such success does not mean that the markets have settled on SOFR as a replacement for LIBOR. SOFR represents the cost of overnight borrowings secured with treasury securities and is generally considered a risk-free rate. Many lenders continue to seek a reference rate that reflects the cost of unsecured borrowing (known as a credit-sensitive rate), which more closely approximates their funding costs. Also, SOFR is an overnight rate and attempts, so far, to create a "Term SOFR" that could be known in advance and fixed for a period (in a manner similar to one-, two-, three-, and six-month LIBOR) have been unsuccessful.

In response to these market pressures, the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) convened a series of “Credit Sensitivity Group” workshops to explore credit-sensitive rates as potential replacements for LIBOR. Moreover, while ARRC may have settled on SOFR as a replacement rate, the Federal Reserve, OCC, and FDIC have emphasized that they are not endorsing any specific replacement rate for LIBOR, such as SOFR, noting that “[a] bank may use any reference rate for its loans that the bank determines to be appropriate for its funding model and customer needs.”[2] The statement reiterated the voluntary use of SOFR and noted that banks may want to explore other alternative rates, including “credit-sensitive alternatives.”

Credit-Sensitive Rates Fallback Language

As a result of the Credit-Sensitive Group workshop discussions, the LSTA drafted a rider that adds optionality to the recommended LIBOR hardwired fallback language. The new language comes in the form of a rider, which adds (or replaces) the definition of Alternative Benchmark Rate, to be included in the existing waterfall of potential benchmark replacements.

The definition of Alternative Benchmark Rate is drafted to accommodate multiple rates under the definition. The draft offers four alternative rates:

1. AMERIBOR, provided by American Financial Exchange LLC,
2. “Bank Yield Index” provided by ICE Benchmark Administration,
3. BSBY, the Bloomberg Short-Term Bank Yield Index provided by Bloomberg Index Services Limited, and
4. IHS Markit Credit Rate provided by IHS Markit.

Lenders and borrowers are not required to use the recommended benchmarks and do not have to use a set number of benchmarks. The rider is drafted to be flexible, and a single credit-sensitive rate, or multiple credit-sensitive rates can be used. LSTA notes that multiple rates provide for the lender and the borrower to respond to market trends as they evolve, providing greater comfort up front, rather than being locked into a single rate. This approach acts as a safety net because it is not apparent what rate might be the best choice when the agreement is entered into, as well as what rate may emerge as a clear favorite when LIBOR is gone. The ultimate goal of the rider is to provide language for any potential LIBOR replacement to be effectuated.

Summary

Whether any of these credit-sensitive rates can meet the IOSC Principals for Financial Benchmarks as a viable benchmark rate, or can meet them before January 1, 2022 when new financings need to use a benchmark other than LIBOR, remains to be seen. As such, a SOFR-based rate may well be in our future, at least for a while. What this advisory from the LSTA shows is that markets may prefer to replace LIBOR not by a single, rigid rate, but rather by a flexible collection of rates that will be selected as favorable conditions exist in the market. The LSTA drafted the credit-sensitive rate rider to assist with that goal.

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[1] The rider is available from LSTA on their website at https://www.lsta.org/content/csr-slot-in-rider-for-fallback-

language-market-advisory/.

[2] Statement on Reference Rates for Loans published November 6, 2020.

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