Banking & Finance
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September 12, 2017

The Transition From LIBOR and the Syndicated Loan Market's Initial Reaction

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"In our view it is not only potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them."

Andrew Bailey,

Chief Executive, FCA, July 27, 2017

As has been widely communicated, on July 27, 2017, Andrew Bailey, the Chief Executive Officer of the United Kingdom's Financial Conduct Authority (the "FCA"), made an announcement that sent a shock wave through the financial markets: the London Interbank Offered Rate ("LIBOR"), the primary reference rate that underpins at least $350 trillion in global financial transactions according to the ICE Benchmark Administration, will be phased out by 2021.

Recent Syndicated Loan Market Responses

The syndicated loan market has been discussing this announcement since late July and has begun to react with various approaches to address the issue in loan documentation.

At the same time, the Loan Syndications and Trading Association (the "LSTA") has indicated that it will continue monitoring the issue and is expected to make an announcement, which may have a significant impact on moving the market in one direction.[1]

The Jane Street Approach

An initial approach to address the LIBOR disruption issue is the one taken in the recent Jane Street Credit Agreement, dated as of August 25, 2017, by and among Jane Street Group, LLC, as borrower, and JPMorgan Chase Bank, N.A., as administrative agent.

The Jane Street approach addresses the LIBOR issue by permitting the credit agreement to be amended to implement a replacement interest rate with borrower and majority lender consent.

Certain lender groups have criticized the Jane Street approach on the grounds that majority lender consent is not appropriate to amend a term as fundamental as pricing. Instead, such lenders have advocated that unanimous lender consent be maintained for any amendments to LIBOR and have noted that borrowers can get comfortable based on the "yank-a-bank" provisions in their credit facilities, which would permit them to remove any lenders that object to a proposed replacement rate amendment.

[1] When publishing the exposure draft of the LSTA form of investment grade credit agreement on August 31, 2017, the LSTA indicated that it is premature to address the possible discontinuation of LIBOR, but it plans to update the form at a later date, if necessary.

The Surgery Partners Approach

Another recent alternative is the approach taken in the Surgery Partners Credit Agreement, dated as of August 31, 2017, by and among Surgery Center Holdings, Inc., as borrower, and Jefferies Finance LLC, as administrative agent.

The Surgery Partners Credit Agreement approaches the LIBOR issue within the definition of "LIBOR" itself, providing that if the LIBOR rate is not available on the Reuters Screen LIBOR01 Page or any other widely recognized successor page, then LIBOR will instead be determined based upon an alternative rate index designated by the administrative agent in consultation with the borrower.

Lenders have also strongly opposed the Surgery Partners approach because it would allow the administrative agent (in consultation with the borrower) to decide the LIBOR replacement rate, without any lender consent required.

Sponsors and borrowers may consider rejecting the Surgery Partners approach because they only have consultation rights and not consent rights.

An Alternative Approach

An alternative approach worthy of consideration is to require the borrower and the majority lenders to negotiate in good faith with respect to any LIBOR replacement provision.

Such a provision could be formulated so that if either (i) the borrower notifies the administrative agent that it is requesting a LIBOR replacement amendment or (ii) the administrative agent notifies the borrower that the majority lenders have requested a LIBOR replacement amendment, then the administrative agent, the borrower and the lenders would be required to negotiate in good faith such amendment in form and substance reasonably satisfactory to the borrower and the majority lenders.

LIBOR Provisions in Existing Credit Agreements

The definition of LIBOR in many Credit Agreements provides that if LIBOR is not available on the Reuters screen page or any successor or substitute page, then the administrative agent may set the LIBOR rate based on its own determination of offered rates.

In addition, many credit agreements have a boilerplate alternative rate of interest provision, which provides that if the administrative agent and/or the required lenders determine in good faith that adequate and reasonable means do not exist for ascertaining LIBOR, then the lenders will be entitled to cease making loans in LIBOR and, when triggered, all LIBOR loans will be deemed converted into base rate loans. Most credit agreements also have boilerplate increased costs and/or change in law provisions providing that if it becomes impractical or illegal for a lender to make LIBOR loans on an individual basis, then such lender's obligation to make or continue LIBOR loans will be suspended.

From a borrower perspective, the boilerplate provisions described in the immediately preceding paragraph are unacceptable as long-term solutions since they would result in borrowers having to borrow in base rate, resulting in increased costs for the borrower.

Background for Replacing LIBOR

The rationale for replacing, rather than reforming, LIBOR from Andrew Bailey's July 27th speech is worth restating: the underlying market that LIBOR seeks to measure – the market for unsecured wholesale term lending to banks – is, according to an FCA study, "no longer sufficiently active" and not expected to become significantly more liquid in the future. Given this reality, LIBOR currently functions as more of a hypothetical rate estimated by a group of expert banks, rather than a rate rooted upon a representative number of actual transactions.

The FCA has encouraged the panel banks, and the panel banks have agreed, to sustain LIBOR for a period of four to five years (i.e., until the end of 2021) to provide sufficient time for a planned and orderly transition. After this time, however, the FCA does not intend to either persuade or exercise its legal authority to compel banks to submit to LIBOR.

Proposed LIBOR Replacement Rates

In terms of who will be responsible for formulating a "replacement" rate, the FCA has made clear that the onus is on market participants to begin the transition to "alternative reference rates that are based firmly on transactions" in the near term.

Thus far, there is no single global replacement rate that has emerged as an alternative. Rather, different rates have emerged in different markets as potential successors.

In the U.S., the Alternative Reference Rates Committee ("ARRC"), which was formed in the aftermath of the financial crisis, announced in June 2017 that it recommended replacing U.S. LIBOR with a Broad Treasuries Repo Financing Rate ("BTFR"), which would be based upon the cost of overnight borrowings secured by U.S. treasury securities. BTFR has also been referred to by the ARRC as the Secured Overnight Funding Rate ("SOFR").

Similarly, in the U.K., the Risk Free Rate Working Group selected the Sterling Overnight Index Average ("SONIA"), which is based upon the weighted average of certain unsecured overnight sterling transactions, as its preferred benchmark.

Both BTFR/SOFR and SONIA are overnight rates and, therefore, differ from LIBOR in that they are backward-looking rather than forward-looking.

The Federal Reserve issued a request for information relating to the production of LIBOR rates on August 27, 2017, and is planning to collect and tabulate such information with the hopes of beginning publication of the BTFR/SOFR as early as the first half of 2018.

Your Weil Finance Team is Available to Assist

Given the changes to LIBOR outlined above, we encourage our private equity clients to reach out to the Weil finance team with any questions regarding the implications of this LIBOR issue in your existing and future credit facilities and other financing transactions.

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Banking & Finance Alert is published by the Banking & Finance practice group of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1 212 310 8000, www.weil.com.

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