KIRKLAND & ELLIS

Derivatives Blog

LIBOR Cessation and Hedging in the U.S. — Cutting to the Chase

20 October 2021

There's no shortage of digital ink being spilled on LIBOR cessation — and probably justifiably so. But we're finding that this is leaving many clients a bit overwhelmed. It's fairly evident to most that USD LIBOR will likely be predominantly replaced with the secured overnight financing rate ("SOFR"). It's also fairly clear that financing arrangements — bonds, loans, securitizations, etc. — and corresponding hedges should either directly incorporate alternative benchmarks like SOFR or (particularly in the case of financing documents that are more difficult to amend) have "fallback" language to ensure an orderly transition from LIBOR to a replacement rate when LIBOR fully sunsets. But it's a bit less obvious how to ensure that these moving pieces come together neatly when LIBOR is in the rearview mirror.

Let's say you're a corporate who entered into a USD LIBOR-based credit agreement two years ago. You entered into a fixed-to-floating interest rate swap when you closed on the loan to hedge USD LIBOR. The loan and the swap have another three years until maturity. What are your next steps?

First, determine whether your credit agreement contains LIBOR "fallback" language. This is as easy as reviewing the credit agreement. Does it describe what happens when LIBOR sunsets? If not, you will likely need 100% lender consent to amend the benchmark. If so, will the benchmark be amended via negative lender consent? Or will it automatically transition to a SOFR-based rate? Let's assume for the purposes of argument that the loan is typical of syndicated loans issued recently and contains hardwired fallback language that will transition to term SOFR no later than when USD LIBOR goes away in June 2023 (and potentially earlier via an optional early switchover).

Second, figure out whether your hedge describes what happens when LIBOR sunsets. This is a little trickier. Your interest rate swap confirmation likely just references "USD-LIBOR-BBA." To figure out what that means, you have to look at the 2006 ISDA Definitions (the "2006 Definitions"). Here's where it gets more complicated. *Prior to* January 25, 2021, the 2006 Definitions didn't set a roadmap for LIBOR cessation. This changed on January 25, 2021, with the effective date of Supplement 70, which built in LIBOR transition mechanics. Note that we're not discussing the 2021 ISDA Interest Rate Derivatives Definitions (the "2021 Definitions"), which were published on June 11, 2021, because historical transactions being evaluated for LIBOR transition issues are almost certainly governed by the 2006 Definitions. That said, it should be noted that the 2021 Definitions incorporate the LIBOR cessation mechanics as well.

If your confirmation references the 2006 Definitions "as amended," then the swap probably incorporates all this new technology, even though it was entered into prior to January 25, 2021. If your confirmation simply references the 2006 Definitions, then the swap probably does not incorporate any of these updates. Long story short, a USD LIBOR swap that incorporates Supplement 70 would be expected to transition to compounded-in-arrears SOFR with the current credit adjustment spread published by *Bloomberg*. A USD LIBOR swap that doesn't incorporate these definitional tweaks will need updating to include LIBOR transition mechanics.

So how do you go about updating? One easy way is to adhere to ISDA's 2020 IBOR Fallbacks Protocol. This is as simple as uploading a form letter to ISDA's website and paying a nominal fee. This will have the result of retroactively updating all your ISDAs to incorporate the LIBOR cessation mechanics (note it also updates non-ISDA trading agreements, though). Another approach is simply updating your swap via a bilaterally negotiated amendment.

In our example, this leaves you with a loan that likely transitions to term SOFR and a hedge that likely transitions to compounded-in-arrears SOFR. Of course, these aren't the same exact thing, so there will likely be a little air — or basis — between the two. Whether this basis becomes problematic begets commercial analysis, and the extent to which it can be eliminated is not altogether clear yet. While ISDA has published a term SOFR definition ("CME Term SOFR"), CME Term SOFR is not a default fallback in the ISDA standard fallback waterfall, and so absent a bespoke arrangement, the basis risk will likely persist.

So how urgent is any of this if USD LIBOR will stick around until mid-2023? Ultimately, in this fact pattern at least, any rush will likely depend on the credit agreement language. For example, if your credit agreement enables transition from

LIBOR earlier than June 2023 (which many credit agreements with hardwired fallback language do), updating the corresponding hedge sooner than later might make sense. But this isn't necessarily straightforward. As noted above, the ISDA standard fallback waterfall differs from the typical hardwired fallback waterfall. But beyond that, it doesn't link its SOFR switch to the timing in any particular credit agreement. So there's a tough-to-avoid element of timing basis as well.

All this is to suggest that now is the right time to be thinking about this. And while the roadmap isn't identical for everyone, in nearly all contexts, the first steps are clear and similar — understand what your *hedged agreement* says and understand what your *hedge* says. Then make a game plan.

Author

Jaime A. Madell

Partner / New York

Related Services

Practices

- Derivatives
- Transactional