HILLIS CLARK MARTIN & PETERSON P.S.

LIBOR PHASE-OUT:

THE CLOCK IS TICKING

Presented by:

Katie S. Chapman | Melody E. Alvarado Latino | Michael N. Kot | Matthew H. Weger

HILLIS CLARK MARTIN & PETERSON P.S.

OVERVIEW

1. LIBOR Background
2. Replacement Risks
3. Understanding SOFR
4. Fallback Language
5. Steps for Lenders
6. Steps for Borrowers

MIKE KOT
ATTORNEY
Lender Services Group

MELODY ALVARADO LATINO
ATTORNEY
Business Group

KATIE CHAPMAN
ATTORNEY
Head of Lender Services Group

MATT WEGER
ATTORNEY
Business Group

HILLIS CLARK MARTIN & PETERSON P.S.

1. WHAT IS LIBOR, AND HOW DID WE GET HERE?

with Michael N. Kot

A BRIEF HISTORY OF LIBOR

- London inter-bank lending rate was launched by British Banker's Association in mid-1980s.

- Forward-looking index designed to *predict* a bank's actual cost of funds over a certain time period in the future (e.g. overnight, 30 days, 60 days, 90 days & 180 days).

- Unsecured and speculative rate *(which is why we are here)*.

A BRIEF HISTORY OF LIBOR

- Estimates of Current LIBOR Use:
  - $370 trillion contracts worldwide.
  - $200 trillion contracts based on US Dollars.
  - 95% of use is in derivatives exposure.

HOW LIBOR IS DETERMINED & WHY IT IS A PROBLEM

- Before 2014, sixteen banks submitted rates at which they 'could' borrow funds in various currencies from other banks in London.
- As early as 2005, there was evidence that Barclays was manipulating LIBOR index through its submitted rates.
- By 2012, attempted manipulation was so widespread that LIBOR could not continue in its current form:
    - Barclays admitted misconduct, paid hundreds of millions in fines, and its CEO and COO resigned.
    - UBS was fined over a billion dollars for attempting to fix the LIBOR index.
    - Deutsche Bank admitted limited staff involved in rigging.
- In 2014, administration of LIBOR was transferred to the ICE Benchmark Administration (IBA).

PHASE-OUT ANNOUNCEMENT & SUBSEQUENT DEVELOPMENTS

- **November 2014:** Alternative Reference Rates Committee (ARRC) was convened by Federal Reserve Board and NY Fed to consider alternative reference rates for USD contracts and a phase-out plan for LIBOR-based contracts.

- **June 2017**: ARRC selected the Secured Overnight Financing Rate (SOFR) as the preferred alternative index rate to LIBOR for USD contracts.

- **July 2017:** IBA announced it would no longer publish LIBOR in its current form after December 31, 2021 because *"the absence of active underlying markets raises a serious question about the sustainability of LIBOR benchmarks that are based upon these markets"*.

PHASE-OUT ANNOUNCEMENT & SUBSEQUENT DEVELOPMENTS

- **February 5, 2020:** Fannie and Freddie announce they will stop accepting ARMs based on LIBOR by the end of 2020 and will start accepting ARMs based on SOFR later in 2020.

- **March 2, 2020:** NY Fed began publishing daily "SOFR Index" to allow for the calculation of compounded averages over a custom time period and three daily compounded averages of SOFR: (1) 30-day Average SOFR; (2) 90-day Average SOFR; and (3) 180-day Average SOFR.

PHASE-OUT ANNOUNCEMENT & SUBSEQUENT DEVELOPMENTS

Will the phase-out of LIBOR be delayed due to the COVID-19 pandemic?

HILLIS CLARK MARTIN & PETERSON P.S.

2. RISKS ASSOCIATED WITH LIBOR REPLACEMENT

with Melody E. Alvarado Latino

TAX IMPLICATIONS

- A change to an interest rate could be deemed a taxable debt-for-debt exchange
  - Under certain circumstances, if the interest rate is changed to a rate that is:
    - Equal to or is higher than the ***"applicable federal rate"*** of interest, neither lender nor the borrower will realize gain or cancellation of indebtedness income
    - Lower than the ***"applicable federal rate"***, then Borrower could realize a "phantom" cancellation of indebtedness income
- Why should I care about this?
  - This could lead to a <u>higher</u> tax liability

NEW PROPOSED REGULATIONS

To address this situation, the IRS released Prop. Reg. § 1.1001-6

- A debt instrument modified to replace LIBOR will not be taxable if:
  - The new interest rate is a "qualified rate"
  - The "currency requirement" is satisfied
  - The "fair market value test" is satisfied

QUALIFIED RATE

1. **The Secured Overnight Financing Rate published by the Federal Reserve Bank of New York (SOFR)**
2. The Sterling Overnight Index Average (SONIA)
3. The Tokyo Overnight Average Rate (TONAR or TONA)
4. The Swiss Average Rate Overnight (SARON)
5. The Canadian Overnight Repo Rate Average (CORRA)
6. The Hong Kong Dollar Overnight Index (HONIA)
7. The interbank overnight cash rate administered by the Reserve Bank of Australia (RBA Cash Rate)
8. The euro short-term rate administered by the European Central Bank (€STR)

QUALIFIED RATE

9. **Other rates identified as a successor to LIBOR by a central bank, reserve bank, monetary authority, or similar institution (including any committee or working group of the institution) as a replacement for LIBOR or its local currency equivalent in that jurisdiction**

10. Any qualified floating rate (as defined in Treas. Reg. §1.1275-5(b))

11. Any rate that is determined with reference to one of the above, including a rate determined by adding or subtracting a number of basis points to or from the erate or by multiplying the rate by a specified number

12. **Any rate identified as a qualified rate in guidance published in the Internal Revenue Bulletin**

CURRENCY REQUIREMENT

- The replacement reference rate must be based on transactions conducted in the same currency as the original referenced rate
- Or must reasonably be expected to measure contemporaneous variations in the cost of newly-borrowed funds in the same currency
- For example, USD-based rate should be replaced with USD-based rate

FAIR MARKET VALUE

- FMV of the modified debt must be **substantially equivalent** to the FMV of the debt instrument before the modification.

- Contains 2 safe harbors:
  - If the historic average of LIBOR does not differ by more than 25 basis points from the historic average of the replacement rate
    - Must take into account any spread or other adjustment to the rate and
    - the value of any one-time payment that is made with the alteration or modification

  - The "arm's-length" safe harbor
    - creates a presumption of substantially equivalent value if the new index is the result of bona fide arm's-length negotiations between the parties
    - not available if the issuer and holder of the loan are related parties (under either IRC 267(b) or IRC 707(b)(1)).

INTEGRATED OR HEDGED TRANSACTIONS

Prop. Reg. § .1001-7(c) allows for:

- Alteration of the terms of a debt instrument
- Modification of one or more of the other components of an integrated or hedged transaction to replace LIBOR
  - New rate must be a qualified rate
- If all conditions are met, the change will not affect the tax treatment of:
  - The underlying transaction
  - The hedge
- Transaction as modified has to continue to qualify for integration

RISK OF RATE INCREASING

- If LIBOR is replaced, there is a possibility that interest rates could go up, triggering:
  - Increases in loan payments
  - Difficulties with financial covenants
- Loan documents could give lender a lot of flexibility to pick a new rate
  - Great for Lender; not so great for Borrower
- Loan documents may not allow for adjustments
  - Can't account for value lost in transaction

SWAPS & OTHER HEDGING PRODUCTS

- Check your swap and other hedging agreements!
    - Keep a lookout for problems that should be addressed now
- It may be the right time to purchase the right hedging arrangement
    - Can protect you going forward

UNCERTAINTY RISK

- Risk of litigation
  - Ambiguous or unclear language in loan documents
  - Lender takes an extreme position

- Lender confusion or inaction
  - Less sophisticated lenders may not take action in the time that is necessary to get Borrower the information needed to comply with the loan

HILLIS CLARK MARTIN & PETERSON P.S.

3. SOFR: THE PROPOSED SOLUTION
BENEFITS & CHALLENGES

with Katie S. Chapman

WHAT IS SOFR?

- **Secured Overnight Financing Rate**
- Administered and produced by Federal Reserve Bank of New York
- Cost of borrowing cash overnight collateralized by Treasury securities
- Published daily on FRBNY's website
- Backward-looking rate
- Based on actual transactions reported by various market participants
- "Risk-free" and correlates with other money market rates

WHY SOFR?

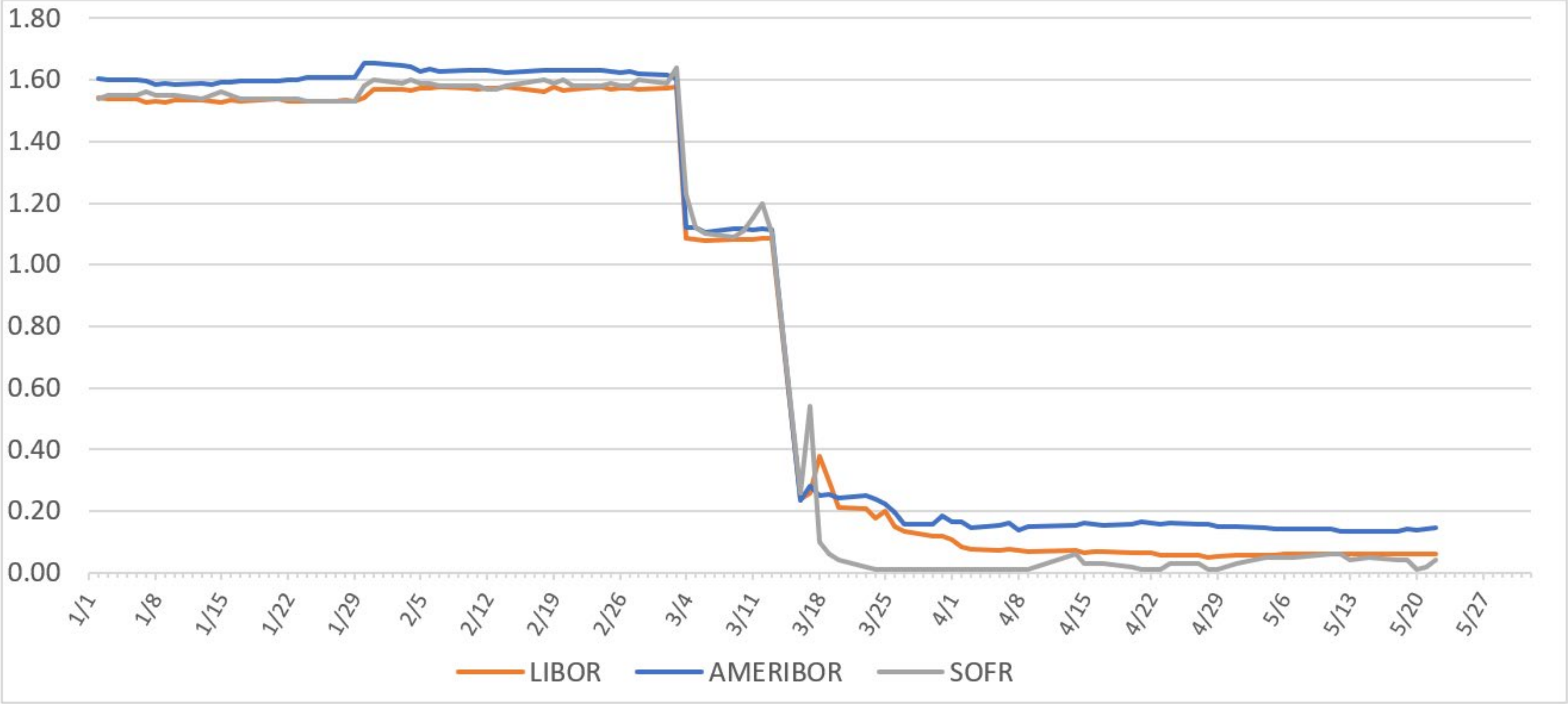
- Robust
  - Largest rates market
  - Based on underlying volume of $1 trillion
- Transparent
  - Fully transaction-based, thus observable
- Resilient
  - Report market weathered past financial crises
  - ARRC believes it can be produced reliably under a wide range of market conditions
- Complies with IOSCO

SOFR CHALLENGES

- Limited historical data on SOFR
- Backward-looking with no forward-looking term SOFR rates
- SOFR rates differ from LIBOR rates
- Volatility

SOFR vs LIBOR

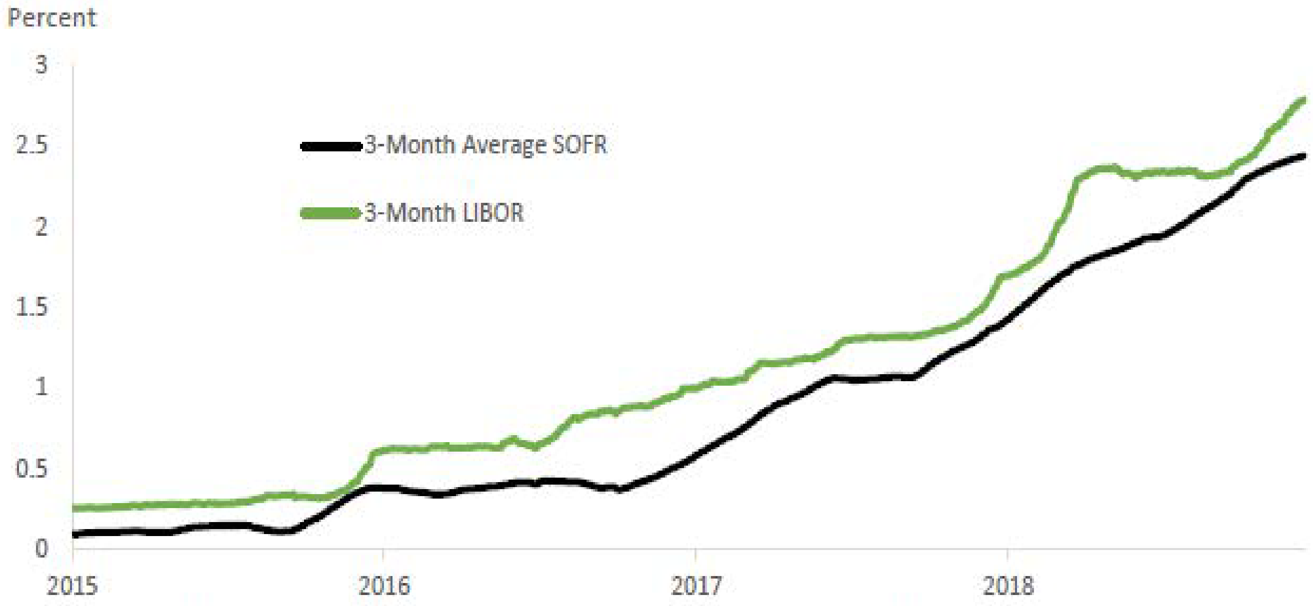
More recently:



Source: https://www.valuewalk.com/2020/06/sofr-ameribor-covid-19-stress/

SOFR vs LIBOR

The graph below compares 3-month LIBOR to the 3-month simple average of SOFR:



Source: Federal Reserve Bank of New York, ICE Benchmarks Administration; Federal Reserve Board staff calculations. Data from August 2014 to March 2018 represent modeled, pre-production estimates of SOFR.

Source: https://www.valuewalk.com/2020/06/sofr-ameribor-covid-19-stress/

HILLIS CLARK MARTIN & PETERSON P.S.

4. LIBOR FALLBACK LANGUAGE

with Katie S. Chapman

AMENDMENT APPROACH

- Lender amends the loan documents to replace the index and make any necessary spread adjustments
- Amendment is effective without the borrower's consent
- Optional objection period for borrowers and co-lenders

HARDWIRED APPROACH

- **Waterfall**

  1. Term SOFR (if available) plus ***spread adjustment***
  2. The Daily Simple SOFR, SOFR Average, or Compounded SOFR, plus ***spread adjustment***
  3. Lender-selected ***benchmark replacement*** plus ***spread adjustment***

- Occurs automatically
- No amendment required

(1) BENCHMARK REPLACEMENT

- Prime/Federal Funds Rate (legacy contracts)
- SOFR
- Rate selected by Lender
- Rate selected by Lender *giving due consideration to**:
  - i. Recommendations of a replacement rate or mechanism for determining the rate by the Federal Reserve Board or FRBNY; ***or***
  - ii. Evolving or then-prevailing market convention for determining a LIBOR replacement; and
  - iii. 0% Floor

  *(ARRC-Recommended)

(2) SPREAD ADJUSTMENT

- **Within Benchmark Replacement:** Adjustment made to benchmark replacement to account for differences between LIBOR and replacement rate *(ARRC-recommended)*

OR

- **Outside of Benchmark Replacement:** Adjustments made to the existing credit spread (margin)

(2) SPREAD ADJUSTMENT

Determined by Lender:

- At Lender's discretion
- By Lender *giving due consideration to:*
  1. Recommended spread adjustment or method for calculating spread adjustment by the Relevant Governing Body; or
  2. Evolving or then-prevailing market convention for determining a spread adjustment or method for calculating spread adjustment

  (ARRC-recommended)

(2) SPREAD ADJUSTMENT

Example 1 – Adjustment to Benchmark Rate

Existing Rate is Daily LIBOR (benchmark rate) plus 3.00% (credit spread)

- Assume LIBOR is .50% but SOFR is .25%
- Lender elects to adjust SOFR instead of the margin

The Benchmark Replacement Rate would be: SOFR + .25%

The Credit Spread would remain at 3.00%

The all-in Replacement Rate would be: SOFR + .25% + 3.00%

(2) SPREAD ADJUSTMENT

Example 2 – Adjustment to Spread

Existing Rate is Daily LIBOR (benchmark rate) plus 3.00% (credit spread)

- Assume LIBOR is .50% but SOFR is .25%
- Assume Lender adjusts the credit spread instead of the benchmark rate

The Benchmark Replacement would be: SOFR

The Credit Spread would be: 3.0% + .25% = 3.25%

The Replacement Rate would be:

- SOFR + 3.25%

(3) TRANSITION EVENTS

Permanent Cessation Trigger:

- Public statement from the administrator or authority with jurisdiction over the administrator of LIBOR that the administrator will cease to provide LIBOR permanently or indefinitely and there is no successor administrator *(ARRC-recommended)*

- Any government authority with jurisdiction over Lender has made a public statement identifying a specific date after which the LIBOR Rate may no longer be used for determining interest rates for loans

(3) TRANSITION EVENTS

Pre-Cessation Trigger:

- A public statement or publication of information by the regulatory supervisor for the administrator of the LIBOR announcing that LIBOR is no longer representative *(ARRC-recommended)*

(4) EARLY OPT-IN

Lender's determination that:

- LIBOR is no longer representative
- LIBOR has been succeeded by another floating index rate or is no longer industry standard for loans of the same type as the loan
- At least [five] currently outstanding US dollar-denominated credit facilities use Term SOFR plus a spread adjustment and the Lender's notice to Borrower of its election to *(ARRC-recommended)*

(5) WHEN DOES TRANSITION OCCUR?

Examples

- The *earlier of:*
  - Date of public statement; or
  - Date on which administrator permanently or indefinitely ceases to provide LIBOR
- Notice to Borrower
  - Immediately or # of days after notice
  - Objection periods for early opt-in

HILLIS CLARK MARTIN & PETERSON P.S.

5. STEPS TO TAKE AS A LENDER

with Michael N. Kot

DETERMINATION OF MATURITY DATE OF EXISTING LOANS IN PORTFOLIO

- Before December 31, 2021?
- Is there an extension option?
- Should December 31, 2021 be the focus date?

DETERMINATION OF INDEX FOR NEW LOANS

- Will SOFR be used?
- If so, will SOFR be calculated based on *simple interest* or *compounding interest*? Will interest be determined *in advance* or *in arrears*?
- Will a SOFR term rate be a satisfactory replacement for a LIBOR term rate?

DETERMINATION OF REPLACEMENT INDEX FOR EXISTING LOANS

- Do the loan documents specify an alternative index rate?
- Do the loan documents anticipate a permanent cessation of LIBOR?
- If an alternative index rate may be substituted, may the spread be adjusted?

DETERMINATION OF REPLACEMENT TRIGGER

- Potential roadblocks with replacement trigger language in existing loan documents (e.g., LaserPro provides no longer published on "widely available basis" or "widely accepted as an index" for similar loans).
- Conversions prior to replacement trigger for administrative ease.
- Coordination of timing with replacement swap index.
- Coordination with co-lenders for syndicated or participated loans.

TITLE INSURANCE FOR EXISTING LOANS

- Will title companies require endorsements to existing title policies in connection with a conversion to a non-LIBOR index?

- If so, will an ALTA 11 modification endorsement be required or will there be a new endorsement form?

- Will a deed of trust or mortgage modification be required?

ARRC PRACTICAL IMPLEMENTATION CHECKLIST FOR SOFR ADOPTION (SEPTEMBER 2019)

(Available on NY Fed website: www.newyorkfed.org)

- Understand financial, customer, and legal impacts of transition away from LIBOR.
- Analyze impacts on accounting, disclosures, taxes and secondary market transactions.

HILLIS CLARK MARTIN & PETERSON P.S.

6. STEPS TO TAKE AS A BORROWER

with Matthew H. Weger

ANALYZE LOAN DOCUMENTS
(EXISTING AND PROPOSED)

- As a Borrower, you should be proactive your existing loan documents. Take inventory of the LIBOR provisions.
  - Is there a fallback mechanism? If so, does it match the economics of your current loan?
  - If there is no fallback mechanism, what happens next?
- How much can Borrower participate in the process?

"ACT NOW AND SAVE!"

- Get in touch with your lenders now or over the next few months
  - Acting early lets you exercise your leverage
  - Acting early also lets you mitigate not having any leverage

- Lenders have finite amount of time
  - Consider experiences with COVID-19

- Acting early gives you the opportunity to make informed decisions on your loan, including a refinance

RESOURCES

Alternative Reference Rates Committee website: https://www.newyorkfed.org/arrc

Goodman, Gary A. and Yurke, Alice F. "The Death of LIBOR and the Afterlife." American Bar Association Real Property Trust Estate Magazine. January/February 2020.

Internal Systems and Processes: Transition Aid for SOFR Adoption. Alternative Reference Rates Committee. July 8, 2020. https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Internal-Systems-Processes-Transition-Aid.pdf

HILLIS CLARK MARTIN & PETERSON P.S.

Q&A SESSION

Use the "Q&A" function in Zoom to send us your questions.

MIKE KOT
mike.kot@hcmp.com
206.470.7621

MELODY ALVARADO LATINO
melody.alvaradolatino@hcmp.com
206.470.7655

KATIE CHAPMAN
katie.chapman@hcmp.com
206.470.7654

MATT WEGER
matt.weger@hcmp.com
206.470.7650