Cassels

Interest Rates Watch: LIBOR Transition – A Limited Legislative Solution

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Welcome back to our Interest Rates Watch series, developed to provide timely updates and practical advice on developments related to interest rates and benchmarks on a regular basis. As always, we are here to help.

Background

What Happened?

Having been introduced by Governor Cuomo earlier in January, on March 24, 2021, the New York State Legislature passed a LIBOR discontinuance bill[1] (the LIBOR Transition Legislation). This bill is based on the Alternative Reference Rates Committee (ARRC) updated proposed LIBOR transition legislation. On March 6, 2020, ARRC first proposed language for a legislative approach to addressing certain LIBOR transition issues. On March 1, 2021, the ARRC released an updated version of the legislation, which was the language passed by the New York Legislature.

As a result of the passage of this bill, the State of New York has decided to provide a legislative solution to market and legal uncertainty surrounding LIBOR cessation and legacy contracts. Below we discuss the background of this legislation and some of the implications.

Why Did this Happen?

In anticipation of the end of USD LIBOR, the ARRC has recommended that all USD LIBOR-based contracts include fallback language (i.e., language that addresses how contracts will transition away from LIBOR). Although some contracts have followed the amendment approach, since August 2020, the ARRC has recommended that USD LIBOR-based contracts adopt a hardwired fallback approach, which would automatically switch LIBOR to a benchmark replacement based on the Secured Overnight Financing Rate (SOFR), with relevant adjustments to the spread and conforming changes to documents.

Despite the impending deadlines (**December 31, 2021** for 1-week and 2-month USD LIBOR and all GBP, EUR, CHF and JPY LIBOR and **June 30, 2023** for overnight and 1-month, 3-month, 6-month and 12-month USD LIBOR), many USD LIBOR based contracts will mature after these deadlines and have no appropriate fallback language. These include mortgage, consumer and student debt, and floating rate debt and derivatives transactions. Until recently, most jurisdictions have relied upon the market to address legacy contracts, but the LIBOR Transition Legislation has shown that a legislative solution may be the best response to avoid a disorderly transition, which, if it occurred, would be widely felt by financial institutions, businesses and consumers.

What Does the Legislation Do?

The LIBOR Transition Legislation:

- applies only to New York law-governed USD LIBOR-based contracts: (i) without fallback language (whether the amendment or hardwired approach); *or* (ii) that include fallback language providing a fallback to last quoted LIBOR or to an alternative, LIBOR-based reference rate (such as a rate derived from taking a poll of participating banks and averaging the quoted rates)
- essentially writes in a “recommended benchmark replacement” so that, on the relevant deadline date, the contracts would automatically fallback to a SOFR-based replacement
- provides for a spread adjustment and conforming changes as recommended by the Federal Reserve Board, the FRBNY or the ARRC

What has Been the Reaction to this Legislation?

The Loan Syndications and Trading Association (LSTA) and the ARRC have both reacted positively to the LIBOR Transition Legislation. On January 26, 2021, in response to the proposed bill, the LSTA stated that “the LSTA believe[s] that anything that smooths LIBOR transition and reduces the potential for market disruption is A Good Thing.”[2]

On March 24, 2021, the ARRC press release included this quote “[the] ARRC applauds the passage of its proposed legislation, which marks a major milestone in the transition away from LIBOR,” said Tom Wipf, ARRC Chairman and Vice Chairman of Institutional Securities at Morgan Stanley. “Especially as we enter the home stretch for USD LIBOR, this legislation will address a key risk in the transition by providing a targeted solution for market participants who hold legacy contracts that have no effective fallbacks when LIBOR is discontinued.”[3]

Implications for LIBOR Contracts

This legislation is undoubtedly significant given that many USD LIBOR contracts are governed by New York law. However, this legislation is only a state law, so it will not apply to USD LIBOR contracts governed by the laws of other US or foreign jurisdictions, like Canada. There are many Canadian transactions that include USD LIBOR-based obligations and that are governed by Canadian provincial law. However, at this time, the Canadian federal or provincial legislatures are not considering adopting a similar approach for USD LIBOR-based contracts governed by the laws of a Canadian jurisdiction.

We note that legislative and regulatory changes are being considered for other LIBOR currencies, including for EUR LIBOR. Most recently, on February 2, 2021, the European Parliament amended its regulations relating to EUR LIBOR cessation and the European legislative approach came into effect. Like the New York LIBOR Transition Legislation, the European regulations allow for a successor benchmark to be designated, as well as for spread adjustment and conforming changes to legacy instruments.

Recommendations

All USD LIBOR-based instruments (whether or not they are not governed by New York law) should be reviewed to account for rapidly changing practices in relation to LIBOR discontinuation provisions. It is now very clear that all new originations, whether or not governed by New York law, should include robust hardwired fallback language that is substantially similar to ARRC’s language with minimal deal-specific changes in any documents that use USD LIBOR, or (b) use a new reference rate (such as SOFR) with appropriate spread adjustment provisions. For documents falling into these categories and where parties wish to transition to SOFR, the following approaches are required as it relates to amending USD LIBOR-based contracts:

Type of Contract	**Amendments Required?**
Contract including ARRC-Recommended Hardwired Fallback USD LIBOR Discontinuation Language	No amendments necessary. NY LIBOR Transition Legislation will *no*
New York law contract without any fallback USD LIBOR Discontinuation Language	No amendments necessary. NY LIBOR Transition Legislation will ap
New York law contract with fallback or market disruption provision falling back to a LIBOR-based rate	No amendments necessary. NY LIBOR Transition Legislation will ap
New York law contract with market disruption provision or fallback to a benchmark replacement *not* based on LIBOR, such as the base rate or federal funds rate	Amendments to be considered unless parties are in agreement that fallback provisions are commercially acceptable. NY LIBOR Transiti will *not* apply
All other fallback language (including amendment USD LIBOR discontinuation fallback language) in contract that is *not* governed by New York law	Yes – amendments necessary before January 1, 2022 or July 1, 202 applicable) to replace USD LIBOR with a benchmark replacement
No fallback or market disruption language in contract that is *not* governed by New York law	Yes – amendments necessary before January 1, 2022 or July 1, 202 applicable) to replace USD LIBOR with a benchmark replacement

For legacy contracts that fallback to base rate advances (such as agreements without AARC-recommended discontinuation language but which contain a market disruption provision), parties may determine that no amendments are necessary particularly given the most likely SOFR-based fallback is also a daily rate of interest (Simple Daily SOFR). Parties will need to determine if the existing discontinuation or market disruption provisions reflect the parties’ commercial expectations.

Parties to documents in the last category should be considering the appropriate replacement rate and ensure that documents are amended to adopt a replacement rate prior to the date upon which the applicable LIBOR setting will no longer be published.

We will be issuing further articles relating to interest rates. Find other articles in our Interest Rates Watch Series here.

[1] https://legislation.nysenate.gov/pdf/bills/2021/S297B

[2] https://www.lsta.org/news-resources/ny-state-legislating-libor-fallbacks/

[3] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/20210324-arrc-press-release-passage-of-libor-legislation