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FINANCING FACILITIES

Preparing for LIBOR Transition: What the Year-End Deadline Means for PE Sponsors With Subscription Facilities (Part One of Two)

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Subscription credit facilities have become a normal part of fundraising and management. With the end of the London Interbank Offered Rate (LIBOR) approaching, however, a new element has been interjected into amending, renewing and entering into credit agreements in the PE space. Although existing U.S. Dollar (USD) LIBOR loans can rely on LIBOR quotes until June 30, 2023, lenders may not issue new LIBOR-based loans for any currency, including USD, after 2021. Most lenders will use a new, non-LIBOR benchmark for any loans issued between now and the last day of the year.

In this first article in a two-part series, the Private Equity Law Report spoke to three lender-side counsel and four borrower-side counsel about what the end-of-year deadline means and the state of readiness in the PE subscription facility space. The second article will explore terms in LIBOR remediation provisions in which borrowers are pushing back against lender language, as well as provide information about the typical legal costs and overall timing associated with LIBOR transition efforts.

See our two-part series on Institutional Limited Partners Association guidance on subscription credit facilities: "Reiterating the Need for Increased Disclosures on the Use of Facilities and LP Obligations" (Aug. 25, 2020); and "Sponsor Skepticism Over the Value and Potential Harms of Excessive Disclosures to LPs About Facilities" (Sep. 1, 2020).

LIBOR and PE Funds

LIBOR and Its Cessation

LIBOR is referenced as a benchmark interest rate in hundreds of trillions of dollars of financial instruments globally. LIBOR is susceptible to manipulation because it is based on estimates collected from global banks on the interest rates they would pay to borrow money from another bank on an unsecured basis. For example, in 2012, there was a widespread scandal in which traders at many leading financial institutions deliberately submitted artificially low or high interest rates to support their own institutions' derivative and trading activities.

As a result of those risks, the G20 governments decided to seek a replacement for LIBOR. In the U.S., the Federal Reserve Board and the New York Federal Reserve convened the Alternative Reference Rates Committee (ARRC) to identify alternative reference rates for USD LIBOR.

How LIBOR Affects PE Funds

LIBOR transition means that, at a certain point, all new credit agreements must use a non-LIBOR benchmark rate. At a later point, all existing credit agreements that currently use LIBOR as a benchmark rate must be amended and restated to reflect the cessation of LIBOR.

For new loans, sponsors should be prepared to review provisions around the new benchmark rate. For existing loans, sponsors should be prepared to review new fallback provisions that spell out what will happen when LIBOR is no longer available. In the U.S., PE sponsors typically pay for LIBOR remediation for their credit agreements.

For PE funds, loan agreements at both the portfolio company and fund level are affected by the LIBOR transition. At the underlying asset level, PE and real estate funds typically leverage the acquisition of portfolio companies and commercial properties. "More than 90 percent of those loans are based on LIBOR," noted Cadwalader partner Michael C. Mascia. "The entire debt suite at the portfolio level needs to be adjusted for the transition away from LIBOR."

At the fund level, almost all subscription credit facilities from the last five years are based on LIBOR. In addition, although pure PE buyout funds typically do not use leverage at the fund level, private credit funds and secondaries funds, for example, tend to borrow and have leverage at the fund level, Mascia observed. "Those leverage facilities will likely need LIBOR amendments too."

See "Characteristics and Benefits of NAV Facilities for Secondary Funds" (Sep. 10, 2019).

Timing

LIBOR will no longer be available after December 31, 2021, for all U.K. pound sterling, E.U. euro, Swiss franc and Japanese yen (collectively, Select Foreign Currencies) settings, as well as for the seldom-used one-week and two-month USD settings. For the remaining USD settings, LIBOR will no longer be provided after June 30, 2023.

The LIBOR transition is coinciding with "an incredibly busy time" for PE funds, Mascia noted, making it difficult for PE sponsors to focus on remediation provisions. Nevertheless, "new LIBOR issuance and multicurrency facilities must transition in Q4 of this year, and people must devote the bandwidth and resources to make it happen," advised Cadwalader partner Jeffrey Nagle.

By Year-End

Banks will no longer be able to offer new loans based on LIBOR in any currency after December 31, 2021, including extensions to existing USD LIBOR-based facilities.

Sponsors hoping to use the familiar LIBOR benchmark for new facilities until the end of the year will likely not find it possible. Many banks set an internal deadline of October 1, 2021, for ceasing to issue new LIBOR loans, according to Nagle. "If deals are in flight and if term sheets are already pre-agreed, there could be some flexibility around that. A non-LIBOR benchmark is on the cusp of being the only game in town, however," he said. In fact, there are already new credit agreements in the market – including subscription credit facilities – using a non-LIBOR benchmark from day one. "The ARRC's endorsement of Term SOFR in late July was a major catalyst," noted Haynes and Boone partner Holly Loftis.

Further, all existing multicurrency facilities must be updated to reflect a non-LIBOR benchmark by the end of 2021.

By Mid-2023

Existing USD LIBOR-based loan agreements have until the end of June 2023 to update their benchmark rates. Borrowers with USD LIBOR credit agreements technically do not need to change anything until then. Lenders have been using the opportunity of other borrower-requested amendments to present LIBOR-related amendments, however.

Most USD LIBOR agreements will likely be remediated well before the mid-2023 deadline, but it remains to be seen how many will be amended in 2021. One expert suggested that much of the USD remediation would occur in 2022 or early 2023, but others thought market participants would address the LIBOR transition sooner. "It's highly unlikely that people would wait until June 2023 without addressing LIBOR in their credit agreements," suggested Foley Hoag partner Thomas Draper. "Borrowers with reputable banks and large direct lending funds will, for the most part, have dealt with it by the end of 2021."

See our two-part series on trends in the use of subscription credit facilities: "Advantages for PE Investors and Sponsors Have Led to Adoption by Some Private Funds" (Jan. 24, 2019); and "Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions" (Feb. 7, 2019).

LIBOR Replacement Rates

In 2017, ARRC identified the Secured Overnight Financing Rate (SOFR), which is based on short-term loans observed in the repurchase agreement market, as its preferred alternative for USD LIBOR. As a general principle, ARRC recommended that market participants use overnight SOFR and SOFR averages. In July 2021, however, ARRC formally recommended forward-looking SOFR term rates (Term SOFR), noting that Term SOFR would be especially helpful for the business loans market.

"The momentum is strongly in favor of SOFR as the fallback benchmark," observed Ropes & Gray partner Steven R. Rutkovsky. "Until recently, there was still a question of whether the fallback would be a daily SOFR rate or a forward-looking Term SOFR rate. Now that Term SOFR has been approved by ARRC as a fallback rate, it looks like the lead contender to replace LIBOR for the vast majority of loans."

See "Alternative Financing Facilities: How Management Company Facilities Offer Liquidity for Sponsors' Working Capital Needs" (Apr. 28, 2020).

How SOFR Differs From LIBOR

Initially, SOFR was only available as a daily rate – daily simple SOFR or daily compounded SOFR – which operates differently from a tenored rate like LIBOR. For a daily rate, a loan administrator must check the rate each day and apply it to the outstanding principal on that day, creating a slew of operational changes for the lender.

ARRC recommended daily SOFR rates for certain financial products, such as derivatives. Term SOFR, however, like LIBOR, is forward-looking and can be determined in advance of the interest period. The market has widely accepted Term SOFR for business loans, including subscription credit facilities.

For existing LIBOR-based loans that must be switched over to SOFR, ARRC recommended using a spread adjustment based on the five-year historical median difference between USD LIBOR and SOFR. ARRC's recommended spread adjustments match those recommended by the International Swaps and Derivatives Association for derivatives.

Alternative Benchmarks

Despite the overwhelming market preference for SOFR, some lenders have opted for other benchmark rates. The Bloomberg Short-Term Bank Yield Index (BSBY), which Bloomberg LP began publishing in October 2020, became available for use as a benchmark in March 2021 and continues to be used by some lenders, despite public criticism by SEC Chair Gary Gensler that BSBY is not "especially robust." Despite that admonition, one expert mentioned direct knowledge of at least two banks using BSBY.

For additional insights from Gensler, see "Two Sides of the Same Coin: SEC Commissioners Gensler and Lee Advocate Further SEC Oversight of ESG Efforts (Part Two of Two)" (Aug. 31, 2021).

Sponsors may have heard of the American Interbank Offered Rate (AMERIBOR) which, like LIBOR, represents unsecured borrowings between financial institutions. Created by the American Financial Exchange, AMERIBOR has been adopted primarily by small, medium and regional banks in the U.S. and has not been used in the fund finance space.

Non-USD Currencies

Sponsors with multicurrency facilities should be aware that after December 31, 2021, LIBOR for the Select Foreign Currencies will be replaced by successor benchmark rates:

- Sterling Overnight Index Average;
- Swiss Average Rate Overnight;
- Tokyo Overnight Average Rate; and
- Euro Short-Term Rate.

The transition for some rates is complicated, however, by the continued existence and use by some banks of the Euro Interbank Offered Rate and Tokyo Interbank Offered Rate.

Current State of LIBOR Transition in PE

Expert opinions varied on the state of readiness in the PE space concerning remediation of existing subscription credit agreements, with borrower-side counsel projecting more optimism. "Subscription facilities tend to run one to three years, and everything done in the last three years has had some kind of LIBOR fallback provision," noted Latham & Watkins partner Benjamin Berman. "Almost all our facilities already have LIBOR replacement language in place because lenders have included it whenever the opportunity to open the document has arisen. For the rest, banks are starting to reach out about LIBOR amendments specifically."

Lender-side counsel were more cautious in their outlook, however. "My sense is that there are a lot of deals out there that haven't been addressed yet," Mascia said. "People are certainly more focused on the LIBOR transition now that the end of the year is approaching, but I think there are still plenty of loan agreements that should be remediated by year-end in the fund finance space," Loftis agreed. "As outside counsel, it's hard to quantify, but I know they exist. The number is likely higher than you may expect, given where we are in the year, along with the statements and strong recommendations coming from the various banking regulators."

In light of the foregoing, Draper suggested that there may be a flurry of amendments in December. "There are some four-year credit agreements out there that still lack benchmark replacement language. Even though they can still quote LIBOR for another 18 months after December, most people will want to have good benchmark replacement language by the end of the year," he said. "We're pretty close to getting there now."

Regulatory Push Outpacing Borrower Urgency

Low Daily Impact of LIBOR

From a PE sponsor's perspective, LIBOR readiness is not nearly as important an issue as it is for lenders. "Ultimately, borrowers are focused on any economic impact, but most don't have to change their systems to adjust to SOFR," Berman explained. "They'll get an invoice for the interest due, and they'll pay that amount, because the idea is that interest rates are supposed to be roughly the same," he continued. "From an economical perspective, it is unlikely that managers will make different decisions based upon the fact there is now a non-LIBOR rate," Nagle agreed.

In addition to the expectation that a borrower's interest payments will remain the same despite being changed to a different benchmark, the amount involved in subscription facilities is not, relatively speaking, that high, Draper observed. "Although important, the interest rate is not a big part of the return the way it is for some hedge funds that focus on derivatives and swaps, for example."

Further, the need for clear guidance on transitioning away from LIBOR is more keenly felt in acquisition financings, which may include hundreds of different lenders and potentially multiple currencies. In the subscription line space, however, borrowers are often dealing with their relationship banks, so there is more trust between them, he added.

Overexposure

Multiple versions of language have been introduced into the market to address the end of LIBOR in existing loan agreements. As Loftis explained, an initial relatively short iteration provided that counterparties would simply agree to pick a new rate were LIBOR no longer available for reasons relating to the contemplated cessation.

ARRC then formally put out an "amendment approach," which was a more detailed formulation of the initial iteration, including:

- how parties would amend the credit agreement;
- how the timing would work;
- what rights the lending syndicate would have under the new benchmark; and
- the unilateral right for the agent bank to make conforming changes without borrower consent.

ARRC later issued a "hardwired approach," which has become the current approach of choice. Under the hardwired approach, when LIBOR is no longer available (or earlier, if parties opt for an earlier date), the replacement benchmark for USD LIBOR will be, in most cases, Term SOFR.

With each iteration of recommended fallback language, banks have had to revise their LIBOR replacement language. “Every time a facility is up for renewal, the lender needs to check internally whether its LIBOR replacement policy has changed and whether it needs to update the language,” Loftis explained.

Borrowers may have become somewhat inured to LIBOR transition issues because they have encountered multiple rounds of LIBOR-related amendments. “Each amendment requested by the borrower is returned by the lender with new LIBOR language. There may have been more anxiety six months or a year ago, but there seems to be less anxiety with each round,” Berman observed.

“Sponsors generally want to get their amendments ironed out and are willing to agree to LIBOR language to get them done, especially when everyone else in the market is doing the same thing. There’s no sense that banks are using LIBOR to change fundamental terms of the deal,” Berman assured.

Incomplete Understanding of Amendment Process

Borrowers may think of LIBOR remediation as a simple “find-and-replace” or “plug-and-play” exercise, lenders’ counsel noted. “For someone who is not in the weeds, it seems a simple matter of substituting one benchmark for another,” Mascia said. “But, SOFR is not LIBOR. The mechanics and spread adjustments are different. Each currency will have its own rate after this year. The way we compare prices is changing.”

From the lender’s perspective, an enormous amount of work goes into creating and sending LIBOR transition provisions to the borrower, but that is largely invisible to the borrower. Although Term SOFR operates on a look-forward basis much like LIBOR, the U.S. market is also expected to use daily simple SOFR in some instances. For some non-USD currencies, the only replacement rate expected to be widely available is a daily rate. As daily rates are fundamentally different from tenored rates, banks have had to reconfigure their operations.

“Whether you have an interest period concept, how prepayments work, how breakage works – there are a lot of details that differ when using a daily rate versus a tenored rate,” Nagle explained. “From the businessperson’s perspective, though, it may just seem like switching one number to another.”

Extended Deadline for USD LIBOR

USD LIBOR will continue to be quoted through June 2023, so technically, USD LIBOR-based loans can operate without amendment until then. “Lenders’ counsel have been trying to educate borrowers that LIBOR transition is complicated and that they are trying to build an industry standard,” Draper observed. “Many subscription facilities are one-year facilities, however, so the CFO of a smaller PE fund, for example, may not want to review and pay for amendments that address an issue that will not occur until 2022 or 2023.”

Uncertainty Causes Anxiety

Although the actual amendments to credit agreement are not the cause of much anxiety among borrowers, a key issue for PE sponsors is when to transition legacy agreements to the new rate. ARRC’s hardwired fallback language provides that legacy agreements will transition when USD LIBOR is no longer available (*i.e.*, after June 30, 2023) or at an earlier date, should the parties opt not to wait. The timing of the switch is a matter of concern to borrowers, however, both for economic impact reasons and general concerns about the lenders' ability to smoothly transition to a non-LIBOR environment.

Economic Impact Can Depend on Timing of Transition

Some sponsors are "highly focused" on the impending transition and are concerned about the impact on their all-in interest rate, Rutkovsky noted. Under the hardwired approach, there is a specified spread adjustment to reflect the historic difference between LIBOR and SOFR. "We are in a very low-interest-rate environment, which artificially reduces the spread based on current rates," he explained. "Given the way the hardwired spread adjustment has been calculated, most borrowers would see an increase in their all-in interest rate if the transition were to happen today."

Lenders, Rutkovsky continued, view the hardwired spread adjustments as fair, since they are based on a five-year average and, over time, will eventually return to the mean historic difference between LIBOR and SOFR. "That argument is unlikely to be persuasive to borrowers, however, that would see an immediate increase in their interest rates," he added.

"A PE sponsor with portfolio investments that are 50-percent leveraged based on LIBOR may have concerns about the value of those investments," Draper agreed. "That same PE sponsor may have a subscription facility that directly affects its investors' return on equity but no certainty about the facility's interest expense. That uncertainty makes people anxious."

See "A Comparison Between Two Liquidity Solution Tools: Preferred Equity and NAV Facilities" (Oct. 13, 2020).

Concerns About Lender Operational Readiness

Moving away from a known, familiar touchstone like LIBOR raises many questions. "Is SOFR going to work well? Is the rate going to be stable over time? Will banks be able to administer SOFR? Will they have issues with the transition or in their general administration of loans?" Berman asked. "Borrowers want to know that banks will be able to administer SOFR loans smoothly. That is a greater concern than what they will need to pay when the transition actually happens."

Those concerns are rooted in the reality that the switch away from LIBOR requires banks to make huge operational changes, including updating systems and models to ingest the new rates and training internal teams to handle a daily rate instead of LIBOR, Nagle explained. In addition, they must amend and restate thousands of contracts. Most banks have set up internal teams to thoroughly vet how new benchmark language would work in their deals.

"Banks will need to roll out a series of changes to their back-office, reporting and administrative functions to transition from LIBOR to SOFR," Rutkovsky said. "There is tremendous pressure to get it all done before the end of the year."

See "Subscription Facilities Provide Funds With Needed Liquidity But Require Advance Planning by Managers (Part One of Three)" (Jun. 2, 2016).