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Services

Public Finance

Single Family Housing

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LIBOR Phaseout/Fallback and Housing Finance Agencies

Background

Many Housing Finance Agencies (HFAs) have interest rate swaps and variable rate bonds or other financial agreements which use the LIBOR (London InterBank Offered Rate) index as the primary or a secondary interest rate index. Due to banking changes and various scandals, the LIBOR rate is presently expected to be phased out for certain terms (e.g., one week and two month) at the end of 2021 and for other terms (e.g., 30-day) possibly as late as mid-2023, which affects trillions of dollars of derivatives/contracts worldwide, and billions for HFAs. LIBOR replacement/fallback language has been developed by various regulatory and related organizations, which language HFAs are going to be, or are currently being, asked to adopt. (HFAs with no swaps or floating or variable rate obligations will not be affected. The following is a brief explanation of that LIBOR replacement/fallback language, how it could/would affect financings of those HFAs, and what HFAs should consider and do in response.

Types of Affected Financial Agreements/Contracts

HFA's LIBOR related contracts fall into two groups for the purposes of the LIBOR phaseout: (1) derivatives, such as interest rate swaps, repos and caps, as well as options and securities lending, which use ISDA and SIFMA form documents, and (2) other non-derivative financial contracts, such as SBPAs (Standby Bond Purchase Agreements), FRNs (floating rate notes), lines of credits and bond indentures/resolutions (some with LIBOR as the primary rate index, as in FRNs, and others as a fallback rate, as in some taxable variable rate bond indentures/resolutions). The distinction between the two types is important.

Technical Aspects of the LIBOR Fallback Proposals

In response to the LIBOR phaseout, banking regulators and industry groups have worked to come up with a replacement index rate for LIBOR. The new index they developed is the Secured Overnight Financing Rate, or SOFR. SOFR is an index based on actual transactions in the Treasury repurchase market, where banks and other institutions make overnight loans to one another secured by US Treasury securities. It is a huge and active market, and SOFR is published daily by The Federal Reserve Bank of New York (the "New York Fed"). Unlike LIBOR, which is a forward-looking rate and published for a

number of different “tenors” or terms (overnight, 30-day, 60-day, etc.), SOFR is a single, backward-looking overnight rate. SOFR is also a **secured** “risk free” rate because it is based on transactions fully secured by US Treasuries, while LIBOR is based on **unsecured** inter-bank rates. Thus the SOFR base index is quite different from the LIBOR base index. Parties cannot simply substitute SOFR for LIBOR in existing transactions as this would substantially change the economics of the transactions. (An HFA’s financial or swap advisor can explain the financial differences in detail.)

The New York Fed has worked with two industry groups to come up with solutions for existing transactions. First, the International Swaps and Derivatives Association (“ISDA”) has come up with fallback language it recommends be used for swaps and other derivatives, based upon SOFR variations. Second, the New York Fed sponsored a committee of financial institutions to address the “cash” or non-derivative side of the market, i.e. loans, floating rate notes, lines of credit, bond indentures and other non-derivative contracts. This committee, the Alternative Reference Rate Committee (the “ARRC”), has published recommended fallback language which is slightly different from that of ISDA. The goal of both committees was to come up with fallback rates which would be expected to be as similar as possible to what one would have expected for the related type of contract if LIBOR were still published.

The ISDA derivative document language provides for setting rates in arrears (as opposed to LIBOR, which is set in advance). The rate, which is called “Fallback” (SOFR), for a particular tenor/term will be set two business days prior to the end of an interest period and will equal daily compounded SOFR for the current interest period up to the day of determination and for the two days before the current interest period, plus a “credit spread.” Thus, the parties will not know the rate for an interest period until two business days before the end of the period. The “credit spread” will be fixed on the date the Fallback rate takes effect for ISDA based agreements, which will be the earlier of (1) the day the British regulatory authority or the LIBOR administrator sets as the day LIBOR will cease (presently expected to be December 31, 2021 for weekly and two month LIBOR and June 30, 2023 for other LIBOR tenors) or (2) the day that it is announced that LIBOR is no longer representative of the market. The credit spread will be calculated, for each tenor/term, by looking back five years and calculating the median spread between compounded SOFR for that tenor/term and LIBOR for that tenor/term for that five-year period. (So, for example, comparing the average of 30-day LIBOR over such five years to the average of 30-day compounded SOFR over the same period.) Once set, the credit spread will not change.

The ARRC has published four sets of fallback language, one for each of four types of contracts—loans, syndicated loans, securitizations and floating rate notes. The four sets of fallback language use basically the same fallback provisions but are customized in some ways for the type of instrument. For each type of instrument the ARRC language provides that an indexing agent appointed by the New York Fed will calculate, for each of the tenors/terms in which LIBOR is currently calculated, a “term SOFR” rate based on SOFR futures rates plus a credit spread based on the same methodology as the ISDA credit spread. Thus, the ARRC rate will be set at the beginning of each interest period. The markets ARRC is dealing with are less standardized than the derivatives markets, so the ARRC’s documentation releases acknowledge that some parties may prefer to use ARRC’s language but substitute a different index for

term SOFR, such as either compounded or simple SOFR plus the credit spread. The ARRC fallback rate would go into effect at the same time that ISDA's would, except in some of ARRC's provisions there is an optional provision allowing the lender under certain circumstances to convert to the fallback rate on an earlier date.

Both committees' language includes provisions for further fallback rates if SOFR were to cease to be published. Both the ISDA and ARRC fallback rates will be calculated by Bloomberg and will appear daily on a Bloomberg screen.

Incorporating the Fallback Language in Existing Transactions

Derivatives. ISDA has incorporated their fallback language (the "Supplement," published on October 23, 2020) into the 2006 ISDA Definitions, effective January 25, 2021, so any swap or other derivative entered into on or after that date that provides it is subject to the 2006 ISDA Definitions will automatically incorporate the ISDA fallback language unless the parties specifically agree otherwise.

For any swap or other derivative entered into prior to January 25, 2021, ISDA has provided ISDA fallback language in the form of (i) an online master Protocol that may be adopted by parties to swap and derivative instruments, and (ii) form bilateral agreements which may be adopted by parties to swap and derivative instruments instead of the master Protocol. A description of both fallback language adoption options follows, along with considerations for an HFA to take into account when determining whether to adopt the Protocol or instead enter into bilateral agreements for the fallback language.

Derivatives—ISDA 2020 IBOR Fallbacks Protocol Option for Existing Swaps/Derivatives

ISDA has set up an online protocol called the **ISDA 2020 IBOR Fallbacks Protocol** (the "Protocol", also published on October 23, 2020), accessible on ISDA's website in the Protocols section. Parties who adhere to the Protocol, using the procedures set up on ISDA's website, will cause **all** "Protocol Covered Master Agreements" and associated documents between themselves and anyone else who adheres to the Protocol to be amended to include the fallback language from the amended 2006 ISDA Definitions. The amendment of any particular Protocol Covered Master Agreement will become effective on the **later of** January 25, 2021 or the date both parties have adhered to the Protocol. All of the large banks and derivatives dealers have already adhered, so practically speaking, if an HFA opts to sign up for the Protocol and does so prior to January 25, 2021, the HFA's derivative contracts will be amended on January 25, 2021. If an HFA signs up later, the amendments will be effective when the HFA signs up.

The Protocol contains a very long list of Protocol Covered Master Agreements. If an HFA opts into the Protocol, the Protocol will apply to all of its Protocol Covered Master Agreements. Briefly, Protocol Covered Master Agreements consist of industry group forms of various types of master agreements, including the 1992 and 2002 ISDA Master Agreements and accompanying forms of credit support annexes (used for interest rate swaps), various industry standard master repurchase agreements and

master securities lending agreements, and numerous others. (See the first four pages of the Annex to the Protocol.) In each case if the HFA is a party to an agreement using one of these forms and the agreement or a trade confirmation under it uses LIBOR or provides it is subject to the ISDA Definitions (the 2006 ISDA Definitions or any of the previous ISDA definitions booklets), it will be a Protocol Covered Master Agreement if it was entered into prior to the effective date of the HFA's adherence to the Protocol (assuming the other party to the agreement has already adhered). ("Cleared derivative contracts," unusual for HFAs, are not covered.)

Derivatives—ISDA Form Bilateral Agreements Option for Existing Swaps/Derivatives

ISDA also has published various bilateral forms of agreement (all in the Protocols section of its website) for, among other things, incorporating the Protocol language in an agreement that is not a Protocol Covered Master Agreement, or providing that although the HFA has entered into the Protocol, a specific Protocol Covered Master Agreement is excluded from the Protocol. An HFA may have some Protocol Covered Master Agreements that it may not want to be covered by the ISDA Fallback language. For example, if an HFA's swap hedges a LIBOR based loan from a bank and the bank insists on using ARRC fallback language, or another index, adhering to the Protocol will cause the HFA's swap to bear a rate that will differ from the HFA's loan rate. (According to the ARRC these rates should over time be very close, but that is a matter for the financial advisors to address, not the lawyers.)

Certain HFAs will have a choice of law issue with one aspect of the Protocol. The Protocol provides that it is governed by English law, although it also provides that the amendments it makes to any Protocol Covered Master Agreement are governed by the law that governs that Protocol Covered Master Agreement. In some states (Illinois, for example), public entities are required by law to have their obligations under swaps be governed by the law of the state where they are located. Accordingly, it is not clear that public entities in those states can enter into the Protocol. Interestingly, the opinion of ISDA's own counsel, regarding enforceability of the Protocol, excluded enforceability against governmental entities

Non-Derivatives. The language of each non-ISDA form document needs to be carefully reviewed to determine when and how it technically defines "LIBOR" as it relates to its cessation. There are numerous variations among such contracts and the specific wording can have a significant effect on the timing of the cessation. For example, in some agreements LIBOR is defined by reference to a particular page of a specified daily publication. If the publication ceases or the referenced number is moved to a different page, is that a LIBOR cessation? And, a related issue, would that trigger a termination payment?

Also, state laws may affect such contracts, particularly New York state law because most such contracts provide that New York law will apply in the construction of the terms of the contract, and legislation has already been introduced in New York to specifically address various aspects of the LIBOR transition. Presumably banks will want ARRC language to be used in amending non-derivative contracts, although they could opt to use LIBOR fallback or even other language. In any event, individual amendments with each lender or counterparty will have to be included in loan agreements and other financial agreements that are not Protocol Covered Master Agreements.

Other Issues in Amending Existing Contracts

HFAs should also bear in mind that there are tax and accounting issues involved in changing the rates in their contracts, whether they are derivative contracts or non-derivative (cash market) contracts such as loans, SBPAs, lines of credit, FRNs or indentures/resolutions.

In tax-exempt financings, changing the rate of debt instruments (such as bonds) can cause a reissuance of the bonds (creating a new tax plan requiring the filing of an IRS 8038 and sometimes requiring a new TEFRA hearing) and other issues, and changing the rate of a hedge/swap can affect arbitrage yields and possibly create yield compliance problems, particularly for HFAs at or near full spread. The IRS has issued a revenue procedure that provides that a bond will not be considered reissued upon substitution of a LIBOR based bond rate with the ARRC protocol rate (SOFR). Similarly, the IRS also provided that a swap contract with a LIBOR based rate will not be considered terminated when that contract is amended to substitute that LIBOR rate with the rate provided by the ISDA protocol (SOFR). However, if that swap is integrated with the bonds for arbitrage purposes, the new swap rate will have to be taken into account in determining the arbitrage yield for the bond. If the substitution of a new swap rate does not follow the ISDA protocol for a substitute swap rate, the new swap might trigger a deemed termination of the swap, and the issuance of a new swap. Such new swap would have to go through the IRS procedures to determine whether it can qualify for integration with the bond rate for arbitrage yield purposes.

Accordingly, HFAs should consult their tax/bond counsel before signing up to any amendments or the Protocol. Similarly, the accounting authorities have issued helpful guidance and are working on more, so HFAs should also consult their accountants with respect to the financial reporting treatment of signing up to any such amendments or the Protocol.

What Should HFAs Be Doing Now?

Right now, an HFA should:

1. Identify and make a list of all the HFA's agreements that reference LIBOR for any purpose as well as any which may be of the type on the ISDA list of Protocol Covered Master Agreements (for HFAs which have conduit financings, be sure to also check any conduit financing documents to which the HFA is a party);
2. Determine which of those would be Protocol Covered Master Agreements;
3. For Protocol Covered Master Agreements, determine whether the Protocol is a good idea for all of the HFA's Protocol Covered Master Agreements and sign onto the Protocol only if it is; otherwise the HFA should do bilateral amendments with its counterparties (for example if a swap hedges direct placement LIBOR indexed bonds and the bondholder wants to amend the bonds to use the ARRC fallbacks, since the Protocol uses a slightly different fallback the HFA's hedge would no longer be perfect if it adheres to the Protocol);
4. For agreements that are not Protocol Covered Master Agreements, determine when the LIBOR cessation would technically occur per the wording of the agreement, contact the other party and

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start discussing amending the agreement to put in fallback language, probably the applicable ARRC fallback if the other party is a bank, or if the agreement has provisions that lets the counterparty unilaterally choose a fallback, find out what the counterparty proposes to use; some recent agreements (e.g., recent SBPAs with Federal Home Loan Banks) might already have the ARRC or other fallback language already built in, in which case no amendments may be needed; and

5. In all cases, before adhering to the Protocol or adding ARCC or any other language to non-derivative contracts, an HFA should consult its tax/bond lawyer, financial/swap advisor and accountants to assure the HFA fully understands and appreciates the legal, financial and accounting implications of its actions.

Finally, Things to Keep In Mind

- Don't rush into the ISDA Protocol or panic—LIBOR is still here for the time being and it is expected it to be available until at least December 2021, and in most cases possibly as late as mid-2023. Note that the ISDA definition changes to LIBOR apply to all derivatives/contracts as of the date the Protocol or bilateral agreement is entered into by both parties, even if the LIBOR tenor that relates to the contract is a LIBOR tenor that won't go away until 2023.
- An HFA isn't *required* to do anything yet; however, regulators are pressuring banks and financial institutions to complete the process now. Just because an HFA swap counterparty has entered into the Protocol does not obligate the HFA to enter into the Protocol; HFAs may instead opt to enter into bilateral agreements.
- **An HFA needs to know what bonds, swaps and other contracts it has that use LIBOR before it can evaluate its options.**
- The new ISDA Protocol
  - doesn't start until January 25, 2021, but an HFA can sign onto it at any time before or after that date;
  - will only apply to swaps, caps, repo agreements and other derivative contracts; and
  - any other contracts (like bond indentures, FRNs, lines of credit and SBPAs) must be amended separately.
- Although initial guidance from the IRS indicates that compliance with the Protocol will not result in adverse bond "reissuances," there are some issues that haven't been addressed and there can be indirect adverse consequences for arbitrage compliance purposes.
- The financial effects of using a different index can be highly complex, so the HFA should be sure to work with its financial/swap advisor and talk to its accountants.

Additional Information

If you have questions about any of the foregoing, please contact any of the attorneys listed on the left in Kutak Rock's Housing Finance Agency Practice Group. We would be happy to discuss this with you.

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