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PODCAST

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In this episode of Let's Talk Lending, Finance Partners Andy Hutchinson and Rachel Gray-Pundir provide an update on the LIBOR transition to SOFR since their last episode in July of 2021. Listen to their perspectives on recent trends in the market today as a result of the transition.

For more on this topic, listen to our previous episode Let's Talk LIBOR Replacements.

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Audio Transcript

Andy Hutchinson: Welcome to Winston & Strawn's Let's Talk Lending podcast. I'm Andy Hutchinson a partner in our Chicago office. I'm delighted to be joined today by Rachel Gray. One of our New York finance partners. Rachel has insight on both borrower and lender sides of complex leveraged finance transactions, so we're excited to hear her perspective on today's topic. Back in July of 2021, we spoke on the podcast about LIBOR replacements. Today, we're going to be discussing the transition from LIBOR to SOFR and recent market trends that we're observing. Rachel, how are you?

Rachel Gray: Hi, Andy. I'm good. Thank you. Happy to be here again.

Andy Hutchinson: Terrific. Well happy that you're here. So, let's talk about what we're seeing. First, I thought it would be helpful to recap in terms of where we're at and the sort of playing field that we're operating in. I'll speak for myself here, sponsor led acquisition financings, syndicated corporate financings, debt financings, and what benchmark are we seeing what's happening with LIBOR, so as of the first of this year regulated banks are no longer permitted to use or issue debt that references LIBOR. At least in my practice, what I've seen is that this applies both to true new issuances and new issuances of new incremental debt material amendments DTLs similar transactions, the regulated banks, the transition from LIBOR to a replacement rate, which for the most part is term SOFR has been a big focus and on the other hand non-bank lenders. So direct lenders and private credit continue to enter new deals, issue new debt, and new incrementals referencing LIBOR, not because those lenders are not subject to the same regulatory regime as a bank. Although, as a reminder to folks that are listening, the remaining available LIBOR tenants, so your one month, three month, six month, your back office can still get LIBOR rates on those settings through mid-2023. I think after that day, at least as it stands now, you won't be able to calculate LIBOR after middle of next year. So that's where we're at on the big picture of LIBOR. Rachel, I'd love to hear what you're seeing in some of the deals that you're currently working on.

From my practice and the bank deals, there's not really discussion about LIBOR versus something else. It's really SOFR as a starting point. And then there are some nuances with respect to term SOFR that folks focus on, but whereas last year there was still some talk and focus on LIBOR replacement language and hardwire versus amendment. I haven't had those conversations this year. I probably haven't had them since maybe Q4 of last year.

Rachel Gray: I think that's right. When we spoke last July, there was still definitely a focus on the language for LIBOR replacement. I think it was becoming clear at that point that the term SOFR was going to be the front runner as the replacement rate, but there was still a bit of uncertainty about that. And I know some of the banks were pushing different rates. I will say that in Q4 of last year on deals that I was involved in, particularly LBOs that were in the market they were seeking commitments for the commitment papers. All contemplated closings happened after January 1st that the loans would originate in terms SOFR. What we were seeing is a move away from the, ARRC credit spread adjustments that were sort of suggested in the hardwired language and in the commitment papers, people were guessing at what the credit spread adjustments would be for the new SOFR terms.

So generally, they would sometimes say there was no adjustment and there would be flex to add adjustments. Sometimes there'd be 10 basis point adjustments, and there would be flex to increase that to a 10, 15, and 25 basis point adjustment for one month, three months, and six months. So, for tenors sort of what we were seeing toward the end of last year. All deals led by regulated banks and starting in January this year, and even in a couple of deals that closed late last year, I have only seen deals originate in term SOFR. I have not seen any done anymore that originated in LIBOR, including with some of the direct lenders. I guess they're just moving that way now as well and there's less discussion in the replacement language because it becomes less relevant now.

I think it's being implemented fairly consistently across the board is term SOFR, and the biggest discussion is around the private spread adjustment, as I said, and what that will be. I think borrowers and sponsors who have power are pushing back on there being a credit spread adjustment at all. And their view is just that the rate should be set to sort of compensate for that from the get-go. And they're having success in that. Well, I don't think in deals that have closed this year had the flex, I don't think that I've seen that flex exercised. So oftentimes the deals will close with the no adjustment or just a 10-base point adjustment.

Andy Hutchinson: I guess what I've seen mirrors your experience it's either flat 10, 15, 25, or those are actually the only two flavors in terms of amount. One thing I've seen, which I thought was interesting is the comment to include in this spread adjustment, a mechanism that basically says like, you can have your, whatever it is, 10, 15, 25 for a period and if there is then the borrower agent can talk about it.

Rachel Gray: I've seen language like that, and it sort of says if the market moves towards a different or a better and more borrow favorable adjustment, that they will take that into account. Some of the language that I've seen goes back to the old LIBOR replacement language that we saw that sort of said that if there was at least five deals in the market that had adjustments that were better, then they could that then actually it automatically switches to those adjustments. So, I agree. I've seen that too. I also closed a deal this week for a direct lender, and they were insistent on sticking with the arc credit spread adjustments, which bar was cancel kind of questioned and, and pushed back on initially. And, and I think we all acknowledge that that wasn't necessarily consistent with what we were seeing in the market, but the client wanted to continue to push those, and they ultimately fell them through.

Andy Hutchinson: I did prep for this and read some articles. It does seem as though there's maybe an expectation that credit spread adjustments and this focus on CSAs will actually fall away. As term SOFR becomes more widely adopted and replaces LIBOR entirely, and then you have nothing to adjust to. It's just term SOFR enough time as a lapse between the transition from LIBOR to term SOFR where you no longer need the CSA at all.

Rachel Gray: Yeah, that makes sense to me that that would be the way it goes.

Andy Hutchinson: What about the regulated bank versus direct lender distinction? Because there definitely is one, I mean, there's a clear distinction in terms of the approach and focus on, you know, LIBOR transition and the mechanics and operational issues that arise in connection with that transit position for regulated banks, versus the direct lenders that I work with don't really seem all that focused on the issue, at least not right now and not at the deal team front, maybe there are discussions at different parts of those institutions, but not from a frontend perspective. Interestingly, I had heard that some direct lenders are actually using that distinction as a sort of a marketing perspective to this.

Rachel Gray: A distinguishing factor?

Andy Hutchinson: Yeah. Like as a positive differential saying if the issue with term SOFR and the LIBOR replacement is kind of a pain, don't worry about it. It's not an issue at all. It's status quo. The last doc we did for you two years ago with LIBOR, just take that off the shelf and use it.

Rachel Gray: I got away with that for so long though.

Andy Hutchinson: Can, I can get away with it for sure this year? I think they can probably continue to get away with it but there does definitely seem to be a real distinction where some of the direct lenders just don't and they are still originating new deals with just LIBOR.

Rachel Gray: They definitely seem to be much more relaxed about it. Obviously, the regular banks have had task force looking at this for the last couple of years and they have a lot of processes and conversation around it. But I think it's interesting because you and I were talking about this before, before we started recording, on a transaction I'm working on. It's an incremental facility for a company that has existing loans with one of the banks and in connection with that, they're going to have to do a SOFR amendment because it's a revolver. So, the pricing must be the same for the new revolver and the way the language and the credit agreement works through replacement language. They have to just do it across all of the facilities, but as the banks have become pretty efficient at this already, even though we're only in March 2022 now, and they've been doing this since January or even late 2021.

But there's still a lot of questions coming up. And a lot of things we haven't seen before, things that they haven't thought about like the credit agreement doesn't specifically say, what will or when the transition to SOFR will happen. So, will it be at the end of the existing interest periods, or if not, it comes into effect on the date that the SOFR amendment becomes effective, will there be breakage? Obviously, the company wants to limit their exposure to that. So, then they want the SOFR amendment to be conditioned upon their ability to get this new incremental facility and relooking at the language to see whether they could even do that. The language that's in the document is negative consent and as it's written, it's pretty clear (or it seems to be) that we post this amendment.

If there's no objections, it becomes effective. So to us, that would suggest that there is very limited conditionality you can put on it. And these are all things that were sort of talking to the bank about. It was surprising to me that they haven't had it come up yet. I'm sure it will come up later in the year. But we're sort of trying not to break new ground for them and they're reluctant to break new ground, but there's all these issues that are arising that I frankly was surprised at that they hadn't been worked through already at this point in the year.

Andy Hutchinson: Putting the incremental revolver amendment aside. So, the amendment with respect to term SOFR is that arising via the existing hardwired language in the doc or whatever the replacement language is in the existing?

Rachel Gray: Yeah. I mean, the conditions for a LIBOR replacement can be triggered. It could be triggered at any point in time if the agent wanted to call it or the recliners wanted to call it because whatever the benchmark transition conditions were, this language in the particular credit agreement is not straight like our hardwired replacement language. They could call it SOFR amendment anytime they wanted to but obviously there's sensitivity to the company and the company not necessarily wanting to switch over earlier than they need to. It's just been looking at whether they could do a tranche by tranche, but actually this particular facility has multiple tranches, but there's no tranche voting. The negative consent is just a required lender consent. That means that everybody's going, whether I do it to one tranche everybody gets to vote, so it's just going, and everybody's being dragged along cause of this. And these are things that people weren't necessarily thinking about or at front of mind when we were all talking about the LIBOR replacement language when that was being worked out. It's funny when you see it being put in into practice now there's an innumerable number of things that nobody ever gave thought to because it couldn't anticipate it.

Andy Hutchinson: To your point, just the question of timing, right? If you're breaking the existing contracts versus waiting till the end of the month and if you do break, presumably my guess is the company probably says we want you to waive the breakage costs.

Rachel Gray: Yes, and they have relationship lenders, but also term line B lenders so they're just a large, so they don't really know what to expect. There's no way knowing really.

Andy Hutchinson: I do think it's a good opportunity for us to, with the benefit of 2020 hindsight, go back and really take a look at that language. Then, to the extent to make tweaks and edits based on the real-world application that you're seeing on deals that you're working on now you to make those tweaks on deals going forward.

Rachel Gray: Yes, but I just don't think that we're going to see as much of LIBOR except for in the direct lender deals. We're not seeing as much of this LIBOR replacement language, it's sort of becoming moot at least for the regulated banks. You can't go back and amend that language without an all-lender consent. I think that's part of the problem as well so we can't really fix some of these problems in the amendment because it would require the consent of a hundred percent lenders.

Andy Hutchinson: For sure, maybe I guess I was thinking the SOFR replacement language.

Rachel Gray: I think that can definitely be worked in, although that's another thing that's arisen on this particular deal, is whether or not you would need a hundred percent lender consent to add in SOFR replacement language because it currently just has the general LIBOR replacement language. Our read of it is that it could be the LIBOR conforming or the LIBOR replacement conforming changes in the document that we have that says other administrative or technical changes in connection with the implementation of the SOFR rates. I think everybody has come to the view that if we duplicate the existing LIBOR replacement language for SOFR, that's just sort of an administrative trait change because we have to legislate for what happens if SOFR goes away for whatever reason. There was some back and forth to get that and whether we could even do that without any sort of replacement language for SOFR, because otherwise, it would trigger a greater lender vision.

Andy Hutchinson: Are you still working through these issues in real-time?

Rachel Gray: They are still ongoing and yes, there's a lot of back and forth. But for that particular one we settled that we can do it.

Andy Hutchinson: Credit spread adjustments seem to be a focal point discussion. It seems like there's not enough data points to determine what's truly market. It also feels as though market will depend on the space in which you're operating in. So, I think there will be a distinction between your middle-market sponsor that acquisitions versus your BSL. Those may end up aligning, but versus your corporate credit, non-sponsored financings whether they're unsecure revolvers or otherwise. Then, this additional real work and analysis involved in implementing in terms of inaction with your LIBOR replacement language. That's the example that you gave, Rachel. I think that's something that will continue to and is going to require work, right?

Rachel Gray: Unless you're entering into a new deal or already doing an amendment that required a hundred percent votes, I think that's going to continue to be a focal point. Then again the distinction between the approach that regulated banks have taken in terms of no longer issuing LIBOR in connection with new issuances and direct lenders who are not subject to those same restrictions.

Andy Hutchinson: It looks like we're at the end of our time here. Rachel, did you have anything else you wanted to share or talk about?

Rachel Gray: I don't think so. I think that covered most of what we're seeing right now, I'm sure it'll continue to evolve. Like you said, I think the most challenging part is now dealing with the SOFR amendments as opposed to new deals originating in SOFR because on those you're working within the confines of what the document says, as well as the language and the lender consents that you need. I think that's going to be the area that throws up a few more interesting questions and issues to work through. Like we said, we'll see what happens on the credit spread adjustment, whether that continues or if that eventually falls away.

Andy Hutchinson: Agreed. Well, thank you, Rachel, for joining me today, and thank you all for listening to our Let's Talk Lending podcast. You can subscribe to the podcast via Apple iTunes or Google, or by visiting the Winston & Strawn website for more insights on the latest market updates and trends.

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