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U.S. LIBOR Cessation: How to Prepare

December 2021 is rapidly approaching, lenders and borrowers need to focus on their transition plans for the U.S. dollar London Inter-bank Offered Rate (LIBOR) cessation ahead of the December 31, 2021 deadline. The Alternative Reference Rates Committee (ARRC) and other international committees tasked with transitioning from LIBOR have not pushed back the LIBOR end date. As of May 2020, the ARRC estimated that current outstanding contracts referencing U.S. LIBOR total nearly \$200 trillion – approximately 10 times U.S. Gross Domestic Product. Even the Federal Reserve is taking its time using LIBOR as the base rate for the Main Street Lending Program developed under the CARES Act.

ARRC is a group of private-market participants that was formed by the Federal Reserve Board and the New York Fed to help ensure a successful transition from the U.S. LIBOR to a replacement mechanism. Both ARRC and International Swaps and Derivatives Association, Inc. (ISDA) recommend using the Secured Overnight Financing Rate (SOFR) as the replacement index for U.S. LIBOR. However, much uncertainty remains surrounding the calculation and implementation of U.S. LIBOR fallbacks.

Inconsistencies exist in the documentation of U.S. LIBOR fallbacks. ARRC provided recommended U.S. LIBOR fallback language for commercial loan documents in May 2019. This language has still not been universally adopted and loan documentation continues to vary. Conversely, interest rate swaps are typically drafted using the ISDA master agreement with the 2006 ISDA Definitions incorporated, which have not been updated for U.S. LIBOR fallbacks. The mismatch between loan and swap documentation creates risk for borrowers and lenders.

To resolve this issue for interest rate swaps, ISDA is developing and will soon finalize and publish a supplement to the 2006 ISDA Definitions (“Supplement”) that will amend the floating rate options to account for the discontinuation of US LIBOR. ISDA plans to provide two weeks’ advance notice of the publication date, which will occur after the U.S. Department of Justice and other authorities provide approval. The Supplement will revise the definitions for

existing U.S. LIBOR indices to include objective triggers that activate the U.S. LIBOR fallback (“Index Cessation Event”) and describe the relevant U.S. LIBOR fallback that will apply upon an Index Cessation Event as well as a further replacement for the U.S. LIBOR fallback if it is also permanently discontinued. Under ISDA, the U.S. LIBOR fallback will apply on the effective date of the earlier of (i) the permanent discontinuation of U.S. LIBOR or (ii) the non-representativeness of US LIBOR based on predetermined, objective triggers and determined by the United Kingdom’s Financial Conduct Authority. It is anticipated that U.S. LIBOR will be permanently discontinued at the end of 2021.

Once the Supplement is published, all swap transactions entered into on or after the date of publication will automatically include the LIBOR fallback. Swap transactions that were entered into before the publication date of the Supplement will continue to be based on the 2006 ISDA Definitions without the amendments in the Supplement. ISDA plans to publish a standardized protocol for amending existing swap transactions to incorporate the amendments in the Supplement, which will be effective three to four months after publication of the Supplement with a target effective date around year-end 2020. Adherence to the protocol will be completely voluntary. By adhering to the protocol, market participants are agreeing that their existing swap contracts with other adherents will include the U.S. LIBOR fallbacks. Although a party may elect to adhere to the protocol, such adherence will not amend swap contracts with any party that does not elect to adhere to the protocol. If a party elects not to adhere to the protocol, it can agree to include the amended rate options via an amendment to each swap agreement. ISDA plans to publish a form of amendment that can be used for this purpose.

There are also inconsistencies in the calculation of the U.S. LIBOR fallback. While both ISDA and ARRC agree that SOFR will be the replacement index for U.S. LIBOR, SOFR is a risk-free, overnight, backward-looking rate whereas US LIBOR is an unsecured, forward-looking, term rate. To adjust for the difference in these indices, the U.S. LIBOR fallback will use SOFR plus a spread adjustment based on the median spot spread between U.S. LIBOR and SOFR for each term over a five-year lookback period prior to the Index Cessation Event

("Spread"). The daily value for SOFR will be compounded in arrears for each relevant term and then adjusted so that the observation period is two business days before the relevant payment date ("Adjusted SOFR"). Although ARRC and ISDA have recommended a similar approach to calculating the U.S. LIBOR fallback and agree that the U.S. LIBOR fallback is Adjusted SOFR plus Spread, it is unclear whether the same values will be used as the Spread and they are working to reconcile any potential mismatch between these values.

On July 17, 2020, Bloomberg began publishing the U.S. LIBOR fallbacks for ISDA on an indicative basis. Quotes are indicative because the Spread will not be finalized until the Index Cessation Event occurs. As of August 5, 2020, Adjusted SOFR was 10 bps and the indicative Spread was 1 bp for daily, 4 bps for weekly, 11 bps for one month, 18 bps for two months, 26 bps for three months, 38 bps for six months, and 55 bps for one year.

In preparation for the U.S. LIBOR cessation, lenders and borrowers should consider the following:

- Review the U.S. LIBOR fallback rates published by Bloomberg to assess any economic risks.
- Analyze existing loan and swap documents to understand U.S. LIBOR exposure.
- Consider whether other types of agreements use U.S. LIBOR to calculate interest or damages.
- Determine whether existing loan documents for US LIBOR-based transactions that extend beyond December 2021 have a U.S. LIBOR fallback and, if so, whether the fallback is acceptable.
- For loans tied to interest rate swaps based on US LIBOR, determine whether the fallbacks are consistent and consider amending the loan documents to have the fallback mirror the ISDA fallback in the Supplement.
- Use ARRC-recommended fallback language on any new U.S. LIBOR loans.

- Once published, adopt the ISDA protocol or amend swap documents to incorporate the Supplement.
- Complete any desired loan and swap amendments by June 2021 at the latest.
- Stop using U.S. LIBOR on new loan and swap transactions by June 2021 at the latest.
- For contracts specifying that a party will select a replacement rate for U.S. LIBOR at its discretion following an Index Cessation Event, the determining party should disclose their planned selection to relevant parties at least six months before the date that a replacement rate would become effective and by June 2021 at the latest.

FBT's Financial Services industry team helps lenders and borrowers plan for and implement a strategy to deal with the end of LIBOR. Our team regularly analyzes and negotiates proposed LIBOR replacement language in documents and advises lenders and borrowers on loan documents, swap agreements, and other agreements based on LIBOR.

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