Hardwiring LIBOR Fallback Language in Syndicated Loans: The ARRC-Recommended Approach

On June 30, 2020, the Alternative Reference Rates Committee (the "ARRC") published recommendations for hardwiring LIBOR fallback language in the U.S. dollar-denominated syndicated loan market (the "ARRC Recommendations").[1] The ARRC Recommendations include recommended fallback language and a detailed user's guide (the "User's Guide") to the fallback language.

I. Background

The ARRC was created in 2014 by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York and was tasked with, among other things, finding an alternative reference rate for LIBOR (London Interbank Offered Rate) and setting forth a plan to implement the alternative reference rate. In 2017, the ARRC selected the Secured Overnight Financing Rate ("SOFR") as its recommended alternative reference rate in anticipation of the potential phaseout of LIBOR at the end of 2021. The ARRC's recommended best practices to facilitate the transition away from LIBOR state that institutions "should take active steps" to incorporate hardwired LIBOR fallback language in all new syndicated business loans by September 30, 2020.[2]

This memorandum discusses the latest language that the ARRC recommends be incorporated into new U.S. dollar-denominated business loan facilities.[3] The ARRC's current recommendation to hardwire fallback language differs from its previous recommendation to take either an "amendment approach" (which provided for streamlined amendments to account for LIBOR cessation) or the "hardwired approach." With thousands of syndicated loan facilities outstanding, executing amendments for all of them at the time of a transition event would be difficult. Therefore, in order to facilitate an orderly transition from LIBOR in the syndicated loan market, the ARRC no longer recommends the "amendment approach" and instead recommends the hardwired approach, which would allow implementation of a replacement benchmark upon a specified trigger occurring without consent or prior notice to lenders or borrowers.

The ARRC states that its recommendations are completely voluntary and that each market participant should make its own decision about whether, and to what extent, to adopt the language in the ARRC Recommendations. Given the target date of September 30, 2020 in the ARRC's best practices recommendations,

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[1]See ARRC Recommendations Regarding More Robust Fallback Language For New Originations of LIBOR Syndicated Loans (June 30, 2020), available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/Updated-Final-Recommended-Language-June-30-2020.pdf. The ARRC has also published recommended language for various other products that currently utilize LIBOR as a reference rate, such as floating rate notes. These are available at https://www.newyorkfed.org/arrc/fallbacks-contract-language.

[2]See ARRC Recommended Best Practices for Completing the Transition from LIBOR, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Best-Practices.pdf. "Business loans" are defined as "new loans, including renewals and refinancings, of all non-consumer loans with maturities after December 31, 2021." Id. at 4. The target date for bilateral business loans is October 31, 2020.

[3]The ARRC's recommended fallback language is set forth on pages 4–9 of the ARRC Recommendations. Unless otherwise specified, all quoted statements in this memorandum are from the ARRC Recommendations, and capitalized terms used in this memorandum without definition have the meanings assigned to such terms in the ARRC Recommendations.

we believe that, in the coming weeks, large market participants will introduce some variation of the hardwired approach in new transactions or applicable amendments for syndicated loan facilities.[4]

II. Overview

The ARRC-recommended language answers the following questions:

- What events or triggers result in a shift to the successor rate?
- Following these events or triggers, what successor rate will be used and what adjustments are needed?
- What conforming changes should be made to the loan documents to implement the shift to the successor rate?

This memorandum discusses the ARRC's recommendations related to each of these questions in turn.

A. Triggers and Early Opt-In

Under the ARRC-recommended language, any one of three events triggers a shift to the successor rate.[5] These triggers can be found in the definition of "Benchmark Transition Event."

The first trigger is based on a public statement or publication of information by the ICE Benchmark Administration (the administrator of LIBOR) that it has ceased or will cease to provide all available tenors of LIBOR.[6]

The second trigger is such public statement or publication of information by the Financial Conduct Authority (the "FCA") (the supervisor of the administrator of LIBOR), the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, a bankruptcy official or resolution authority or a court with jurisdiction over the administrator of LIBOR. In the case of the first two triggers, the applicable public statement or publication would trigger a Benchmark Transition Event, but the date on which the replacement becomes effective, as set forth in the definition of "Benchmark Replacement Date," would occur upon the later of (1) the date of such public statement or publication and (2) the date on which the LIBOR administrator permanently or indefinitely ceases to provide all available tenors of LIBOR. For example, if, sometime during 2020, the ICE Benchmark Administration publicly states that it will cease to provide all available tenors of LIBOR on December 31, 2021, the Benchmark Transition Event will occur on the date of such statement. However, under the ARRC recommended language, the "Benchmark Replacement Date" would be December 31, 2021.

[4] Incorporation of the fallback language to an existing credit agreement would typically require consent of all lenders since the fallback language, in effect, changes the amendment provisions of a credit agreement by not requiring lender consent for future amendments contemplated by the fallback language. Although the ARRC best practices target date for adopting the fallback language applies only to new loans (including renewals and refinancings), the language would likely also be considered in amendments that otherwise require consent of all lenders, such as amendments to lower the interest margins or extend the maturity.

[5] These three triggers are intended to align with certain triggers that are expected to be included in the standard documentation of the International Swaps and Derivatives Association ("ISDA").

[6] Because the ARRC-recommended language defines "Benchmark" as, initially, USD LIBOR, this memorandum references LIBOR in the instances where the ARRC-recommended language refers to the "Benchmark."

The third and final trigger is a public statement or publication of information by the FCA that all available tenors of LIBOR are no longer representative. This trigger is referred to as the "pre-cessation trigger," and would occur if the FCA determines that the quality of LIBOR "has deteriorated such that it would likely have a significant negative impact on its liquidity and usefulness to market participants."

The ARRC-recommended language recognizes that certain tenors of LIBOR may cease to exist or be no longer representative before other tenors. For example, if three-month LIBOR ceases, but one-month LIBOR continues to be available, the Benchmark Transition Event would not occur. The ARRC-recommended language provides flexibility for the administrative agent to remove or reinstate tenors offered under the credit agreement based on their availability, and a Benchmark Transition Event occurs only if a trigger occurs with respect to *all* available tenors of LIBOR. The recommended language therefore allows parties to continue to use LIBOR for as long as possible in the event that some tenors cease or are not representative before others.

In addition to the three triggers, the ARRC included an early opt-in mechanism that can be used to shift to the alternative reference rate while LIBOR is still being published. This can be found in the "Early Opt-in Election" definition. The early opt-in may be triggered by the administrative agent or the borrower if there are at least "[five]" publicly available and outstanding U.S. dollar-denominated syndicated credit facilities with a SOFR-based rate as a benchmark rate. The parties to the agreement may choose a different threshold than "[five]," as the number is intended to illustrate that there are a sufficient number of SOFR-based agreements in the market to provide "objective, clear direction." An early opt-in would be subject to negative consent by the majority lenders in the same way that the "amendment approach" had been: the administrative agent must notify the lenders of the early opt-in election, who then have five business days to object to such election. If the majority lenders have not objected by 5:00 p.m. on the fifth business day, then the early opt-in election is effective as of the sixth business day following the notice. The early opt-in mechanism is intended to help reduce the backlog of loans that must be transitioned when LIBOR ceases, thereby reducing the risk of market disruption.

B. Benchmark Replacement

Following one of the three trigger events or an early opt-in election, the benchmark used throughout the loan documents is replaced with the successor rate per the definition of "Benchmark Replacement." The ARRC-recommended version of this term includes a three-step waterfall for the successor rate, as set forth below:

- Step 1: Term SOFR + Adjustment
- Step 2: Daily Simple SOFR + Adjustment
- Step 3: Borrower and Administrative Agent Selected Rate + Adjustment

The first alternative in the waterfall that can be determined by the administrative agent at the relevant time becomes the replacement benchmark. In the baseline ARRC-recommended waterfall language, the determination is made once and is not later reevaluated or retested. The User's Guide suggests some alternatives to the baseline waterfall language. For example, parties may choose to eliminate Step 1 when entering a credit agreement if Term SOFR does not seem likely to be available at the time of LIBOR cessation or if Daily Compounded SOFR is preferred as the first option (e.g., if the borrower has a swap and wishes to better align its interest rate with ISDA's selected fallback rate). The User's Guide also suggests the option of replacing Daily Simple SOFR in Step 2 with "Daily Compounded SOFR + Adjustment" or "SOFR Average + Adjustment" (i.e., Compounded in Advance).

Term SOFR is defined as "the forward-looking term rate based on SOFR that has been selected or recommended by" "the Board of Governors of the Federal Reserve System or the Federal Reserve Bank of New

York, or a committee officially endorsed or convened by" one of the foregoing. SOFR is an overnight rate, with SOFR for a given day being published the following day. On the other hand, Term SOFR would be a rate that is determined in advance—rather than in arrears—and fixed for a term of a specified period commencing on the date of borrowing. Term SOFR would therefore be similar to how LIBOR functions today; that is, interest due at the end of the period would be known at the beginning of that period. Unfortunately, Term SOFR does not exist today and is not expected to be available before LIBOR cessation, so it is likely that the benchmark replacement determination would pass to the next step in the waterfall.

Daily Simple SOFR, the second option in the baseline ARRC-recommended waterfall, is the basic form of SOFR, with interest accruing on a daily basis calculated using SOFR for such day and the principal loan amount outstanding on such day. For Daily Simple SOFR, the "interest period" represents the period at the end of which interest would be due (e.g., a month or a fiscal quarter), rather than the period in which the interest rate is fixed. This differs from LIBOR, for which an "interest period" refers instead to the loan's tenor (e.g., one-month LIBOR or three-month LIBOR). Although the description of Daily Simple SOFR is straight-forward, there are some nuances in applying this rate because, if payment is due on the last day of the interest period (as with LIBOR), the borrower would not know until the business day after the due date how much interest is due, since SOFR for any given day is published on the next business day. There are different ways to address this, including (1) repeating SOFR for the last few days in the period (a "lockout"), (2) making interest payments due after the last day of the interest period (a "payment delay") or (3) shifting backwards the observation period for the rates (a "lookback"). The ARRC recommends use of the lookback method, which is reflected in the definition of "Daily Simple SOFR," but does not specify how the lookback would be implemented. The details of such a convention are left to be addressed in the "Benchmark Replacement Conforming Changes," described below.

In Daily Compounded SOFR, interest is compounded on a daily basis both on principal and the interest that has already been earned.[7] Compounded SOFR is operationally complex for syndicated loans. If the principal amount of a loan changes during an interest period due to a prepayment, the compounded rate cannot be applied to a fixed principal amount. Moreover, syndicated loans typically trade without accrued interest. If a loan is assigned during an interest period, the administrative agent would need to track and allocate to the assignor and assignee each daily "stub" piece of interest.[8]

The Loan Syndications and Trading Association (the "LSTA") posits that, economically, simple SOFR and compounded SOFR are very similar.[9] In favoring simple over compounded SOFR, the ARRC states that "Daily Simple SOFR is already operationalized, reduces operational risk relative to compounded SOFR in arrears and poses fewer challenges for a heavily traded asset, like syndicated loans, where intra-period payments are routine." We understand that vendors are working to operationalize Daily Compounded SOFR, and it is possible that market participants that favor compounded SOFR may opt to include Daily Compounded SOFR in the waterfall, either in place of Daily Simple SOFR (if Daily Compounded SOFR is operationalized at the time the fallback language is incorporated) or in addition to Daily Simple SOFR.

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[7]The User's Guide specifies that compounding would not apply to the margin or the Benchmark Replacement Adjustment. ARRC Recommendations at 22, footnote 27. However, the recommended definition of "Daily Compounded SOFR" leaves the methodology for compounding to be established by the administrative agent in accordance with a methodology and conventions selected by the relevant governmental body.

[8]See Loan Syndications and Trading Association, Surviving the End of LIBOR (July 30, 2020), slide 15, available to members of the Loan Syndications and Trading Association ("LSTA") at https://www.lsta.org/content/surviving-the-end-of-libor-tools-and-tips-from-the-trenches-presentation.

[9]The LSTA estimates that, for a $3 million loan, average compounded SOFR over the 20 years ending February 2018 was 1 to 5 basis points higher than average simple SOFR. See id. at slide 14.

In lieu of Daily Compounded SOFR or Term SOFR, parties may choose to use Compounded SOFR in Advance in the waterfall. In Compounded SOFR in Advance, the rate is calculated by referencing the compounded SOFR Average over a period of time (i.e., SOFR Average + Adjustment). In March 2020, the Federal Reserve Bank of New York began publishing compounded SOFR averages over rolling 30-, 90-, and 180-day periods which can be used for this purpose. Compounded SOFR in Advance is an "in advance" rate, which has the operational benefit of functioning like LIBOR today.

The third step of the ARRC-recommended waterfall provides an option for the administrative agent and the borrower to choose an alternate interest rate giving due consideration to recommendations by a "Relevant Governmental Body" or market conventions. Like with the early opt-in election, the administrative agent must notify the lenders of such proposed Benchmark Replacement, and if the "Required Lenders" do not object within five business days, the Benchmark Replacement becomes effective.

Although Term SOFR may not be available at the time of the initial transition to SOFR, given the market's familiarity with and the operational benefits of using a term rate, parties may want loan documentation to provide for a transition to Term SOFR when it becomes available. To do so, the loan documentation would build in provisions for a second shift – that is, a transition to Term SOFR if it became available after the first transition to an initial SOFR benchmark. The baseline ARRC-recommended language does not include provisions for a second shift to Term SOFR, but the User's Guide suggests that parties may consider adding either a hardwired approach or amendment approach for a second transition to Term SOFR.[10]

C. Benchmark Replacement Adjustment

Because transactions underlying SOFR are fully secured by U.S. Treasuries, SOFR is a near risk-free rate and does not reflect the credit risk of the banks that borrow based on this rate. Therefore, in order to make SOFR more comparable to LIBOR, the ARRC-recommended language includes a spread adjustment in each step of the Benchmark Replacement waterfall. The Benchmark Replacement Adjustment would differ for each LIBOR tenor and would be selected at the time that the Benchmark Replacement is determined. To select the appropriate spread adjustment, the ARRC-recommended language includes another waterfall:

- Step 1: ARRC Selected Adjustment
- Step 2: ISDA Fallback Adjustment
- Step 3: Borrower and Administrative Agent Selected Adjustment

Steps 1 and 2 of the Benchmark Replacement Adjustment waterfall apply to Steps 1 and 2 of the Benchmark Replacement waterfall, and Step 3 of the Benchmark Replacement Adjustment waterfall applies to Step 3 of the Benchmark Replacement waterfall.

Step 1 in the waterfall is "the spread adjustment, or method for calculating or determining such spread adjustment, (which may be a positive or negative value or zero) as of the Reference Time such Benchmark Replacement is first set for such Interest Period that has been selected or recommended by the Relevant

[10] See ARRC Recommendations at 20, footnote 23. Parties interested in this option may wish to consult the LSTA SOFR concept credit agreement, which includes provisions for a "Term SOFR Transition Event." See Loan Syndications and Trading Association, LSTA's SOFR Concept Credit Agreement (Daily Simple SOFR/Daily Compounded SOFR), September 15, 2020, available to LSTA members at https://www.lsta.org/content/lstas-sofr-concept-credit-agreement-daily-simple-sofr-compounded-sofr/.

Governmental Body. . . provided . . . such adjustment is displayed on a screen or other information service that publishes such Benchmark Replacement Adjustment from time to time as selected by the Administrative Agent in its reasonable discretion." The ARRC previously announced that it would recommend "a spread adjustment methodology based on a historical median over a five-year lookback period calculating the difference between USD LIBOR and SOFR." In the User's Guide, the ARRC committed to working with potential vendors to ensure that the ARRC's recommended spread adjustments will be made publicly available in order to meet the screen requirement within the first step of the waterfall. The User's Guide assumes that the spread adjustment would become static at the time of the mandatory transition. However, given that the definition of "Benchmark Replacement Adjustment" includes the option of the spread adjustment being a "method," the ARRC recommended language would seem to allow a dynamic spread adjustment if the Relevant Governmental Body ultimately selects or recommends a dynamic spread adjustment.

The User's Guide explains that parties that wish to more closely align the credit agreement with hedges and use Daily Compounded SOFR may opt to remove Step 1 of the Benchmark Replacement Adjustment waterfall and use Step 2 instead. The ISDA Fallback Adjustment under Step 2 is similarly "based on the median over a five-year period of the historical differences between IBOR, here USD LIBOR, in the relevant tenor and the relevant risk-free rate, here SOFR, compounded over each corresponding period." Finally, like Step 3 of the Benchmark Replacement waterfall, Step 3 of the Benchmark Replacement Adjustment waterfall gives due consideration to recommendations by a "Relevant Governmental Body" or market conventions in determining the spread adjustment.

The User's Guide states that since the replacement benchmark plus the spread adjustment together are intended to replace LIBOR, it is appropriate for a floor applicable to LIBOR to apply to the Benchmark Replacement. The definition of "Benchmark Replacement" includes language that if the Benchmark Replacement would be less than the benchmark floor, then the Benchmark Replacement will be deemed to be the floor. This means that, if the Benchmark Replacement (the definition of which includes the Benchmark Replacement Adjustment) would be less than the LIBOR floor, the Benchmark Replacement would be equal to the LIBOR floor.

For a credit agreement that has transitioned to SOFR pursuant to early opt-in provisions, the spread adjustment would be reset at the beginning of each interest period; however, when the spread adjustment becomes static (i.e., after a mandatory transition event), the spread adjustment would be fixed over the remaining life of the credit agreement.

Because SOFR is a credit risk-free benchmark rate, SOFR may not reflect banks' cost of funds, particularly in periods of economic stress. In June 2020, the Federal Reserve Bank of New York began hosting workshops of the Credit Sensitivity Group to understand this issue and to explore a potential credit-sensitive supplement to SOFR. Various participants in the Credit Sensitivity Group have stressed that "a supplement to SOFR should be credit sensitive, dynamic, based on unsecured funding and reflect marginal funding costs."[11] These discussions are still in early stages, and the ARRC Recommendations do not describe or expressly provide for a potential credit-sensitive supplement.

[11] Credit Sensitivity Group Workshop 3, Meeting Minutes, August 12, 2020, available at, https://www.newyorkfed.org/medialibrary/media/newsevents/events/markets/2020/csg-workshop-minutes-presentations-08122020.pdf. Minutes and presentations from all workshops are available at https://www.newyorkfed.org/newsevents/events/markets/2020/0225-2020.

D. Conforming Changes

The ARRC acknowledges that their recommended fallback language does not address all issues that may arise in transitioning to a successor rate. The language therefore permits the administrative agent to make certain conforming changes at the time of the transition and from time to time "to appropriately implement and administer the successor rate," such as adjusting the frequency of rate determinations, adjusting the interest accrual period lengths, setting the lookback period length, or shifting from months to day counting (e.g., 30 days instead of one month). Additional examples set forth in the definition of "Benchmark Replacement Conforming Changes" include operational, technical or administrative changes, such as changes to the definitions of "ABR," "Business Day," and "Interest Period," timing and frequency of making interest payments, borrowing request or prepayment timing, timing of notices of conversion or continuation, and breakage provision applicability. Because these types of conventions may evolve over time, the ARRC-recommended language allows the administrative agent to implement conforming changes at the time of the successor rate transition and from time to time thereafter. In order to streamline these changes, such amendments would be implemented without consent of the lenders or the borrower.

E. Additional Considerations

1. Notices

The administrative agent is required to send certain notices to the lenders under the ARRC-recommended fallback language, including (1) the occurrence of a trigger event or early opt-in election, (2) when a Benchmark Replacement is implemented, (3) when Benchmark Replacement Conforming Changes become effective, (4) when a Benchmark tenor is removed or reinstated, and (5) at the start or end of any Benchmark Unavailability Period.[12]

2. Multicurrency Facilities

The ARRC-recommended language was developed for U.S. dollar-denominated syndicated loan facilities and therefore does not apply directly to multicurrency facilities. The ARRC is not currently recommending fallback language in multicurrency facilities due to "the lack of full clarity with respect to the transition plans of the other LIBOR currency jurisdictions" and suggests that the amendment approach may be more appropriate at this time.

3. Scope of Recommendations

The ARRC acknowledges that while the fallback language is a solution, it does not address every possible impact on a credit agreement of the cessation of LIBOR. It observes, for example, that certain provisions, such as illegality, increased costs, and breakage may need to be reevaluated if LIBOR is no longer used as the reference rate. In addition, the ARRC recognized that "[a]dministrative agents may deem it prudent to include general disclaimer language with respect to LIBOR or any successor rate" as it "understands the needs of the administrative agents and . . . does not consider the inclusion of such language to be at odd with its principles."

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[12] A "Benchmark Unavailability Period" could occur if the Required Lenders reject the proposed Benchmark Replacement under Step 3 of the Benchmark Replacement waterfall, but LIBOR has already ceased or become non-representative. Under this scenario, the relevant loans would accrue interest at ABR.

III. Conclusion

The ARRC's hardwired fallback language offers a logical approach to the challenge of transitioning away from LIBOR before the end of 2021. A theme runs throughout the recommended language and User's Guide: there remain many uncertainties in the transition from LIBOR, and it is important to build in flexibility for various contingencies to avoid market disruption. This is illustrated by the various different triggers for transition, the waterfalls for the replacement benchmark and spread adjustment and the ability of the administrative agent to implement ongoing conforming changes.

Because the language is not mandatory, there may be some concern that, at least initially, the market may see splintering approaches. Nevertheless, the ARRC-recommended language seeks to provide market participants with a structure upon which to transition from LIBOR in a systematic and orderly way, while incorporating their own institutional priorities and operational needs.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email Susanna Suh at 212.701.3686 or ssuh@cahill.com; or Alex Kramer at 212.701.3899 or akramer@cahill.com; or email publications@cahill.com

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