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ARRC Releases Recommended LIBOR Fallback Language for Bilateral Business Loans and Securitizations

Interest rate calculations on trillions of dollars of loans and other financial products are pegged to the U.S. dollar London Interbank Offered Rate (LIBOR), a reference rate that will likely not exist or be robust after 2021. It is anticipated that the transition away from LIBOR to a new reference rate has the potential to be disruptive to the financial markets and market participants. In order to avoid disruptions in financial activity and financial transactions, Day Pitney is advising clients entering into LIBOR-based contracts to consider including "fallback language" in the documentation. Fallback language is designed to provide an orderly and transparent transition from LIBOR to a new replacement reference rate.

In the transition away from LIBOR to the Secured Overnight Financing Rate (SOFR), an alternative to LIBOR, the Federal Reserve Board and the Federal Reserve Bank of New York created the Alternative Reference Rates Committee[1] (ARRC), which was tasked with recommending fallback language to market participants. On May 31, the ARRC made their recommendations on fallback language for bilateral loans and securitizations.

Bilateral Business Loans

The ARRC has recommended three sets of fallback language for new originations of LIBOR-based bilateral business loans, broken out into the following approaches: (1) a hardwired approach, (2) an amendment approach and (3) a hedged loan approach.

Hardwired Approach

Current practice for bilateral and syndicated loans tends to use an amendment approach to successor rates. Hardwiring the LIBOR replacement process at the time of document execution limits the amount of discretion required from lenders, thereby reducing the risk that lenders will be overwhelmed by the enormous volume of loan facilities that will immediately require amendments when LIBOR goes away. A hardwired approach provides concrete triggers and decision-making sequences for determining how and when to change the benchmark rate. Because LIBOR and SOFR have differing tenors and risk profiles, the ARRC recognized that adjustments will likely need to be made to have SOFR be economically consistent with LIBOR. Therefore, the recommendations also provide a hardwired decision-making process for upward or downward adjustments to SOFR based on standards available at the time of such rate replacement.

Amendment Approach

One of the shortcomings of a hardwired approach is that it seeks to predict the way the world will look more than two years from today. Despite its waterfalls and catchalls, it could cause loans to fall back to a suboptimal benchmark rate. To protect against this, an amendment approach affords the lender broad discretion to select a benchmark rate (with appropriate adjustments) after giving due consideration to recommendations of governmental bodies and market practice when it is time to replace the benchmark rate.

Hedged Loan Approach

A hedged loan approach seeks to eliminate any discrepancy between a swap and the underlying loan. This approach provides that if the benchmark rate has been replaced in derivatives transactions referencing the ISDA definitions, then the benchmark rate for the underlying loan will be similarly replaced and the lender will make all necessary conforming changes to the loan documents to reflect such replacement.

Securitizations

Consistent with a hardwired approach for bilateral loans, the ARRC's approach to securitizations uses specified decision-making processes to determine the appropriate reference rate and the appropriate reference rate adjustment. Because exposure under securitizations may be subject to interest rate swaps, the ARRC endeavored to make their fallback language consistent in many ways with the approach ISDA may use for derivatives. There still are some determinations that require someone to exercise judgment. In a hardwired approach, those judgments are generally made by the lender. In the ARRC's fallback approach for securitizations, the language provides for the creation of a "Designated Transaction Representative" who can make those decisions. Fallback language leaves it to the deal-specific transaction documentation to decide who would actually act in that role.

Next Steps for You

- Consider your current and future LIBOR exposure.
- Determine whether you have appropriate fallback language and which fallback language and benchmark rates are best for your situation, and then consult with your advisors, if necessary.
- Develop a plan for and then begin the transition to another rate.

The attorneys at Day Pitney routinely counsel clients on the matters discussed herein. Please feel free to contact any of the attorneys listed to the right of this alert if you would like to discuss this alert or any related matters.

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[1] The ARRC is a group convened by the Federal Reserve Board and the Federal Reserve Bank of New York to help ensure a successful transition from LIBOR to SOFR. It comprises a diverse set of private-sector entities, each with an important presence in markets affected by LIBOR, and a wide array of official-sector entities, including banking and financial sector regulators, as ex officio members.

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