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Avoiding Windfalls on Libor Fallback Reference Rates

Brandon Dalling, Frank X. Schoen, Tristan Pelham Webb, and CR Park*[*]

The Alternative Reference Rates Committee recently issued guidance and recommended fallback language for bilateral and syndicated loans in preparation for the retirement of the London Interbank Offered Rate after 2021. The authors of this article discuss the Guidance and a key point within the Benchmark Unavailability Period that arises consistently across the market.

Although the Alternative Reference Rates Committee (the "ARRC") recommends using an agent bank's prime rate as an interim fallback reference rate during periods of London Interbank Offered Rate ("Libor") unavailability, sponsors in particular may wish to consider selecting an interim fallback rate that correlates, as closely as possible, to a short-term lending rate substantially similar to the economics provided by Libor. This will avoid giving unintended economic windfalls to lenders (at the expense of borrowers), introducing the risk that floating rates of interest on loans may be uncorrelated to the interest rate hedges intended to mitigate floating-rate interest risk and creating problems for lenders as well. Borrowers have been pushing for, and lenders have accepted in some cases, the federal funds rate (plus a margin) as the interim fallback rate in lieu of the agent bank's prime rate, and this trend is expected to continue.

ARRC GUIDANCE

As most participants in the syndicated lending markets are aware, the ARRC recently issued guidance and recommended fallback language for bilateral and syndicated loans in preparation for the retirement of Libor after 2021 (the "ARRC Guidance").[1] Herein we refer to "fallbacks" as readily available alternate reference rates that can be used in financial contracts, such as syndicated loans

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[1] ARRC Recommendations Regarding More Robust Fallback Language for New Originators of LIBOR Syndicated Loans (April 25, 2019), *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Syndicated_Loan_Fallback_Language.pdf.

and interest rate hedges, to facilitate a smooth and orderly transition in the event that LIBOR becomes unavailable.

TWO APPROACHES

The ARRC Guidance offers two options for addressing the replacement of Libor as a reference rate for floating-rate loans.

The first, the "hardwire approach," purports to provide clarity and consistency by utilizing predetermined triggers and successor reference rates with interest-rate spread adjustments, including the widely referenced secured overnight funding rate ("SOFR"), together with some flexibility to rely on an amendment if such rates or adjustments become unavailable or indeterminable.

The second, the "amendment approach," generally follows the Libor replacement language used in the current syndicated loan market, with some specificity as to fallback trigger events and interest rate spread adjustments to be applied to the successor reference rate to make it more comparable to Libor. The recommended fallback language for both the hardwire approach and the amendment approach is intended to provide a market standard approach to the transition away from Libor-based pricing to a new benchmark reference rate.

FOUR MAIN TOPICS

The ARRC amendment approach language generally covers four main topics:

- "Benchmark Transition Events," or trigger events that cause the parties to begin the amendment process and select a new benchmark reference rate (which trigger events include, for example, public statements or information from regulators or benchmark administrators that Libor is ceasing or will cease);
- "Benchmark Replacement," which includes parameters surrounding how the benchmark replacement rate is chosen;
- "Benchmark Replacement Adjustment," which provides parameters for agreeing on interest rate spread adjustments between Libor and the selected benchmark replacement rate to preserve the economics of the applicable transaction in a manner that is consistent with prevailing market practice; and
- "Benchmark Unavailability Period," which is defined generally as the period between the date when Libor is no longer being published or is no longer representative, but prior to the selection of a Benchmark Replacement.

Although there are issues associated with each of the four main topics noted above, this article focuses on a key point within the Benchmark Unavailability Period that arises consistently across the market.

A KEY POINT

The ARRC's recommended language provides that, during a Benchmark Unavailability Period, all Libor loans will be converted to ABR/Base Rate loans. In most floating-rate Libor credit agreements (and, in fact, in the Loan Syndications and Trading Association ("LSTA") model credit agreement), the ABR/Base Rate is defined as the highest of (a) federal funds rate plus 50 basis points, (b) one-month Libor plus 100 basis points, and (c) the agent's (or another reference bank's) prime rate.

Because the prime rate is almost always the highest of the three options (in some cases, upwards of 300 or more basis points higher than one-month LIBOR), the ARRC language, in effect, requires floating-rate interest pricing based on the prime rate during a Benchmark Unavailability Period in almost all cases. Using the prime rate results in an interim fallback reference rate that materially skews the negotiated economics of the loan simply due to a Benchmark Unavailability Period.

From the sponsor seat, this is obviously an undesirable outcome due to the economic impact and effects on any debt service coverage ratio, interest coverage ratio or fixed charge coverage ratio, but this outcome can also pose issues for lenders if the foregoing economic changes lead to defaults under the borrower's financial covenants.

Furthermore, a borrower's interest rate hedges will not utilize or reference the prime rate as a fallback reference rate in the event of Libor unavailability—the foregoing is another inherent substantial economic and accounting frailty with the prime rate as a fallback reference rate.

A better result is an interim fallback reference rate that correlates, as closely as possible, to a short-term lending rate substantially similar to the economics provided by Libor. Although other options certainly exist (including by reference to the successive series of fallback replacement rates under the hardwire approach, including SOFR), many of these fallback reference rates do not accurately reflect a bank's dollar-based cost of funds. For example, SOFR measures overnight interbank lending costs when such funds are collateralized by U.S. Treasury bonds. A typical bank's syndicated loan book, for example, is a much different risk profile than U.S. Treasuries. In times of market dislocation, SOFR has the potential to substantially misrepresent a bank's actual cost of funds (particularly smaller banks), which has the potential to substan-

tially squeeze bank margins. A replacement reference rate that is based on the federal funds rate mitigates undesirable rate fluctuations for both borrowers and lenders.

Typically, it can be advisable for borrowers and sponsors to advocate for an interim fallback reference rate based on the federal funds rate plus a margin (typically in the range of 10 to 20 basis points, depending on whether the borrower expects to borrow at one-month or three-month Libor as the underlying benchmark reference rate). This solution avoids a potential economic windfall to lenders and avoids any unintended changes to coverage ratios on the loan.

CONCLUSION

The ARRC Guidance provides a helpful framework for determining a replacement reference rate after the retirement of Libor. However, it is not a one-size-fits-all solution and requires parties to develop language designed to fit to their needs. Savvy borrowers and lenders alike will benefit from a careful review of the ARRC Guidance, including the Benchmark Unavailability Period issues noted above, to ensure their negotiations result in financial contracts that appropriately reflect the economic agreement of the parties and do not result in unintended consequences for any party. Parties that agree to properly tailored provisions addressing the interim fallback reference rate will benefit from a smooth and orderly transition during a Benchmark Unavailability Period.