

ELECTION SEASON SPECIAL: 2021 CANDIDATES FOR LIBOR REPLACEMENT

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Get excited. The next big election season is about to kick-off. The London Interbank Offered Rate (“LIBOR”) is going away, and despite the impact COVID-19 has had on the global market, the United Kingdom’s Financial Conduct Authority, with the support of the U.S. Federal Reserve, continues to stay committed to transitioning the market away from LIBOR by December 31, 2021. This sentiment was reaffirmed more recently following the announcement by the ICE Benchmark Administration (“IBA”), the administrator of LIBOR, that the IBA will consult on its intention to cease publica-

tion of the one-week and two-month USD LIBOR settings immediately following the LIBOR publication on December 31, 2021, and the remaining USD LIBOR settings immediately following the LIBOR publication on June 30, 2023.

Over the course of 2021 and leading up to the cessation of LIBOR’s publication, parties will need to amend existing LIBOR-referencing contracts to elect a new reference rate to replace LIBOR. Additionally, parties originating new loans over the course of 2021 and beyond may find new options when picking the loan’s underlying non-LIBOR reference rate.

Not long ago, the race to replace LIBOR appeared to be a single-candidate event following the Alternative Reference Rate Committee’s¹ (the “ARRC”) selection of the Secured Overnight Financing Rate (“SOFR”) as the successor rate to USD LIBOR. The selection of SOFR, a new reference rate based on the overnight lending market and published daily by the Federal Reserve Bank of New York² was also consistent with other G-7 nations selecting similar overnight reference rates in their local currency. Additionally, to address the issue that SOFR does not have an implicit credit component like LIBOR does, the ARRC and other stakeholders determined that a credit adjustment would need to be added to SOFR (the “Credit Spread Adjustment”). The industry consensus settled on a static Credit Spread Adjustment that would represent the his-

torical percentage difference between USD-LIBOR and SOFR over a five-year look-back period starting from the occurrence of any certain “trigger events” indicating that LIBOR should no longer be referenced in the applicable contract.³

However, many community and regional banks identified issues with using SOFR as the new reference rate. LIBOR, as an unsecured bank-to-bank lending rate, provides some indication to banks of “*What will it cost us to lend money, unsecured, during this interest rate term?*” In other words, LIBOR was essentially based on the unsecured cost of funding a loan over the course of a certain future term period. SOFR, on the other hand, tells a bank what it costs to lend the *previous* night under terms that are fully secured by U.S. Treasuries. As a result, but for those larger banks that typically maintain and lend (to some extent) against large reserves of U.S. Treasuries, community and regional banks using SOFR risked lending money over an interest rate term at rates *below* their associated cost to fund those loans—i.e., “lending could become unprofitable during periods of economic stress, when funding costs tend to diverge from risk-free rates, [such as SOFR].”⁴

Then, as the COVID-19 pandemic’s impact on the market in early 2020 resulted in significant volatility and liquidity demands, SOFR quickly dropped to near zero rates during a time when banks’ lending costs, and related LIBOR rates, increased. This event confirmed, in real time, that questions about the use of SOFR plus a static credit spread adjustment and demand for some alternative were valid. Banks that needed a more dynamic credit component to their floating lending rates, a credit component that could serve as a proxy for their respective institution’s funding

costs, began to seriously demand/consider alternatives to SOFR.

Today, the race to replace USD LIBOR is no longer a single candidate race. To be clear, SOFR will have a significant place and is the primary candidate to replace LIBOR. Not only does SOFR have the support of the ARRC, but SOFR is part of a globally coordinated effort by other G-7 nations to utilize similar overnight lending reference rates and many financing documents today include suggested language (“Fallback Language”) from the ARRC intended to facilitate a transition to SOFR plus a static credit spread (the “ARRC’s Fallback Language”).

Additionally, outside of the loan market, SOFR will be the dominate rate for USD-based swaps and securitizations. In the loan market, however, alternative candidates to SOFR include: the ICE USD Bank Yield Index (“Bank Yield Index”) and the American Financial Exchange’s AMERIBOR[®] benchmark (“Ameribor”), both of which certain stakeholders proposed as more appropriate alternative replacement rates than SOFR plus a static Credit Spread Adjustment.⁵

In this environment with multiple options, understanding the menu of possible new interest rates to replace LIBOR will position market participants to better manage not only their LIBOR transition, but new loans (and any related hedges) that originate with one of these new non-LIBOR rates. This article is intended to give the reader a summary of the salient issues involved in transitioning a LIBOR loan (or swap) to a new reference rate, whether it is SOFR (with a static or dynamic Credit Spread Adjustment), the Bank Yield Index or Ameribor (collectively, the “New Reference Rates,” or individually, the “New Reference Rate”). Additionally, looking beyond

2021, when banks should be originating and pricing loans based on a New Reference Rate, this article aims to provide background on these rates and a framework for analyzing financing options that consist of a New Reference Rate plus a spread, such as SOFR+4.0% or the Bank Yield Index+3.5%. To this end, this article is subdivided into the below discussions:

1. Amending Existing Loans: New Rates and New Terms
2. SOFR: An Overview
3. SOFR + Static vs. Dynamic Credit Spread Adjustment
4. Bank Yield Index: LIBOR with a New Name
5. Ameribor: “The Most Boring Benchmark in America”
6. Legacy Amendment vs. Legacy Refinance
7. Hedging Considerations
8. Beyond 2021

AMENDING EXISTING LOANS: NEW RATES AND NEW TERMS

Before even considering the concept of originating loans based on one of the New Reference Rates, marking participants are initially going to need to address existing LIBOR-based loans. Whether parties utilize SOFR, the Bank Yield Index or Ameribor, the New Reference Rate will be an inexact replacement of LIBOR. As a result, the necessary changes to a loan agreement to implement a New Reference Rate, while minimizing any value transfer or otherwise changing the economics of the agreement in a way that will

advantage one party or the other (a “Value Transfer”), will involve more than just an exercise of “*let’s find the term ‘LIBOR,’ delete it and replace it with the term ‘New Reference Rate.’*” Parties will need to appreciate the New Reference Rate and how it is fundamentally different from LIBOR (e.g., SOFR is a “riskless rate”⁶ while Ameribor would represent the lending rate for banks significantly different than the panel of banks used to determine LIBOR), and also understand:

- Why the new interest rate used in a LIBOR-based loan will be more than just the New Reference Rate, but must also incorporate a Credit Spread Adjustment, such that it will be a “New Reference Rate +/- ____%” (the “Adjusted Reference Rate”), meaning that (for example) for someone with a “LIBOR + 4.5%” floating rate, the new rate could be “SOFR + ____% + 4.5%” or “Ameribor +/- ____% + 4.5%);
- Why, if the New Reference Rate is not quoted as a forward looking term rate,⁷ this will require the loan to further modify the Adjusted Reference Rate to be an actual/average/index rate,⁸ and then further provide whether such actual/average/index rate is based on either a “simple daily interest”⁹ convention or a “compound interest”¹⁰ convention;
- Why the “+/-_____%” Credit Spread Adjustment is included, whether it is static or dynamic (e.g., based on the Bank Yield Index) and whether it fairly represents an amount indicative of the anticipated difference between LIBOR and the New Reference Rate;

- How all of the above could impact commonly defined terms in loan agreements and related payment and operational issues, such as: interest rate floors, determinations of payment amounts, notification times regarding payment amounts, breakage fees for failure to borrow, any adjustments for prepayments or payments in the middle of an interest period and more broadly tracking asset/liability mismatches; and
- The scope and limitations of the streamlined standardized industry protocol published by the International Swaps and Derivatives Association called the “ISDA 2020 IBOR Fallbacks Protocol” (the “ISDA Protocol”), intended to assist the swaps and derivatives market in its LIBOR transition efforts.

Due to the ARRC’s Fallback Language and concerns about effectuating a seamless transition from LIBOR to SOFR, we do expect that the vast majority of today’s LIBOR loans (and any related hedges) will transition to SOFR, at least initially. However, in the long run, as loans are originated with New Reference Rates, it is possible that the way the New Reference Rates are quoted will evolve over time.

For example, the use of a separately quoted static Credit Spread Adjustment in the overall loan rate may not be needed if banks begin to incorporate this concept directly into a price quote. In this scenario, a lender could quote a new loan at SOFR+3.0%, with the understanding that the 3.0% is a single number representing two inputs: (1) the borrower’s credit risk and (2) a Credit Spread Adjustment determined by the bank that reflects the bank’s funding costs, which could vary from bank-to-bank. Furthermore, as

derivatives markets develop around SOFR and Ameribor, we may see term rate structures in SOFR and Ameribor,¹¹ which may make loan hedges that use these rates more cost effective than using a rate that is backward-looking.

In the immediate future, particularly over the course of 2021 and through to the cessation of LIBOR’s publication, parties willing to amend their loan agreements via a one-off amendment (a “Legacy Amendment”) or via a refinancing (a “Legacy Refinance”), may have questions as to (i) why a particular new reference rate is being selected over the other options, (ii) why the credit spread added to SOFR is static (rather than dynamic) and (iii) questions regarding the impact on their documentation and related hedges more broadly.

For the swaps market, the transition should be relatively straightforward, with the primary option available for market participants being adherence to the ISDA Protocol. The ISDA Protocol, is intended to assist the swaps and derivatives market in amending swap contracts to update existing LIBOR-based swaps and certain swap-related documents. The amendments implemented via the ISDA Protocol will provide standardized Fallback Language that will transition USD LIBOR swaps to SOFR swaps. For other markets, transition may be more complicated and cumbersome, particularly the loan market if lenders offer (or borrowers demand) multiple options. Then, if parties desire for a swap or other hedge to have terms that match the terms of a related financial contract which was amended to have payment terms substantively different than the ISDA Protocol, even the transition for hedges could be cumbersome.

SOFR: AN OVERVIEW

SOFR is a rate based on the overnight Treasury repo market. It is published daily by the Federal Reserve Bank of New York¹² and was selected by the ARRC¹³ as the rate that represents best practice for use in new USD loans, derivatives and other financial contracts that previously used LIBOR. The selection of SOFR as the preferred alternative to USD LIBOR is consistent with the local rates selected by other jurisdictions with respect to LIBOR-based agreements in their local currencies, which also looked to their local overnight repo markets. As market participants begin considering New Reference Rates, there may be a rush to discredit or otherwise dismiss SOFR as these parties begin to appreciate the significant differences between SOFR and LIBOR, rather than take a more holistic view that also appreciates how some of these differences are positive changes or improvements on LIBOR.

Significant focus tends to be on (1) the implications of SOFR possibly not having a term rate structure (e.g., no “one-month SOFR”), and (2) the implications of a static vs. dynamic Credit Spread Adjustment and whether there is a Value Transfer. Both of these items represent something of a wild card for market participants.

However, these concerns do not mean SOFR is inadequate, or that parties should necessarily resist a transition to SOFR. For example, as further discussed below under Hedging Considerations, for parties with hedged credit facilities, SOFR may be the best option for your loan agreement’s New Reference Rate. In fact, for many, their loan agreements are already set up to transition to SOFR; particularly those which incorporated the ARRC’s Fallback Language for bilateral business loans¹⁴ intended transition loan

agreements from USD LIBOR to SOFR.¹⁵ Other bespoke Fallback Language in loan agreements is often less specific about the New Reference Rate, and instead commits the lender to utilizing a New Reference Rate that the lender uses with other commonly situated borrowers. In these loans, borrowers and lenders may have flexibility to consider multiple options, particularly whether to utilize any of the New Reference Rates.

With this in mind, parties considering SOFR as the New Reference Rate will want to review and consider:

- **Is there a term rate?** If a SOFR term rate is available in the same tenor as the original agreement, parties should expect the modifications to input a SOFR term rate of the same tenor. Alternatively, if (for example) a one-month tenor is available, but not a three-month tenor, then parties may wish to consider modifications to a three-month LIBOR agreement so it can utilize a one-month SOFR. This would still allow the borrower to anticipate payment obligations well before the end of the interest rate period. Lastly, in the event there is no term rate, or not a term rate of the same tenor, parties may also wish to include language allowing the modified loan to transition to a term rate, if such term rate is available in the future.
- **If no term rate, will parties use the actual/average/index rate of the New Reference Rate?** Loan agreements utilizing a backward looking rate will need to agree to terms regarding how the New Reference Rate is applied based on one of the following: (i) is the interest rate applied each day to principal the actual rate quoted,

which has historically had a high degree of day-to-day volatility; (ii) is the interest rate an “average rate” over the interest rate period, resulting in decreased daily volatility or (iii) will an index rate¹⁶ be used which is intended to make it easier for parties to calculate interest over a customized number of days to reflect the effect of compounding the New Reference Rate each business day (but also presumes no intra-period prepayments).

- **If no term rate, will interest amounts be compounded each day?** Without a term rate, parties will need to consider how interest is applied to outstanding principal, particularly whether interest should be (i) compounded such that it applies to outstanding principal plus the previously days accrued interest payment amounts¹⁷ or (ii) kept simple such that the interest rate is only applied to the outstanding principal each day.¹⁸ While the compounded interest method is a more accurate indication of the accrued interests amounts, market participants have noted the existing technologies and systems can more easily implement and calculate interest based on the simple daily interest calculation. Additionally, the simple daily interest calculation will result in a lower interest payment amount.
- **If no term rate, new terms to reflect new payment conventions?** SOFR, without a term structure, lets us know what it costs to borrow last night. As a result, when calculating the SOFR-based payment owed at the end of a term, a payor would have to wait until the end of the term to know the final interest amount due at the end of the inter-

est rate period. Parties will need to review and appreciate what conventions/terms are being used to provide parties sufficient time to pay interest at the end of the period (e.g., Payment Delays,¹⁹ Lookback Periods,²⁰ Lockout Period,²¹ Last Reset or Last Recent²²).

- **How is the Credit Spread Adjustment determined?** Significant work has gone into how to determine a Credit Spread Adjustment for SOFR in order to minimize the risk of any Value Transfer. The Credit Spread Adjustment to any New Reference Rate is critical to providing both parties the same economic terms and bargained-for exchange on their loans. To the extent Fallback Language or modified terms provide that the Credit Spread Adjustment is based on something other than by reference to a published rate,²³ parties should carefully consider how this adjustment is determined. For example, language which only refers to the most recent LIBOR rate could result in an Adjusted Reference Rate that is perpetually always equal to or greater than the recent LIBOR Rate, which prevents the borrower from taking advantage of rates going lower and prevents the lender from having a rate more indicative of its cost of funding.

SOFR + STATIC VS. DYNAMIC CREDIT SPREAD ADJUSTMENT

SOFR is intended to reflect a “riskless rate of return.”²⁴ In contrast, LIBOR, which is a bank-to-bank lending rate, could be thought of as comprising: (i) a riskless rate of return, plus (ii) a percentage equal to the credit risk premium

charged in an unsecured bank-to-bank loan. This value in (ii) is what the Credit Spread Adjustment is intended to reflect.

Public consultations regarding the appropriate methodology for calculating a Credit Spread Adjustment which minimized any Value Transfer ultimately yielded an industry consensus to utilize a static Credit Spread Adjustment using a methodology based on the median of the historical differences between USD LIBOR and SOFR over a five-year look-back period following the occurrence of a Trigger Event.²⁵

Thus, the use of a static Credit Spread Adjustment, instead of a dynamic spread, was intentional. The ARRC, which also supported a static Credit Spread Adjustment, noted when considering the Credit Spread Adjustment in the context of loan and other cash products, “*The ARRC is not considering dynamic spread adjustments because these would need to be based on the same wholesale unsecured funding markets that underpin LIBOR and that have now grown to be so thin*” and also noted that based on the ARRC’s own review “*a static spread of the type that ISDA will use for derivatives and that the ARRC is considering here **can produce results that are as accurate as a potentially dynamic spread.***”²⁶ (Emphasis added)

However, as regional and community banks, and other stakeholders, evaluated the impact of this decision on their lending businesses, some pointed out that lending could become unprofitable during periods of economic stress, when funding costs tend to diverge from risk-free rates, so these stakeholders started to advocate for non-SOFR options.

BANK YIELD INDEX: LIBOR WITH A NEW NAME

The Bank Yield Index, published by the IBA, may be the closest proximity to LIBOR, which may be both a positive and a negative. The positive is obvious: consistency with LIBOR requires fewer changes to documents and technology, since it is something closer to “*just replace LIBOR with the Bank Yield Index, and everything else is fine as-is.*”

The negative, particularly for regional and community banks, is that the Bank Yield Index, like LIBOR is not intended to be an accurate indicator of lending costs and credit risk for *all* banks, since the rates are based entirely on transaction data related to a limited pool of certain international banks.

IBA has been testing the Bank Yield Index since December 2017, and during this time published numerous white papers providing information on the rate, how it is determined and how it compares to LIBOR.²⁷ The IBA is also publishing initial test rates in one-month, three-month and six-month tenors with the anticipation being that such rates will be published and fit for market use in the near future. In addition to these term rates, IBA is educating the market on how the Bank Yield Index could be used to calculate a separate dynamic Credit Spread Adjustment that can be added to SOFR Rates.

Thus, there is a chance that parties could amend documents to use either (i) an IBA published Bank Yield Index as the New Reference Rate *without the need for any Credit Spread Adjustment* or (2) a dynamic Credit Spread Adjustment to be added to SOFR that is based on IBA’s Bank Yield Index. IBA provides the public a

weekly update which indicates the differences between the Bank Yield Index and LIBOR in the tenors of one-month, three-month and six-month.²⁸ To the extent any party were to use the Bank Yield Index as the New Reference Rate without the need for any Credit Spread Adjustment, the parties should work with counsel and advisors to familiarize themselves with IBA's white papers and studies to appreciate the differences between this New Reference Rate and LIBOR, so that parties can identify any risk of a Value Transfer and determine (i) how to mitigate the risk of such Value Transfer(s) and/or (ii) compensate a party of any Value Transfer.

Initial analysis from IBA indicates there are differences between these tenors of the Bank Yield Index and LIBOR, with the Bank Yield Index providing a higher rate. However, such difference is often a couple of basis points in the one-month and three-month tenors, and about 26 basis points in the six-month tenor, based on the historical differences published by the IBA as of the writing of this article.

One reason for the Bank Yield Index's tenors showing such a close alignment to LIBOR rates of a similar tenor is that the Bank Yield Index focuses on the bank credit risk consistent with the panel banks used to determine LIBOR. Specifically, the IBA limits its transaction data to these banks based on wholesale, unsecured bank investment yields found in (i) primary market funding transactions and (ii) secondary market bond transactions. This, as noted above, is both the positive and the negative of this New Reference Rate, so regional and community banks may prefer a rate more closely aligned to their cost of funding, particularly if the differences in time, costs and energy for transitioning to any New

Reference Rate are largely the same, even if the Bank Yield Index is more "similar" to LIBOR.

AMERIBOR: "THE MOST BORING BENCHMARK IN AMERICA"

Richard L. Sandor, chairman and CEO of the American Financial Exchange ("AFX") once called Ameribor "the most boring benchmark in America."²⁹ Ameribor tends to be correlated with LIBOR, and, at least as of the date of this writing, appears to lack the volatility of SOFR, which is an asset when looking at benchmark rates.

Ameribor is a benchmark that was first published in 2015 and reflects actual unsecured borrowing costs of banks, similar to LIBOR, and in contrast to SOFR. Like LIBOR, Ameribor contains an implicit credit component that reflects the unsecured cost of funding for its member banks, which cover more than 1,100 American lenders, which are comprised of approximately 180 primary members that are mid-size regional banks, and hundreds of smaller lenders that participate via these primary members. These banks have priced debt over Ameribor, so it does have a historical use case. Although Ameribor's transaction volume may not currently match SOFR, it makes up for that by the breadth of its market participants; in this sense it may reflect the actual cost of funding for many American banks, in contrast to SOFR, which may be more suitable for larger banks that hold a large portfolio of U.S. Treasuries. For these larger banks, SOFR may serve as a proxy for their cost of borrowing against a U.S. Treasury portfolio. For smaller or regional banks that do not have large treasury portfolios, Ameribor is likely a closer proxy to cost of funding.

Further, in May 2020, Federal Reserve Chairman Powell described Ameribor as “based on a cohesive and well-defined market” that is a “fully appropriate rate for the banks that fund themselves through [AFX] or for other similar institutions for whom Ameribor may reflect their cost of funding.”³⁰ Chairman Powell’s acknowledgment that SOFR is not the only game in town should encourage market participants looking for an option other than SOFR.

Before adopting Ameribor as a New Reference Rate, however, participants should know that one of Ameribor’s current drawbacks is that it lacks a forward-looking term rate, and, in that sense, shares one of the same issues that SOFR currently has. Both Ameribor and SOFR have listed futures contracts, but will not have a stable term structure that can be used to price debt on a forward-looking basis until a liquid and transparent derivatives market develops for these rates.³¹ Consequently, today, any loan priced off Ameribor will face similar operational challenges that SOFR faces, in terms of how to manage a rate calculated in arrears, on a compounded or simple daily basis.³²

Another impediment to a wider adoption of Ameribor is whether FASB will approve the rate as a hedging benchmark rate for purposes of hedge accounting. (FASB has already approved SOFR as a qualified benchmark rate.) AFX has asked FASB to add Ameribor to its list of approved benchmarks so that it qualifies for fair value hedge accounting treatment.³³

In addition to the foregoing considerations, market participants should conduct an analysis of how closely Ameribor (or any New Reference Rate) in fact correlates with LIBOR in order to

determine the extent to which any Value Transfer might be occurring upon a transition to Ameribor or other New Reference Rate.

LEGACY AMENDMENT VS. LEGACY REFINANCE

To implement the necessary modifications to an existing LIBOR-based obligation, the initial options provided to market participants will likely fall within one of two buckets:

1. Legacy Amendment: amend an existing LIBOR-based loan agreement to provide an Adjusted Reference Rate that minimizes any Value Transfer since the parties are trying to keep the original economic terms and bargained-for exchange as unchanged as possible.
2. Legacy Refinance: refinance the existing loan to replace with a new loan agreement, allowing the borrower to take advantage of the current low interest rate environment and adopt a New Reference Rate as part of the execution of an entirely new loan agreement (a “Legacy Refinance”).

Additionally, as further discussed below under *Hedging Considerations*, if the loan agreement is hedged by an interest rate swap or cap, then this will also play a significant part in any amendment.

LEGACY AMENDMENTS

The Legacy Amendment option will appeal to parties focused on quickly implementing the necessary changes to a New Reference Rate. In fact, some loan agreements that have appropriate Fallback Language will default to this option, in some cases automatically, with little involvement

from the borrower (though this depends on the specific terms of the Fallback Language). In anticipation of transitioning away from LIBOR, lenders began to add Fallback Language to their loans, particularly following May of 2019 when the ARRC published the ARRC's Fallback Language providing three options for recommended Fallback Language for bilateral business loans.³⁴

Borrowers presented with the Legacy Amendment as the only option need not necessarily balk at this. It may just be a practical reality for all similarly situated borrowers, as the focus on needing speed and certainty will increase as parties get closer to January 1, 2022, and fewer resources are available to provide any meaningful negotiation.

For parties reviewing a Legacy Amendment, thematically the terms should achieve not only transitioning to a New Reference Rate, but parties will also want to consider how other terms are adjusted or new terms are introduced in order to minimize any Value Transfer. Doing this, however, can still result in fundamental changes to the agreements (e.g., details around how payment amounts are calculated could change, impacting when a borrower's actual payment amount can be determined with 100% certainty). To this end, parties should analyze:

- How is the New Reference Rate adjusted? If no such adjustment is made, then parties may wish to consider, based on historical differences between the New Reference Rate and LIBOR, who is likely to benefit from a Value Transfer and how this party should compensate the other for such transfer. For parties relying on the ARRC's Fallback Language and/or the ISDA Protocol, or parties with bespoke Fallback Lan-

guage but who desire consistency with such market documentation, this adjustment should be done by reference to a credit adjustment to be published by Bloomberg.³⁵

- Is the Credit Spread Adjustment static or dynamic? At the time of this article, it seems unlikely that a dynamic option will be available, unless parties agree to a New Reference Rate other than SOFR. For borrowers using SOFR plus a static Credit Spread Adjustment, while this could result in a Value Transfer that benefits borrowers in a time of market stress (since a bank could potentially be funding the loan, during that time, below its cost of funding), market participants have generally accepted this Value Transfer given the broad support for this Adjusted Reference Rate;
- Review all terms related to any interest rate calculations, including any rate caps/floors in a loan agreement to ensure that these values now are based on the "all-in" rate of the New Reference Rate, plus any Credit Spread Adjustment.
- As further discussed below, consider how any changes in the loan agreement should require similar changes in any related hedges (and vice versa).
- Consider other items highlighted earlier in this article³⁶ related to calculating interest payments (e.g., simple vs. compounded interest, using the actual/average/index rate).

LEGACY REFINANCE

A Legacy Refinance describes a typical refi-

nancing of an existing loan, except that the new terms provide Fallback Language to ensure a smooth transition from LIBOR to the New Reference Rate. Similar to a Legacy Amendment, any agreements made today—i.e., in anticipation of a LIBOR transition—will likely either (i) expressly fallback to SOFR or (ii) kick the can down the road by not committing to any specific New Reference Rate (though SOFR is the likely rate to be selected). It is unlikely any lender would agree, today, to a specific New Reference Rate other than SOFR. As a result, any Legacy Refinance prior to January 2022 will look very similar to a Legacy Amendment and have the same considerations noted above. For this reason, and considering that a Legacy Refinance will require more time than executing a Legacy Amendment, parties may only have the Legacy Amendment option during 2021.

After 2021, or whenever LIBOR is no longer available as a reference rate, the Legacy Refinance presents itself as the option best suited for parties that also want to consider a New Reference Rate other than SOFR. Here, similar to how banks today can offer a loan based on LIBOR or the Prime rate, banks may begin quoting loans based on SOFR in addition to other New Reference Rates.

When presented with multiple New Reference Rates, borrowers should work with their counsel and advisors to identify how a New Reference Rate will perform in times of market stress. For example, some market participants have noted that banks will ultimately have to add a spread to any SOFR rate in order to hedge against times of market stress when SOFR drops. In other words, a SOFR loan, when compared to one of the other New Reference Rates may result in a higher

all-in interest rate (e.g., SOFR+4.0% > Ameribor+3.4%), because banks may include, in the additional spread, extra basis points to ensure that they are better positioned to weather instances when SOFR diverges from their core funding costs. As noted earlier, this additional spread may vary bank-to-bank depending on the bank's funding costs, or how confident they are in their estimate of their funding costs in the absence of LIBOR (if a lender is less confident in its estimate of its funding costs, it may result in yet additional basis points of "cushion" being added to SOFR).

Ultimately, the issue of "*How will banks insure against having loan rates that are unprofitable during market stress?*" will be a significant driver for future loans based on a New Reference Rate, which could result in future loans being priced as (i) SOFR, plus a dynamic credit spread plus margin based on borrower-risk, (ii) SOFR plus a single spread that includes both borrower-risk and a few basis points to insure against the all-in SOFR rate ever dropping below the bank's funding costs or (iii) one of the New Reference Rates which already includes a cost of funding spread embedded in the rate. However, if a borrower is also wanting to hedge the New Reference Rate, the loan will ultimately reference the New Reference Rate offering the least expensive and most effective hedge.

HEDGING CONSIDERATIONS

Market participants with an interest rate derivative hedging the loan agreement may have limited options. For example, one constraint relates costs. Borrowers considering a Legacy Refinance to their current loan(s) may discover this option is cost prohibitive due to the termina-

tion payment obligation that would be triggered by a refinancing, a payment obligation likely owed by a borrower since interest rates have generally been dropping over the last decade (or longer). In such instances, the Legacy Amendment amending both the loan and swap may be the only financially viable option for the borrower since this would not trigger a termination payment on the swap.

Furthermore, options will be limited due to the fact that the borrowers will often want the new Adjusted Reference Rate on the loan to equal the new Adjusted Reference Rate on the hedge. Here, parties will often provide that (i) one agreement, the loan or hedge, will have detailed Fallback Language regarding how the agreement will transition from LIBOR to another rate and (ii) the other agreement will simply provide Fallback Language providing that the New Reference Rate will be whatever rate is provided for in the related loan/hedge. For example, the ARRC's Fallback Language provided exactly for this if parties incorporated the "Hedged Loan Approach" into their loan agreement.³⁷ As a result, parties should check for this. If the loan agreement incorporated the "Hedged Loan Approach" (or other language but with the same intent and result), then the loan will sync up with SOFR plus a static Credit Spread Adjustment that will be effected by a borrower's adherence to the ISDA Protocol.³⁸

The ISDA Protocol was published on October 23, 2020, including related amendments to the 2006 ISDA Definitions.³⁹ Together, they allow parties to modify any over-the-counter derivatives to address the discontinuation of LIBOR by using ISDA's protocol mechanism, which is a multilateral contractual amendment process that

has been used to address changes in ISDA contracts for over two decades. The process is widely adopted and provides an efficient way for parties to an ISDA agreement to implement standard contractual changes across their counterparty base. ISDA often also publishes bilateral versions of their protocols, for parties that prefer a one-off bilateral counterparty-by-counterparty amendment option, as opposed to a multilateral, across-the-board amendment process. The bilateral version may also be used in those instances where market participants desire bespoke modifications to ISDA's adopted protocol language.

A party that adheres to the ISDA Protocol will amend all their "Protocol Covered Documents" to incorporate ISDA's LIBOR Fallback Language, which selected compounded in arrears SOFR as the New Reference Rate. The Trigger Event signaling the cessation of LIBOR is, generally, defined as the first date on which either (i) LIBOR is determined not to be representative of the underlying market by a regulatory supervisor or benchmark administrator or (ii) a statement by a regulatory supervisor or benchmark administrator that LIBOR is, or will be, no longer published. Upon the cessation of LIBOR, each Protocol Covered Document will then transition to SOFR plus a static Credit Spread Adjustment and interest payment amounts will be based on a compounded in arrears calculation. This is a daily compounded rate that is determined at the end of each calculation period based on the average of the overnight SOFR rates over the term of such calculation period. Thus, a one-month LIBOR rate would transition to this SOFR Adjusted Reference Rate based on a calculation period of 30 days. As noted earlier, Bloomberg will be publicly publishing both the SOFR Adjusted Refer-

ence Rate and the Credit Spread Adjustment for each tenor of LIBOR.⁴⁰

Because the ISDA Protocol defaults to compounded in arrears SOFR as the New Reference Rate, for most corporate borrowers with hedged credit facilities, adhering to the ISDA Protocol and modifying the loan such that it tightly aligns with the ISDA Protocol will make sense, in order to ensure hedge stability. This process effectively implements two separate amendments, one to amend the loan and another that amends the swaps, but with a view of the transaction as a whole. In implementing these two distinct amendments, borrowers will need to conduct an evaluation of the terms of the ISDA Protocol against the modifications that they are making to their related loans, in order to mitigate any basis risk that might arise from different language between the two contracts. Similarly to the analysis that borrowers need to engage in for determining whether to conduct a legacy amendment, borrowers with hedged loans that have Fallback Language which could result in the loan's new rate being different from its related hedge, should review all interest rate terms in their loan (including any caps or floors), determine whether the static Credit Spread Adjustment in the ISDA Protocol aligns with any similar credit adjustment being made under the loan, and ensure that the calculation of interest is consistent between the loan and the hedge (e.g. simple vs. compounded SOFR, and use of daily/index/average SOFR, and how prepayments and any floors or caps are calculated). Moreover, to the extent that a borrower wants the ability to opt into a term SOFR—once a liquid term structure develops—then the borrower should ensure that it has similar rights under *both* the loan agreement and the swap to transition to term SOFR at the same time

under each instrument in order to avoid disrupting its hedge.

In theory, borrowers with hedged loans should also be able to use Ameribor, the Bank Yield Index, or any other New Reference Rate so long as the swap documentation and the loan documentation provide for a stable hedge. In practice, however, the market for swaps in Ameribor and the Bank Yield index is less liquid (currently) than the SOFR swaps market, meaning that even if a borrower were to find a lender willing to offer an Ameribor or Bank Yield Index swap, the costs may be high for the lender to offer this due to the current lack of liquidity in this swap market, and those increased costs would likely result in the borrower paying a higher fixed rate on the swap than a comparable SOFR swap (which should have a more liquid swap market, presumably).

Additionally, any termination amount (e.g., in the event of prepayment or refinance) may be significant if the Ameribor or Bank Yield Index swaps market is not sufficiently developed at the time of such termination. Essentially, the transaction costs associated with conducting a non-SOFR hedged loan may deter market participants from going this route, at least until such time as a more liquid market derivatives market develops in these non-SOFR rates. For parties that desire keeping some exposure to floating rates, and that have loan agreements that do not require hedging that risk, then the options may be greater.

Ultimately, for many the question will be whether the loan and hedge can convert—in the form of a package, as it were—in the most efficient way with minimal costs. Of particular importance regarding costs is the question of whether the Fallback Language in the loan and

hedge are consistent in terms of the fallback trigger, New Reference Rate, and Credit Spread Adjustment, and whether the New Reference Rate is eligible for hedge accounting treatment. If any of these do not match, there could be a negative impact to a borrower, particularly those sensitive to hedge accounting treatment. In summary, corporate borrowers with hedged loans would do well to evaluate the ISDA Protocol in tandem with reviewing the terms of their loan documentation. Borrowers should be on the lookout for any gap risk between the ISDA 2020 Fallbacks Protocol and their loans.

LOOKING BEYOND 2021

Today, SOFR appears to be the primary option for legacy contracts, particularly when considering a loan agreement that a borrower has also hedged since the LIBOR-based swap market will transition to SOFR. However, parties can and may agree to different rates, particularly for new contracts. For lending institutions struggling to find the resources and expertise necessary to update existing systems to account for SOFR and the fact that it is a backward looking rate, the Bank Yield Index may be appealing, because it is so similar to LIBOR and already has an existing term rate structure. Additionally, because fewer changes to documentation would be necessary to implement the Bank Yield Index than implementing a rate that lacks a term structure or Credit Spread Adjustment, lenders may also find it easier to articulate the rationale for transitioning to the Bank Yield Index.

In some sense, the Bank Yield Index may appeal to a lender trying to find short-term fix by allowing the lender to quickly transition loans from LIBOR to a New Reference Rate with

minimal changes, and give SOFR and/or Ameribor a more fulsome consideration in the future whenever a term rate structure exists. However, if any payment terms on a loan utilizing the Bank Yield Index will have some basis risk with any related hedge that has transitioned to SOFR.

Although market participants will start casting their ballots in 2021 to pick the New Reference Rate, the question of what will ultimately be the most commonly utilized benchmark rate may not be answered until well after LIBOR is gone, and loans are being originated based on a New Reference Rate. At that time, lenders and borrowers will be able to compare the all-in interest rate across a menu of New Reference Rates.

Which of these rates succeeds will, in large part, depend on (i) the costs of the quoted all-in New Reference Rate plus spreads and (ii) how market participants are able to hedge their exposure to such rates. For instance, if lenders overestimate the additional credit spread necessary to mitigate the risk of an all-in SOFR rate dropping below their cost of funding, then other New Reference Rates may present all-in interest rates that are lower than SOFR (e.g., $\text{SOFR}+4.0\% > \text{Ameribor}+3.4\%$). However, if SOFR continually offers the least expensive hedge, then for borrowers that want a hedge, or want the option to execute a hedge in the future a SOFR-based loan may be the better alternative. The extent to which a liquid derivatives market develops around these New Reference Rates will be a primary factor in the evolution of options available to borrowers and lenders and whether any single candidate wins this election.

The intent of this article is to help readers better understand the differences between various New Reference Rates and the factors to consider

in analyzing the menu of options available to clients and counterparties. Appreciating the differences between New Reference Rates also puts parties in a position to make informed decisions as to how the transition away from LIBOR might impact asset/liability alignments and operational frameworks surrounding how interest is calculated. Further, even if a borrower or lender finds that it has no options for legacy agreements other than adopting SOFR, when dealing with new loans, the parties may have more flexibility to consider non-SOFR alternatives.

ENDNOTES:

¹The ARRC is a public-private working group convened by the Federal Reserve Board and the Federal Reserve Bank of New York to help ensure a successful transition away from USD LIBOR. *See*, <https://www.newyorkfed.org/arrc>.

² <https://apps.newyorkfed.org/markets/autora/tes/sofr>; *see also* 82 FR 58397 (Dec. 12, 2017) (Notice from the Board of Governors of the Federal Reserve System (Board) announcing the production and publication of SOFR).

³The five-year period ends on the occurrence of a specified “Tigger Event.” The Trigger Events are referred to as “Index Cessation Events” in the 2006 ISDA Definitions and are events indicating that USD LIBOR should no longer be utilized, whether due to it no longer being published or public statement from the relevant regulator that USD LIBOR is no longer representative of its underlying market.

⁴*See*, Robert Mackenzie Smith, *Credit problem: SOFR faces uphill struggle in loan market*, RISK.NET (Jun. 16, 2020), <https://www.risk.net/risk-management/7561711/credit-problem-sofr-faces-uphill-struggle-in-loan-market>.

⁵Broader discussions and analysis of this topic have been facilitated by the Credit Sensitivity Group, a group of regulator-convened U.S. regional banks. At the time of writing this article,

to the authors it seems unlikely formal determination will be made by this group that indicates a clear “winner” or preferred option for stakeholders demanding a reference rate with some indication of credit sensitivity. In fact, on October 21, a group of U.S. financial agencies wrote to the executives of financial institutions that participated in the Credit Sensitivity Group workshops, stating that the agencies do not intend to recommend a specific credit-sensitive rate for use in commercial lending products in place of LIBOR, but instead, the agencies will continue to convene additional working sessions to highlight innovation in the credit-sensitive rates and explore implementing solutions for commercial loans transitioning away from LIBOR. For more about the Credit Sensitivity Group Workshops and a copy of the letter discussed in this Endnote, *see* <https://www.newyorkfed.org/newsevents/events/markets/2020/0225-2020>.

⁶At least in theory. SOFR is secured, but whether a secured rate is ever riskless depends on the credit profile of the counterparty (or custodian), the underlying collateral package, and ability of the secured party to enforce against the collateral pool.

⁷Currently, SOFR and Ameribor are not quoted as term rates. For example, there is no 3-month SOFR/Ameribor. The Bank Yield Index, however, is quoting a one-month, three-month and six-month tenor. Although the intent is that a term rate structure will be available in SOFR and Ameribor, unless market participants can develop a forward looking curve that reflects market expectation as to what will happen to interest rates (this curve first requires sufficient derivative transaction with respect to such rate to exist) or, in the case of Ameribor, being quoting/lending in such tenors, parties may have to forgo a term rate and instead rely on a backward looking rate. If a backward-looking rate is used, then there are questions around how to apply a backward-looking rate to calculate interest owed over the relevant period that interest accrues (e.g., compounding vs not compounding interest on the outstanding principal during the interest period, and using the daily rate, index rate or average rate over the interest period).

⁸“Actual” would apply the reported rate each night. The “average” calculates the average of the overnight rate, not a single day’s reading, and such average rate will accurately reflect changes in interest rates in a time period and smooths out daily volatility in overnight rates. The “SOFR Index” published by the New York Federal Reserve Bank reflects the effect of compounding SOFR each business day and should be used to calculate a compounded interest rate payment over a customized period of time during which there will be no intra-period prepayments on the loan.

⁹Simple Daily Interest is calculated by applying the daily rate to the principal borrowed, and the payment due at the end is the sum of those amounts. In comparison to Compound Interest, Simple Daily Interest may be computationally easier such that banks and borrower’s treasury teams may prefer this rate as it is easier to work within, or implement into, existing technologies.

¹⁰Compound Interest keeps track of the accumulated interest owed but not yet paid. The interest owed each day is calculated by applying the daily rate to both the principal borrowed and the accrued, unpaid interest. In comparison to Simple Daily Interest, Compound Interest is the more economically correct convention as it more accurately reflects the accrued interest amounts over the interest period. Compounded SOFR could either be “Compounded In Advance” (e.g., calculated based on the prior equivalent period and thus known in advance of the interest period) or “Compounded In Arrears” (e.g., calculated during the course of the interest period and thus not known in advance).

¹¹*Supra*, Endnote 7 (discussing the lack of term rate structures in SOFR and Ameribor, and the important role the derivatives market will play in the development of any term rates).

¹² <https://apps.newyorkfed.org/markets/autorates/sofr>; see also 82 FR 58397 (Dec. 12, 2017) (Notice from the Board of Governors of the Federal Reserve System (Board) announcing the production and publication of SOFR).

¹³The ARRC is a public-private working group convened by the Federal Reserve Board

and the Federal Reserve Bank of New York to help ensure a successful transition away from USD LIBOR. See, <https://www.newyorkfed.org/arrc>.

¹⁴See, Ivey, Edward, *Bilateral Loans and Hedging the LIBOR to SOFR Transition*, FUTURES AND DERIVATIVE LAW REPORT, Vol. 39, Issue 9 (October 2019) (article summarizes the ARRC’s Fallback Language for bilateral business loans).

¹⁵See the ARRC’s Press Release, “*ARRC Releases Recommended Fallback Language for Bilateral Business Loans and Securitizations; ARRC Encourages Use of this Language in New Contracts, Which Aims to Minimize Market Disruptions if LIBOR is No Longer Usable*,” available at <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-May-31-2019-announcement.pdf>

¹⁶*Supra*, Endnote 8 (discussion of the SOFR Index rate that is published by the Federal Reserve Bank of New York, which is published quoted at <https://apps.newyorkfed.org/markets/autorates/sofr-avg-ind#:~:text=The%20SOFR%20Index%20measures%20the,value%20date%20of%20the%20SOFR>).

¹⁷*Supra*, Endnote 10 (further discussion of “Compound Interest” calculation methodology).

¹⁸*Supra*, Endnote 9 (further discussion of the “Simply Daily Interest” calculation methodology).

¹⁹The averaged SOFR is paid X days after the end of the interest period.

²⁰For every day in the current interest period, SOFR from X days earlier is used.

²¹The averaged SOFR over a current interest period “locks” the last few days’ rates at a rate fixed X days before the period ends.

²²“Last Reset” is the averaged SOFR for the equivalent time period of the upcoming interest period, while “Last Recent” is the averaged SOFR for a shorter time period than the upcoming interest period.

²³For example, the Bloomberg Index Services Limited (“Bloomberg”) will calculate and publish an Adjusted Reference Rate (compounded in

arrears) based on the New Reference Rates captured in the Fallback Language to be implemented by ISDA to its standard interest rate derivative definitions. Bloomberg will also publish the spread adjustment and the “all in” Interbank Offered Rate (or “IBOR”) fallback rates for the Australian dollar Bank Bill Swap Rate, Canada’s CDOR, Swiss franc LIBOR, EURIBOR, euro LIBOR, sterling LIBOR, HIBOR, euroyen TIBOR, yen LIBOR, TIBOR and USD LIBOR. *See also, IBOR Fallback Rate Adjustments Rule Book*, available at <https://data.bloomberglp.com/professional/sites/10/IBOR-Fallback-Rate-Adjustments-Rule-Book.pdf>

²⁴Again, in theory.

²⁵*Supra*, Endnote 3.

²⁶*See, ARRC Consultation on Spread Adjustment Methodologies for Fallbacks in Cash Products Referencing USD LIBOR*, January 21, 2020, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Spread_Adjustment_Consultation.pdf.

²⁷*See, ICE Benchmark Administration U.S. Dollar ICE Bank Yield Index Update* (May 2020), available at https://www.theice.com/publicdocs/IBA_US_Dollar_ICE_Bank_Yield_Index_Fourth_Update.pdf.

²⁸*See, https://www.theice.com/iba/Bank-Yield-Index-Test-Rates.*

²⁹*See, Jessica Love, Why Financial-Market Pioneer Richard Sandor is Building “the Most Boring Benchmark in America,” KELLOGINSIGHT* (Mar. 2, 2020), available at <https://insight.kellogg.northwestern.edu/article/financial-market-pioneer-richard-sandor-building-ameribor>.

³⁰*Powell: Ameribor ‘Fully Appropriate’ for Banks When It Reflects Cost of Funding*, ABA Banking Journal (Jun. 3, 2020), available at <https://bankingjournal.aba.com/2020/06/powell-ameribor-fully-appropriate-for-banks-when-it-reflects-cost-of-funding/>.

³¹*Supra*, Endnote 7 (discusses the lack of a term rate and need for a derivatives market to develop prior to the creation of any term rate).

³²*Supra*, Endnotes 8 (discussion of using the

actual rate each day, or applying an average rate over the interest rate period), 9 (discussion of calculating interest based on a simple daily basis) and 10 (discussion of calculating interest on a compounding basis).

³³*See Adding AMERIBOR® to FASB’s List of Benchmark Interest Rates for Fair Value Hedge Accounting*, letter from certain members of the AFX to Richard R. Jones, Chairman of Financial Accounting Standards Board (Sep. 16, 2020), available at https://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blonwhere=1175836184518&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=1351663&blobheadervalue1=filename%3DLIBORSOFR.UNS.001.AFX_BANK_MEMBERS_CEOS_SEE_LISTED.pdf&blobcol=urldata&bloitable=MungoBlobs.

³⁴*See the ARRC’s Press Release, “ARRC Releases Recommended Fallback Language for Bilateral Business Loans and Securitizations; ARRC Encourages Use of this Language in New Contracts, Which Aims to Minimize Market Disruptions if LIBOR is No Longer Usable,” available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-May-31-2019-announcement.pdf; see also, Endnote 14 (Article cited here discusses and analyzes the ARRC’s Fallback Language for bilateral loans).*

³⁵ISDA engaged Bloomberg Index Services Limited (“Bloomberg”) to calculate and publish the SOFR fallback rates (and fallback rates of other G-7 nations). On a daily basis Bloomberg will publish (i) SOFR’s Adjusted Reference Rate, (ii) the Credit Spread Adjustment and (iii) the “all-in” fallback rate for each tenor of USD LIBOR. These rates will be published in a way that is generally available to the public. Bloomberg has already begun publishing indicative data, reflecting what the fallback rates for each tenor of USD LIBOR would be if an event occurred today that, under the ARRC’s suggested language and the ISDA Protocol, would trigger the calculation of the definitive Credit Spread Adjustment (referred to as an “Index Cessation Event”). Under the ARRC’s suggested language

and the ISDA Protocol, Bloomberg's published "all-in" SOFR fallback rates will be the official designated source for the replacement rate for each tenor of USD LIBOR following the occurrence of an Index Cessation Event.

³⁶*Supra*, Endnotes 8 (discussion of using the actual rate each day, or applying an average rate over the interest rate period), 9 (discussion of calculating interest based on a simple daily basis) and 10 (discussion of calculating interest on a compounding basis).

³⁷*Supra*, Endnote 14 (Article cited notes the benefits of using the Hedged Loan Approach).

³⁸For loans that are hedged but that have not incorporated the "Hedged Loan Approach," we note that the Loan Syndications and Trading Association ("LSTA") is designing a Form of Consensual Amendment that would, effectively, allow the parties to amend loans that incorporate ARRC's "Amendment Approach" Fallback Lan-

guage for loan documents. To the extent that parties decide to use LSTA's Form of Consensual Amendment—which has not been published as of the date of this writing—they would need to evaluate whether the Form of Consensual Amendment aligns with ISDA Protocol, in order to ferret out any potential gap risk between the loan and the hedge. LSTA is also working on a Form of Notice of Conforming Changes, which is designed for amending loans that incorporate ARRC's "Hardwired Approach;" the Form of Notice of Conforming Changes would allow the administrative agent to make technical or operational changes to the loan in order to implement the hardwired fallback.

³⁹See *ISDA 2020 IBOR Fallbacks Protocol*, available at <http://assets.isda.org/media/3062e7b4/08268161-pdf/>.

⁴⁰*Supra*, Endnote 35.