

## BILATERAL LOANS AND HEDGING THE LIBOR TO SOFR TRANSITION

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The financial markets have about 24 months until hundreds of trillions of dollars of contracts that have an interest rate referencing the London Interbank Offered Rate (“LIBOR”) may need to transition/fallback to a reference rate other than LIBOR. The reason: LIBOR will cease to exist. Unfortunately, it appears many financial market participants are not actively working towards modifying existing agreements and continue to execute new agreements lacking adequate terms to address a permanent<sup>1</sup> cessation of LIBOR (“**Fallback Language**”). In some cases, the lack of adequate Fallback Language is due in large part to a lack of market consensus or acceptance of any specific Fallback Language, but in the

bilateral loan market, standardized Fallback Language is publicly available.<sup>2</sup> Yet, incorporation of this Fallback Language is still lacking in many contracts.

This article provides a suggested approach to end-user borrowers (“**Corporates**”), and middle market banks with around \$10 billion in total assets or less (“**Middle Market Banks**”), that have executed bilateral loans which reference LIBOR (or any other interbank offered rate or “**IBOR**”).<sup>3</sup> Corporate and Middle Market Banks will need to include Fallback Language in new bilateral loans (and amend existing loans to include Fallback Language), but trying to understand those options can be difficult given much of the discussions on this topic focus on the uncertainties that remain, rather than providing tailored guidance to market segments regarding how to mitigate those uncertainties.

The lack of tailored advice may be part of the reason that many in the market continue to take a “wait and see” approach, rather than incorporate the Fallback Language published in the market and discussed in this article. Given the scope of the task at hand, if Corporates and Middle Market Banks take a “wait and see” approach, many may be left scrambling for the attention of counterparties barely able to keep their heads above the ever-growing stack of papers during the inevitable transition from LIBOR to SOFR.

To the extent parties have agreed to Fallback Language in broad terms that give unilateral rights to the lender, at the end of this article we provide thoughts on potential concerns and related mitigants any lender may wish to consider when preparing/reviewing such language. For borrowers in this situation, we also note items that should be considered and remembered upon notice of any amendments pursuant to the lender's unilateral right.

## WE MUST ADAPT

As a former Chairman of the U.S. regulator overseeing the interest rate derivatives market put it, *“The discontinuation of LIBOR is not a possibility. It is a certainty. We must anticipate it, we must accommodate it and we must adapt to it.”*<sup>4</sup>

Globally, estimates show that the total gross notional exposure to U.S. dollar denominated LIBOR<sup>5</sup> in loans, bonds, securitizations, deposits and other financial products is close to \$200 trillion.<sup>6</sup> Despite the demise of LIBOR being inevitable, loans, swaps and other financial products continue to be issued that reference and rely on a particular LIBOR rate (e.g., 3-Months LIBOR or 6-Months LIBOR). While these agreements will often have language regarding instances where LIBOR is unavailable, such language has an underlying assumption that the “unavailability” is due to a technical issue or other temporary incident. If the unavailability were permanent, the language may not address such situation or provide solutions that are workable (e.g., a “solution” of either (i) polling dealers in the market or (ii) relying or re-using the most recently available rate). New Fallback Language must be added that can adapt to a real-

ity where LIBOR no longer exists or is otherwise unavailable.<sup>7</sup>

In the United States, most Fallback Language will change the reference rate from LIBOR to the Secured Overnight Financing Rate<sup>8</sup> (“SOFR”), a new reference rate based on the overnight Treasury repo market and published daily by the Federal Reserve Bank of New York.<sup>9</sup> Unfortunately, SOFR is an inexact replacement for LIBOR.<sup>10</sup> As a result, the amendments necessary to effect this change are significantly more involved than swapping references from “LIBOR” to “SOFR.” Changes incorporating SOFR-based payments will require fundamental changes to how interest payment amounts are calculated. Many such changes can present significant risks to borrowers or other parties. One notable “risk” being the difficulty in managing future SOFR-based payment obligations since some changes may result in interest payment amounts not being known until a few days before payment is due.

Today, there are formal Fallback Language options for market participants published by a committee charged with assisting in the transition from LIBOR to SOFR (the “**ARRC Recommendations**”) which cover a variety of products (e.g., floating rate notes, securitizations, and syndicated loans).<sup>11</sup> However, the adoption of the ARRC Recommendations continues to be slow in some markets, which only may be the result of many market participants only beginning to appreciate the scope of the task at hand and are still grappling to understand the various ARRC Recommendations and decide if there is a “best option” for particular situations.

The ARRC Recommendation for the bilateral business loan market for loans referencing LI-

BOR (or any other IBOR) (“**Floating Rate Loans**”) provides three options for market participants to consider (Hardwired Approach, Amendment Approach, and Hedged Loan Approach). As discussed in greater detail below, when the Floating Rate Loan is also coupled with a swap to hedge the borrower’s payment obligations under the loan, which is a common arrangement for Corporates and Middle Market Banks, the parties to the Floating Rate Loan should strongly consider including the ARRC Recommendation referred to as the “Hedged Loan Approach” in their Floating Rate Loan. Also, as discussed in this article under *What if the Floating Rate Loan is Not Hedged?*, this article discusses the Hardwired Approach and Amendment Approach, and the considerations that Corporates and Middle Market Banks should make if the Floating Rate Loan is not coupled with a swap.

A copy of the Fallback Language for the Hedged Loan Approach is included as an Exhibit A to this article. Due to the length of the Hardwired Approach and Amendment Approach amendments, they are not included as an Exhibit to this article, but are available online.<sup>12</sup>

## BACKGROUND: LIBOR’S DECLINE

Traditionally, the various LIBOR rates were based on actual bank-to-bank lending transactions, but changes in certain laws<sup>13</sup> have led to a significant change in how banks fund themselves, including a reduction in short-term funding through the unsecured bank-to-bank transaction marketplace. Today, with too few actual bank-to-bank transactions, the panel of banks providing quotes to the administrator of the LIBOR quotation services are having to provide an “expert

judgment”<sup>14</sup> as opposed to rates based entirely on substantial transaction data.

The submission of LIBOR rates by the panel banks is currently mandated by the UK’s financial regulator, the Financial Conduct Authority (the “**FCA**”). However, starting in 2022, the FCA will not mandate LIBOR submissions. Without this mandate, banks may no longer provide submissions for the calculation of LIBOR given the risks and liabilities associated with the difficulties banks faced in preventing fraud and manipulation in this market, including exposure to billions of dollars in fines for some panel banks. Additionally, even if any panel banks were willing to continue submitting LIBOR rates, local UK and EU regulators could determine that LIBOR no longer satisfies the requirements of the European Benchmark Regulation. The result of this determination would be that banks subject to the relevant laws in Europe could no longer utilize LIBOR for new business.

The demise of LIBOR is further certain due to the larger international coordination to find and establish new reference rates that are less susceptible to fraud and manipulation. In the United States, for U.S. dollar-based transactions, the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York convened the “Alternative Reference Rates Committee” (“**ARRC**”). ARRC’s membership includes a broad set of public and private sector market participations, including banks, trade associations, insurance companies, clearing houses, and governing agencies. ARRC’s mission, in its most basic description, is to lead the charge for the transition of USD-based transactions from LIBOR to SOFR. While this may sound easy; something akin to “*Well, don’t we just go through*

*the contracts and replace LIBOR with SOFR, and call it a day?,"* this is, unfortunately, not the case. Because LIBOR and SOFR are entirely different rates in many ways,<sup>15</sup> parties will need to understand:

- (i) why the new rate will not just be SOFR, but instead “SOFR + \_\_\_\_%” (the “**Adjusted Reference Rate**”), meaning that (for example) someone with a “LIBOR + 4.5%” floating rate, will have a new rate of “SOFR + \_\_\_\_% + 4.5%”;
- (ii) why the “SOFR” reference in the Adjusted Reference Rate will be supplemented based on the available SOFR rates;<sup>16</sup>
- (iii) why the “+\_\_\_\_%” (the “**Credit Risk Premium**”) is being added in addition to any existing spread already being added to the current LIBOR rate; and
- (iv) the various options in the ARRC Recommendations to accommodate all of the above, so that an Adjusted Reference Rate can be successfully incorporated into a LIBOR contract, and understanding which option is the “best option” for their situation.

## BACKGROUND: LIBOR ≠ SOFR

LIBOR and SOFR are two very different rates. Two differences that cause a number of concerns and issues for market participants are:

- (i) **Interest Calculation Method & Lack of a Term Rate.** LIBOR is quoted in a term structure (e.g., 3-Months, 6-Months, 1-Year LIBOR), but SOFR currently has no term structure. As a result, the New

York Federal Reserve does not quote a “6-Months SOFR” or other term rate. Instead, SOFR is a backward-looking overnight rate. If no term structure is available when contracts transition to SOFR, parties will need to agree on the interest calculation method for an interest rate that is (x) backward looking and (y) changes everyday. Additionally, without a term rate, parties making a SOFR-based payment will not know the total amount of the interest payment until a few days before such payment is due, which can create risks for parties’ cash flow management.

- (ii) **The Credit Risk Premium & Value Transfer Risk.** The difference in basis points between LIBOR and SOFR is not a consistent number, so whatever spread amount is added to SOFR to create the Adjusted Reference Rate will likely result in a “winner” and a “loser,” in the sense that (at any time) what a party may have paid with LIBOR is more or less than what is paid pursuant to the Adjusted Reference Rate.

### *INTEREST CALCULATION METHOD & LACK OF A SOFR TERM RATE*

LIBOR is quoted in various maturities (e.g., overnight, 1-Week, 3-Months, 6-Months and 1-Year). By contrast, SOFR is a rate is quoted in the overnight maturity only—i.e., SOFR is a spot rate that is calculated based on observed transactions that happened the previous night.

That is to say, SOFR lets us know what it cost 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 apply all the rates observed during such term. This presents a number of complexities that require a number of changes in any financing arrangement that will transition from a forward-looking term rate, to a backward-looking overnight rate.

When calculating an interest payment based on a backward-looking overnight rate, such as SOFR, market participants will not engage in the daily process of applying the overnight rate determined each day to the loan principal amount every day of the interest payment calculation period. Instead, the rate applied to a loan principal will be based on an average of the SOFR rates over the interest calculation period (the “**Average SOFR**”), then the Average SOFR will be applied to the loan principal amount based on either (i) the simple average calculation method<sup>17</sup> of simply applying the Average SOFR to the loan principal amount each day, or (ii) the compounded average<sup>18</sup> calculation method that will apply the Average SOFR to the daily accruing interest amount.<sup>19</sup>

Regardless of the averaging calculation method, this calculation method is often referred to as an “in arrears” payment structure to describe how it is a backward looking calculation method.<sup>20</sup> When paying in arrears, as a practical matter, a short time will generally be included at the end of the interest rate period to calculate amounts owed, give notice and make required payments (or, alternatively, parties may agree to an “anticipated amount” that is paid on the future payment date, but would add/subtract from such amount an amount reflecting whether the previous payment date’s anticipated amount was more or less than the actual amount owed).

There are efforts to create a term rate SOFR, and ARRC does hope to have a term SOFR rate available by the end of 2021.<sup>21</sup> However, many uncertainties exist around this figure, most notably whether it will be available since this requires that there first be a significant volume of actively traded SOFR derivatives to develop reliable models for generating a term SOFR rate. Currently, this market is in its infancy (but growing). Still, it is uncertain when any forward-looking term SOFR rate will be available. Of particular concern is the fact that documents may need to transition away from LIBOR before any term rates are available. For this reason, the ARRC Recommendations falling back to a term rate do so as part of a “waterfall” of options for the replacement rate—i.e., the amendment may initially default to a term SOFR rate, but includes additional fallbacks in the event no such term rate exists.<sup>22</sup>

#### *THE CREDIT RISK PREMIUM & VALUE TRANSFER RISK*

SOFR is intended to reflect a rate that is nearly a “riskless rate of return” and LIBOR can therefore be thought of as a rate that is the combination of (a) a riskless rate of return, plus (b) a spread that reflects the credit risk in bank-to-bank lending. The amount added to SOFR to create the Adjusted Reference Rate is the amount in (b), which is the Credit Risk Premium. The value of the Credit Risk Premium will not be dynamic,<sup>23</sup> which presents an issue since the credit risk of banks changes everyday (e.g., the amount in (b) can vary based on economic and geopolitical events). Thus, once the amount for the Credit Risk Premium is set, the Adjusted Reference Rate will almost certainly result in one party paying more or less than such party would have paid

under the contract's original LIBOR-terms since the credit risk of banks would continue to fluctuate. This situation is often referred to as part of the "value transfer" that will occur with any transition to an Adjusted Reference Rate.

Unfortunately, in this dynamic, if one party looks to maximize the chance that he/she is the "winner" in this value transfer (e.g., by increasing/decreasing the amount in the Credit Risk Premium), that necessarily increases the risk to his/her counterparty that such counterparty will be the "loser." ARRC, appreciating this dynamic, has coordinated with other organizations (e.g., the International Swaps and Derivatives Association or "ISDA") and are asking the market for feedback on methodologies to determine the Adjusted Reference Rate that will minimize any value transfer.<sup>24</sup>

## CORPORATES: BILATERAL LOANS & HEDGING

Today, LIBOR-based Floating Rate Loans continue to be made. However, any Floating Rate Loan presents two risks to a Corporate:

- (i) the risk that interest rates rise, causing a loan to be more expensive throughout its life; and
- (ii) the risk associated with the inability to have certainty around all future amounts that must be paid on the loan, since accrued interest will fluctuate with the loan's floating rate.

Traditionally, Corporates were attracted to these Floating Rate Loans because the lender could offer to "swap out" the floating rate for a fixed rate that was lower than the rate offered in a fixed rate loan. Rarely would a Corporate-

borrower agree to a Floating Rate Loan without hedging the above risks by "swapping out" to a fixed rate. However, more recently (in today's depressed interest rate environment) some Corporate-borrowers may elect to leave such risk unhedged, effectively resulting in such Corporate-borrower speculating on the future of interest rates and accepting the risk of this uncertainty. The risk analysis by such speculators may not have appreciated that, with the transition from LIBOR to SOFR, the uncertainties are magnified. New risks associated with value transfers, cash-flow management and the overall uncertainty related to the impact of transitioning from LIBOR to SOFR, amplify the benefits of hedging the risks associated with a LIBOR-based payment obligation.

## MIDDLE MARKET BANKS: BILATERAL LOANS & HEDGING

Traditionally, Floating Rate Loans packaged with a swap were limited to larger financial institutions, most of which were registered swap dealers. However, in March 2019 the U.S. Commodity Futures Trading Commission (the "CFTC") finalized a rule providing greater certainty<sup>25</sup> for FDIC insured banks regarding to what extent a swap may be executed in connection with Floating Rate Loans, and such swap activity would not constitute the type of dealing activity which could trigger the CFTC's swap dealer registration requirements. Thus, more and more Middle Market Banks began to offer Floating Rate Loans with the option for a borrower to swap out the floating interest rate for a fixed interest rate.

Middle Market Banks offering a "Floating Rate Loan + Hedge" financing now have their

own payment risk associated with a floating interest rate (pursuant to the hedge). To mitigate this risk, a Middle Market Bank may also look to hedge its floating payment due under the swap with the borrower (the “**MMB Hedge**”). The MMB Hedge often comes in the form of the Middle Market Bank entering into a swap with a swap dealer or other price-maker in the market (the “**Dealer**”), the result of which is the Dealer commits to paying the floating rate to the Middle Market Bank, and the Middle Market Bank pays the Dealer an amount no greater than the fixed rate on the swap with the Corporate.<sup>26</sup>

## NEW BASIS RISK BETWEEN LOANS & HEDGES

When LIBOR ceases to be available or a transition to SOFR is otherwise necessary<sup>27</sup> (a “**Benchmark Transition Event**”), this event will impact multiple contracts:

- for the Corporate, both (i) the Floating Rate Loan and (ii) the hedge’s floating payment terms based on LIBOR; and
- for the Middle Market Bank (in addition to the Floating Rate Loan), both of the swaps<sup>28</sup> entered into in connection with providing the borrower a hedge to the Floating Rate Loan.

Unless a party intends to speculate on the movement of interest rates, the (a) Corporate-borrower to a Floating Rate Loan and (b) Middle Market Bank that provides a Floating Rate Loan, both are similarly situated. Both parties have accepted a floating rate payment obligation in one contract, but have entered into a separate but related hedge that converts this floating rate risk to a fixed rate payment obligation.

Because separate contracts are impacted, the Corporates and Middle Market Banks will need to engage in at least two separate amendments/modifications, one to amend the relevant bilateral loan and another that amends the swaps, so that both have Fallback Language. Unfortunately, it is not as simple as just having the same Fallback Language in both agreements. The ARRC Recommendation (and other recommendations produced by ARRC) are not providing the fallback language for swaps. For swaps, ISDA will be publishing the Fallback Language. As a result, loans and the related hedges will have their own independent and distinct Fallback Language, increasing the likelihood for basis risk between a Floating Rate Loan and its hedge.

While the Floating Rate Loans will provide for the payment terms in the loan document itself, including how interest accrues, payment dates and repayment plans, the related hedges will not simply incorporate by reference the loan’s terms or otherwise just “copy the terms of the Floating Rate Loan.” Instead, the terms of a hedge are documented in a confirmation (which may be as short as a few pages). In such confirmation, the payment terms are largely effected therein by incorporating by reference standard definitions published by ISDA (e.g., the 2000 ISDA Definitions or the 2006 ISDA Definitions). As a result, ISDA intends to publish Fallback Language and effect related amendments by amending the 2006 ISDA Definitions (and parties, thereafter, agree to the terms of the amended 2006 ISDA Definitions).

However, this dynamic of distinctly different Fallback Language between related contracts magnifies the potential for basis risk. It is because of this possible basis risk, and the desire to miti-

gate any basis risk, that Corporates and Middle Market Banks should agree to the ARRC Recommendation's Hedged Loan Approach for amending bilateral loans.

## HEDGING THE LIBOR TO SOFR TRANSITION

The Hedged Loan Approach is the only option in the ARRC Recommendations<sup>29</sup> drafted for the purpose of minimizing any basis risk between (x) the Adjusted Reference Rate (and related amendments) pursuant to ISDA's Fallback Language and (y) the Adjusted Reference Rate (and related amendments) pursuant to one of the ARRC Recommendations. As stated in the ARRC Recommendation, the Hedged Loan Approach's Fallback Language "provides for consistency with the approach ISDA will implement for derivatives."<sup>30</sup> Specifically, the operative terms in the Hedged Loan Approach are as follows:

*"Notwithstanding anything to the contrary herein or in any other Loan Document, if a Benchmark Replacement Date has occurred . . . the **Benchmark Replacement** will replace the then current Benchmark for all purposes hereunder or under any Loan Document in respect of such determination on such date and all determinations on all subsequent dates, without any amendment to, or further action or consent of any other party to, this Agreement." (emphasis added)*

As a result of the above, a reference to LIBOR would be replaced by the "Benchmark Replacement," which is defined to be the rate "that would apply for derivatives transactions referencing the ISDA Definitions . . ." Additionally, as noted above, in order to ensure consistency in how the payment amounts are calculated, the Hedged Loan Approach also provides that a "Lender" has the right to make "technical, administrative or

operational changes."<sup>31</sup> At first blush, a Corporate-borrower may be concerned about this sort of ambiguous unilateral right in the power of the Lender. However, a Corporate that has hedged the Floating Rate Loan should remember the following: *The Corporate payment obligations under the Floating Rate Loan are being economically satisfied by the hedge counterparty, and the hedge counterparty is likely the Lender or an affiliate of the Lender. As a result, the practical impact of this unilateral right is to allow the Lender to make changes to the Floating Rate Loan to ensure that when the Lender (or its affiliate) pays under the hedge, that this payment is equal in amounts and timing as the payments due under the Floating Rate Loan.*

In practical terms, the Hedged Loan Approach is designed to allow a lender to ensure there is no basis risk between payments on the Floating Rate Loan and payments on the related hedge. As a Corporate, by electing the Hedged Loan Approach, the Corporate largely puts the burden on the lender to "figure things out." With that said, all Corporates should be vigilant and ensure that the payment obligations match. For example, parties may wish to consider working with counsel to provide language to make clearer the relationship between payment amounts under the Floating Rate Loan and any related hedge, or other terms to ensure any hedge remains an effective hedge following a Benchmark Transition Event. Consistency between the Floating Rate Loan and hedge is not only critical from an operational perspective, but to the extent there is ever a mismatch, it is still the Corporate's obligation to make the payments due under the Floating Rate Loan.<sup>32</sup> Counsel can also explain the impact of any other changes associated with the transition to SOFR, including any changes to the discount



rate used to determine the hedge's mark-to-market (i.e., valuing the swap)<sup>33</sup> and/or regulatory implications.<sup>34</sup>

For a Middle Market Bank, by electing this amendment it mitigates the risk of any mismatch on the swap with a borrower having any basis risk with the MMB Hedge.<sup>35</sup> While a Middle Market Bank still must ensure it has relevant models and payment management systems that work with SOFR, the exercise of amending relevant documents is now significantly easier. "Easier" because the expectation is that necessary amendments to swaps will be effected through an ISDA Protocol process, thereby likely allowing amendments to be executed across an entire book of swaps by only submitting a few protocol related documents to ISDA, a possible payment and a few clicks of a computer mouse. After adhering to the protocol, all swaps of the Middle Market Bank (legacy and future) will be deemed amended to include the Fallback Language for which the Middle Market Bank's counterparty has also adhered. It should also be noted that once ISDA updates the 2006 ISDA Definitions, all new swaps using the 2006 ISDA Definitions will automatically incorporate ISDA's new Fallback Language, even if the parties have not adhered to the relevant ISDA Protocol.

Corporates should also remember: Including the Hedged Loan Approach in a hedged Floating Rate Loan is not the only amendment that will be necessary. As noted above, amendments to their existing hedges will also be required, but similar to Middle Market Banks, they too should only need to adhere to the appropriate ISDA Protocol (and here too, adherence may only require the submission of a few documents, a possible payment and a few clicks of a mouse).

At the time of preparing this article, ISDA has not formalized its Fallback Language nor the ISDA Protocol process for a Benchmark Transition Event.

## WHAT IF THE FLOATING RATE LOAN IS NOT HEDGED?

The Hedged Loan Approach is likely appealing only to a party that hedged a Floating Rate Loan, but the language does not require the relevant loan to have a hedge. Borrowers to an unhedged Floating Rate Loan may wish to reconsider their business' risk tolerances in light of the new uncertainties associated with the transition away from LIBOR (notably, the possibility of not having a term SOFR rate). Such parties can still execute a hedge to the existing Floating Rate Loan, today, while interest rates are still at historical lows. This ensures that a Corporate can have certainty regarding the interest payable each payment period and make appropriate arrangement to pay such amount. However, for those that want/need to continue with a floating rate obligation on the Floating Rate Loan, they will need to consider the Fallback Language in either the Hardwired Approach or the Amendment Approach, both of which provide for more negotiation within the Floating Rate Loan around the determination of the Adjusted Reference Rate. As noted earlier, due to the length of these amendments, they are not included as an Exhibit to this article, but are available online in the ARRC Recommendations.<sup>36</sup>

The names for the two approaches give a strong indication of their differences. In the Hardwired Approach, parties agree to designated successor rates and adjustments at the time the parties execute and agree to the Fallback

Language—i.e., parties hardwire in and agree today regarding how to calculate the Adjusted Reference Rate in the future. Since some uncertainties remain, most notably (i) whether or not a term SOFR will be available and (ii) the amount of the adjustment to the SOFR rate (i.e., the Credit Risk Premium) to create an Adjusted Reference Rate, the Hardwired Approach has parties agreeing to a waterfall approach in selecting the replacement rate.<sup>37</sup> The key tenant for the Hardwired Approach is that it provides greater certainty in the present regarding “next steps” following a Benchmark Transition Event.

The Amendment Approach does not have the parties agreeing to what the successor rate would be (SOFR or otherwise) or the spread adjustment (i.e., the Credit Risk Premium). Instead, the Amendment Approach provides an amendment process for negotiating an Adjusted Reference Rate in the future. This amendment is more than just an *agreement to negotiate in the future*. The language has parties agreeing to specific events that would trigger the need for amendments (including an option for parties to do an “early opt-in” and amend documents prior to any specific triggering event) and the process and parameters for selecting the Adjusted Reference Rate (i.e., the term “Benchmark Replacement” used in the ARRC Recommendation). When a transition from LIBOR is triggered under the Amendment Approach (or an “early opt-in” is elected), the lender selects a successor rate (which may, but need not, be a SOFR term rate) and a spread adjustment. Then, the lender provides notice to the borrower of such terms which are then subject to the borrower disputing the terms or accepting (and acceptance may be given by silence, if the parties agree to a negative consent option).

Another notable difference: the Hardwired Ap-

proach is intended to not only address a LIBOR transition, but also concerns of any future transitions a new rate. In this sense, the Hardwired Approach is described as “future-proofed.” The Amendment Approach is drafted solely to account for the replacement of LIBOR.

### CAN A HEDGED FLOATING RATE LOAN AGREE TO THE AMENDMENT APPROACH?

Yes. Any Floating Rate Loan, hedged or unhedged, could utilize the Amendment Approach (or Hardwired Approach). Upon learning of the Amendment Approach, this option may attract many borrowers because much less is agreed to today, which can seem appealing when there are so many uncertainties about the replacements rate (term vs. compounded average), the spread adjustment (how much and who makes this determination) and other practices that may develop over time (e.g., possibility of a “break-the-glass” feature<sup>38</sup>). Additionally, some borrowers may also consider themselves to be in a position where they may be able to extract some benefits from a negotiation that would not be possible under the Hedged Loan Approach or Hardwired Approach. For example, ARRC noted that “a borrower may be able to extract value from the lenders by refusing to include a compensatory spread adjustment when transitioning to SOFR.”<sup>39</sup>

However, for parties to a hedged Floating Rate Loan, these concerns generally forget that (i) the LIBOR transition will require the borrower to amend both the Floating Rate Loan and any hedge and (ii) the entirety of the borrower’s payment obligations on a fully hedged Floating Rate Loan are satisfied by virtue of the payments under the hedge. Therefore, Corporates (and any

other borrowers) that have hedged the Floating Rate Loan and continue to want a functioning hedge, should not focus on the possibility of “getting something better” or the benefits of a “wait and see” approach. Instead, the focus should be to preemptively avoid there being any differences in payment obligations under the Floating Rate Loan and its hedge.<sup>40</sup>

For Middle Market Banks, if the swap-hedge to a loan no longer fully hedges the relevant loan, they will find dissatisfied borrowers, increased complaints and potential demands to have the swap-hedge modified to better hedge the loan. This could then create a mismatch for the Middle Market Bank between the hedge to the loan and the MMB Hedge (i.e., the back-to-back transaction with a Dealer). A mismatch here could cause balance sheet concerns, as the Middle Market Bank must now manage unhedged payment risks.

The Hedged Loan Approach quickly and simply provides Corporates and Middle Market Banks some assurance that payment obligations today remain consistent before, during and after a Benchmark Transition Event between related obligations. In this sense, the Hedged Loan Approach hedges the LIBOR to SOFR transition.

## UNILATERAL RIGHT ALTERNATIVES & CONCLUSION

Another option that may exist in some Floating Rate Loans is the option which gives the lender a unilateral right to amend the Floating Rate Loan to address a Benchmark Transition Event. There is not necessarily “market language,” but conceptually the substance is the same—i.e., it gives the lender the right to make changes necessary/desired that relate to transitioning the Floating Rate Loan’s LIBOR rate to

an alternative reference rate. This sort of unilateral right is not too different from the unilateral right discussed earlier in the Hedged Loan Approach (which provides the lender with the unilateral right to make “technical, administrative or operational changes”).

Middle Market Banks considering such language should also consider this sort of provision in the context of what will make the transition easier and smoother. Language that is too broad and/or lacking specifics regarding the clear intent behind the provision, may turn out to increase customer complaints during a time that will likely already have highly stressed resources. As a practical reality for Middle Market Banks, some complaints are inevitable regardless of the language used. To mitigate the extent of such complaints and otherwise mitigate any customer dissatisfaction, Middle Market Banks should consider:

- (1) using language that is clear and unambiguous; and
- (2) have plans regarding how the Middle Market Bank will be able to educate counterparties (and their counsel) regarding amendments.

Regarding consideration (1), the clear and unambiguous language should not only convey what rights the lender has, but should strive to indicate to the borrower the “rules for the road” regarding how the appropriate amendments will be determined. For this, considering the language already provided for in the ARRC Recommendations may be helpful. For example, to the extent there is a hedge, language may indicate the efforts (e.g., “may” or “will endeavor”) the Middle Market Bank will go to, to ensure any replace-

ment rates and other payment terms between the Floating Rate Loan and hedge are consistent. To the extent there is no hedge, the Amendment Approach also provides processes and parameters for selecting the Adjusted Reference Rate and therefore could provide helpful language. This sort of language not only ensures that the rights of the Middle Market Bank are clear, unambiguous and, therefore, less susceptible to viable litigation threats, but to the extent the determination of the Adjusted Reference Rate (particularly, the Credit Risk Premium) has language regarding (i) how it is calculated and (ii) why it is included, this too may assuage some of the anxiety and apprehension borrowers will inevitably have upon seeing an entirely new interest rate.

Regarding consideration (2), an obvious benefit regarding the use of the ARRC Recommendation is the availability of ARRC prepared materials. However, the best product will be a tailored product by Middle Market Bank for its customers. These materials will not only be important for customers, but tailored products aimed more towards educating their counsel/advisors are critical, since these professionals will often be the ones ultimately educating, representing and reassuring the Middle Market Bank's customer. Materials for professionals, similar to this article, should have citations where the professionals can learn more on this topic from information not produced by the Middle Market Bank. Once armed with this information, the professional counsel can educate his/her client about why the transition from LIBOR is occurring, and how this risk is addressed in the contractual terms of their Floating Rate Loan. It will be critical for counsel to be able to convey to clients how the agreement's amendments to transition to the new reference rate are amend-

ments intended minimize any value transfer and otherwise keep the contract's original bargained-for exchange and commercial intent (and to also spot any amendments that are not necessary for the transition and/or intended to put more of the value transfer risk on his/her client).

Borrowers to a Floating Rate Loan that give the lender a unilateral right should review any amendments to ensure consistency with any related hedges, and to the extent the new rate is not a term rate, ensure your existing policies and processes related to cash flow management can manage payments in arrears. An important item to remember, not just for the borrower but the lender as well: the determination of the Adjusted Reference Rate should not be considered a time to try and negotiate a "better" rate. Instead, both parties should be focused on having an Adjusted Reference Rate that minimizes any value transfer.

Moving forward, the industry, regulators and global bodies continue to publish materials intended to better prepare market participants for the forthcoming disruption due to the transition from LIBOR to another alternative reference rate. For anyone just beginning to appreciate the size of this task, often there seems to be too much information, making it difficult to find the tailored advice or guidance needed. Even in the ARRC Recommendations, ARRC did not push any single option as a "best option" in any particular instance. That is what individual counsel is for, but as noted earlier in this article, even though this author believes the Hedged Loan Approach presents the best option for a hedged Floating Rate Loan, all involved parties will need to diligently stay abreast of ISDA's developments regarding its implementation of introducing Fallback Language into the 2006 ISDA Defini-

tions, any regulatory consequences associated with this<sup>41</sup> and otherwise review any subsequent amendments to ensure consistency between the future SOFR-Loan and future SOFR-hedge.

### **Exhibit A**

## **Fallback Language for the Hedged Loan Approach**

### **Effect of Benchmark Replacement Date**

(a) *Benchmark Replacement*. Notwithstanding anything to the contrary herein or in any other Loan Document, if a Benchmark Replacement Date has occurred prior to the Reference Time in respect of any determination of the Benchmark on any date, the Benchmark Replacement will replace the then-current Benchmark for all purposes hereunder or under any Loan Document in respect of such determination on such date and all determinations on all subsequent dates, without any amendment to, or further action or consent of any other party to, this Agreement.

(b) *Benchmark Replacement Conforming Changes*. In connection with the implementation of a Benchmark Replacement, the Lender will have the right to make Benchmark Replacement Conforming Changes from time to time and, notwithstanding anything to the contrary herein or in any other Loan Document, any amendments implementing such Benchmark Replacement Conforming Changes will become effective without any further action or consent of the Borrower.

(c) *Notices; Standards for Decisions and Determinations*. The Lender will promptly notify the Borrower of (i) the occurrence of a Benchmark Replacement Date, (ii) the implementation

of any Benchmark Replacement, (iii) the effectiveness of any Benchmark Replacement Conforming Changes and (iv) the commencement or conclusion of any Benchmark Unavailability Period. Any determination or decision that may be made by the Lender pursuant to this Section titled “Effect of Benchmark Replacement Date,” including any determination with respect to a tenor, rate or adjustment or of the occurrence or non-occurrence of an event, circumstance or date and any decision to take or refrain from taking any action or any selection, will be conclusive and binding absent manifest error and may be made in Lender’s sole discretion and without consent from the Borrower.

(d) *Benchmark Unavailability Period*. Upon the Borrower’s receipt of notice of the commencement of a Benchmark Unavailability Period, the Borrower may revoke any request for a Eurodollar Borrowing of, conversion to or continuation of Eurodollar Loans to be made, converted or continued during any Benchmark Unavailability Period and, failing that, the Borrower will be deemed to have converted any such request into a request for a Borrowing of or conversion to ABR Loans. During any Benchmark Unavailability Period, the component of ABR based upon LIBOR will not be used in any determination of ABR.

(e) *Certain Defined Terms*. As used in this Section titled “Effect of Benchmark Replacement Date”:

“*Benchmark*” means, initially, LIBOR; provided that if a Benchmark Replacement Date has occurred with respect to LIBOR or the then-current Benchmark, then “*Benchmark*” means the applicable Benchmark Replacement to the extent that such Benchmark Replacement has

become effective pursuant to clause (a) of this Section titled “Effect of Benchmark Transition Event.”

“**Benchmark Replacement**” means, for any Interest Period, the sum of the successor rate and spread adjustment that would apply for derivatives transactions referencing the ISDA Definitions upon the occurrence of an index cessation date with respect to the Benchmark for the applicable tenor; provided that if the Benchmark Replacement would be less than zero, the Benchmark Replacement will be deemed to be zero for the purposes of this Agreement.

“**Benchmark Replacement Conforming Changes**” means, with respect to any Benchmark Replacement, any technical, administrative or operational changes (including changes to the definition of “ABR,” the definition of “Interest Period,” timing and frequency of determining rates and making payments of interest and other administrative matters) that the Lender decides may be appropriate to reflect the adoption and implementation of such Benchmark Replacement and to permit the administration thereof by the Lender in a manner Lender decides is reasonably necessary in connection with the administration of this Agreement.

“**Benchmark Replacement Date**” means the occurrence of an index cessation date (or other effective date) with respect to the then-current Benchmark upon which the then-current Benchmark for the applicable tenor would be replaced in derivatives transactions referencing the ISDA Definitions.

“**Benchmark Unavailability Period**” means, if a Benchmark Replacement Date has occurred with respect to the then-current Benchmark and

solely to the extent that the then-current Benchmark has not been replaced with a Benchmark Replacement, the period (x) beginning at the time that such Benchmark Replacement Date occurs and (y) ending at the time that a Benchmark Replacement has replaced the then-current Benchmark for all purposes hereunder or under any Loan Document in accordance with the Section titled “Effect of Benchmark Transition Event.”

“**ISDA Definitions**” means the 2006 ISDA Definitions published by the International Swaps and Derivatives Association, Inc. or any successor thereto, as amended or supplemented from time to time, or any successor definitional booklet for interest rate derivatives published from time to time.

“**Reference Time**” with respect to any determination of the Benchmark means (1) if the Benchmark is LIBOR, 11:00 a.m. (London time) on the day that is two London banking days preceding the date of such determination, and (2) if the Benchmark is not LIBOR, the time determined by the issuer or its designee in accordance with the Benchmark Replacement Conforming Changes.

#### ENDNOTES:

<sup>1</sup>Often there is language in a contract addressing what happens when LIBOR is unavailable, but often such language has an underlying assumption that the “unavailability” is due to a technical issue or other temporary incident, and therefore the solution provided in such Fallback Language is only adequate for a short and temporary cessation of LIBOR. *See also, infra*, Endnote 7 and the discussion in this article under *Background: LIBOR’s Decline* for more information regarding possible ways in which LIBOR

may cease to be used by banks.

<sup>2</sup>See, *infra*, Endnote 11 (notes that the “Alternative Reference Rate Committee” has published various proposals for amending a variety of financial contracts which commonly reference LIBOR). See also the discussion in this article under *Background: LIBOR’s Decline* for more information about the Alternative Reference Rate Committee.

<sup>3</sup>Much of the discussion in this article applies across the market, but Corporates and Middle Market Banks are the focus because far fewer of these entities ever desire to manage a floating payment obligation with their balance sheets, and therefore have hedged such risks. Because of such hedging activity, the appropriate Fallback Language is likely to be the language that maintains an effective payment hedge between (x) a Corporate’s payment obligation on a floating rate loan and its related swap providing the hedge or (y) a Middle Market Bank’s payment obligation owed to a borrower pursuant to a swap that was packaged with a loan (the “**Loan Swap**”) and another swap the Middle Market Bank executes to hedge its payment obligations on the Loan Swap.

<sup>4</sup>J. Christopher Giancarlo, Opening Statement of Chairman J. Christopher Giancarlo before the Market Risk Advisory Committee Meeting, Washington, D.C. (2018), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement071218>.

<sup>5</sup>LIBOR is currently produced in five currencies (USD, GBP, CHF, EUR and JPY) and seven tenors (or “term rates”) (Overnight/Spot Next, 1-Week, 1-Month, 2-Months, 3-Months, 6-Months and 12-Months) based on submissions from a reference panel of between 11 and 16 banks depending on currency, resulting in the publication of 35 rates every applicable London business day. Central banks from all five currencies created local working groups to determine a new reference rate and coordinate the transition away from the local currency denominated LIBOR to the new reference rates. For example, in the United Kingdom, the alternative reference rate for GBP is the “Sterling Overnight Index Average or “SONIA.” In the United States, as

discussed in greater detail in this article, the alternative reference rate is the Secured Overnight Financing Rate or “SOFR.” See also, *infra*, Endnote 8 (more information regarding SOFR).

<sup>6</sup>See, Second Report of the Alternative Reference Rates Committee, March 2018, available at <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report>.

<sup>7</sup>For example, local UK and EU regulators could determine that LIBOR no longer satisfies the requirements of the European Benchmark Regulation. The result of this determination would be that banks subject to the relevant laws in Europe could no longer utilize LIBOR for new business. In the United States, bank regulators may also raise concerns around the same time regarding safety and soundness, as it is likely that LIBOR would no longer accurately reflect the interbank lending market.

<sup>8</sup>SOFR represents the cost of borrowing cash overnight that is secured by Treasury securities. Transactions underlying SOFR regularly exceeded \$700 billion in daily volumes, and market participants transacting in the overnight repo market contributing to SOFR includes broker-dealers, money market funds, asset managers, insurance companies, securities lenders, and pension funds. SOFR is considered to represent a nearly risk-free rate of return.

<sup>9</sup> <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).

<sup>10</sup>As further discussed in the subparts to this article under *Background: LIBOR ≠ SOFR*, two of the more notable differences between LIBOR and SOFR are that (i) LIBOR is a forward-looking term rate (e.g., 3-Months or 6-Months LIBOR) while SOFR is a backward-looking rate that currently only provides a party with the interest rate for borrowing the previous night and (ii) LIBOR includes within its rate an embedded premium indicative of unsecured credit risk to a bank that is added to any riskless rate of return, while SOFR represents no such credit risk premium and is nearly a risk-free rate of return. See

also, Endnote 8 (more information regarding SOFR).

<sup>11</sup>ARRC has produced recommendations for a variety of products (e.g., floating rate notes, securitizations, and syndicated loans). For purposes of this article, the ARRC Recommendations refers to the ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans, May 31, 2019, available at [https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Bilateral\\_Business\\_Loans\\_Fallback.pdf](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Bilateral_Business_Loans_Fallback.pdf) (this document provides ARRC's three sets of recommended Fallback Language for new originations of LIBOR-referenced U.S. dollar-denominated bilateral business loans: (i) the Hardwired Approach; (ii) the Amendment Approach; and (iii) the Hedged Loan Approach).

<sup>12</sup>*Id.* (provides web address for downloading the.pdf providing the Hardwired Approach and the Amendment Approach).

<sup>13</sup>For instance, the Basel Committee on Banking Supervision's liquidity rules such as the Liquidity Coverage Ratio and the Net Stable Funding Ratio require banks to be funded by long-term debt (rather than short-term debt) and thus reduced lending activity in the short-term interbank market.

<sup>14</sup>The expert judgment is a market and transaction data-based expert judgment, using the panel bank's own internally approved procedure (based on a set of permitted inputs and agreed with the administrator for LIBOR, the ICE Benchmark Administrator or the "IBA"). For more about the IBA and LIBOR methodologies, see the ICE LIBOR Output Statement, available at [https://www.theice.com/publicdocs/ICE\\_LIBOR\\_Output\\_Statement.pdf](https://www.theice.com/publicdocs/ICE_LIBOR_Output_Statement.pdf).

<sup>15</sup>*Supra* Endnote 10 (discussion of differences between SOFR and LIBOR).

<sup>16</sup>In this article under *Interest Calculation Method & Lack of a SOFR Term Rate*, we discuss issues around the lack of any term rate SOFR (e.g., 3-Months SOFR), and that there may be a term rate at some unknown point in the future. However, if there is no term rate, 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., using the compounded average calculation method). See also, *infra*, Endnote 37 (and related text for discussion of the "waterfall" regarding the adjustments to determine the Adjusted Reference Rate).

<sup>17</sup>As described by ARRC, "*Simple interest* is a long-standing convention, and in some respects is easier from an operational perspective. Under this convention, the additional amount of interest owed each day is calculated by applying the daily rate of interest to the principal borrowed, and the payment due at the end of the period is the sum of those amounts." A Users Guide to SOFR, April 2019, p. 5 available at [https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Users\\_Guide\\_to\\_SOFR.pdf](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Users_Guide_to_SOFR.pdf) ("**SOFR Guide**").

<sup>18</sup>As described by ARRC, "*Compound interest* recognizes that the borrower does not pay back interest owed on a daily basis and it therefore keeps track of the accumulated interest owed but not yet paid. The additional amount of interest owed each day is calculated by applying the daily rate of interest both to the principal borrowed and the accumulated unpaid interest . . . . From an economic perspective, compounded interest is the more correct convention . . . . On the other hand, simple interest is easier to calculate and many systems are designed around its use . . ." SOFR Guide, p. 5.

<sup>19</sup>Regarding the election between simple vs. compounded averaging, ARRC noted that "[L]enders will face a technical choice between using a simple or a compounded average of SOFR as they seek to use SOFR in cash products. In the short-term, using simple interest conventions may be easier since many systems are already set up to accommodate it. However, compounded interest would more accurately reflect the time value of money, which becomes a more important consideration as interest rates rise, and it can allow for more accurate hedging and better market functioning." SOFR Guide p. 1. ARRC also noted that "[t]he choice of a particular averaging convention need not affect the overall rate paid by the borrower, because the differences between them are generally small and other terms can be adjusted to equate the overall cost, but



nonetheless issuers and lenders will face a technical choice between using a simple or a compounded average as they seek to use SOFR in cash products.” *Id.*, p. 5.

<sup>20</sup>ARRC has discussed the possibility of structuring payments using an “in advance” structure, which would reference an average of the overnight rates observed before the current interest calculation period began, but the movement has been towards using an average of SOFR in arrears since this structure will reflect what actually happens to interest rates over the interest calculation period. As a result, the market appears to prefer the “in arrears” structure, but practices may continue to develop and change (particularly based on the length of an interest calculation period, since longer periods tend to show the greatest differences between the two structures). For more on the differences, *see* SOFR Guide, pp. 7-15.

<sup>21</sup>*See*, ARRC’s “Paced Transition Plan” *available at*: <https://www.newyorkfed.org/arrc/sofr-transition#pacedtransition>.

<sup>22</sup>*See, infra*, Endnote 37 (and related text for a discussion of the waterfall).

<sup>23</sup>There is a possibility for the market to develop a Credit Risk Premium calculation that does, initially, provide some re-calculation or dynamic function, but such function would only be in the short-term as the Adjusted Rate is implemented into the document during this transitional period (and assuming LIBOR is still being published). Members of ARRC and other market participants considered whether a more fulsome dynamic Credit Risk Premium could be created, but ultimately it was determined to not be a workable solution. ISDA has conducted consultations with market participants to determine a preferred “Spread Adjustment Methodology,” and responses have strongly favored the “historical mean/median approach” for the spread adjustment. This methodology would include a one-year transitional period after the fallback takes effect. *See*, ISDA Benchmark Fallback Consultations, *available at* <https://www.isda.org/2019/07/24/benchmark-fallback-consultations/>.

<sup>24</sup>*See, Id.* (discussion of the “Spread Adjust-

ment Methodology” and the ISDA Benchmark Fallback Consultations).

<sup>25</sup>*See*, De Minimis Exception to the Swap Dealer Definition-Swaps Entered Into by Insured Depository Institutions in Connection With Loans to Customers, 84 FR 12450 (April 1, 2019).

<sup>26</sup>For example, the Middle Market Bank may effectively pass-through the fixed rate received from the counterparty to the Dealer (the Middle Market Bank having already profited from closing/transaction fees), or pass-through a fixed-rate slight less than the rate paid by the counterparty (here, the Middle Market Bank also makes a spread), or the Middle Market Bank may enter into another type of hedge, such as a risk participation agreement, and the Middle Market Bank offsets any related costs with the cash flows from the counterparty’s payment of the fixed rate.

<sup>27</sup>The ARRC Recommendation’s Fallback Language uses the defined term “Benchmark Transition Event” to describe “[t]he triggers specified in the bilateral business loan fallback language that precipitate the transition away from LIBOR.” There are three triggers, which together generally cover any public statement or information from a regulator, administrator of the relevant benchmark (e.g., LIBOR) or other identified official in the definition which results in the benchmark no longer being published or that the benchmark is no longer representative of the market it is intended to reflect. With respect to the latter, the impact of such determination would trigger relevant laws in Europe resulting in many institutions no longer being permitted to reference such benchmark various financial products. *See*, ARRC Recommendation pp.15-17 (discussing the definition of “Benchmark Transition Event”).

<sup>28</sup>*See, supra*, Endnote 26 (discussion of the MMB Hedge).

<sup>29</sup>The other two options, (i) the Hardwired Approach and (ii) the Amendment Approach, are discussed in more detail later in this article under *What if the Floating Rate Loan is Not Hedged?*.

<sup>30</sup>ARRC Recommendation, p.15.

<sup>31</sup>Pages 31 and 32 of the ARRC Recommen-

dation provide a discussion of the intention behind allowing “Benchmark Replacement Conforming Changes,” noting that the purpose is to provide the lender “the ability to execute certain conforming changes to the bilateral business loan in order to appropriately implement and administer the successor rate. An example of such a change may be moving from months to day count (1 month vs. 30 days) or perhaps an adjustment to the length of interest accrual periods or frequency of determining rates.” As previously discussed, due to significant differences between SOFR and LIBOR, fundamental edits to how interest is compounded or otherwise calculated with respect to a debt are likely necessary (in addition to just replacing LIBOR with an Adjusted Reference Rate). *Supra* Endnote 10 (discussion of differences between SOFR and LIBOR).

<sup>32</sup>When transitioning to SOFR, this article discusses under *Interest Calculation Method & Lack of a SOFR Term Rate* that payment terms will have to consider simple vs. compounding average (in the absence of using a term rate). These payment terms include the choice of day count convention (which determines how annualized rates are quoted), but there will also be other areas for possible mismatches (e.g., how the rate to be applied over weekends and holidays are set—i.e., whether to use the rate on transactions taking place before the weekend or holiday, which mirrors how repo markets operate, or the rate after).

<sup>33</sup>Part of the transition to SOFR also includes moving the market towards using SOFR as the discount rate to value future anticipated cash flows for a swap. Currently, the market generally uses the Effective Federal Funds Rate or EFFR. To the extent this impacts the mark-to-market on a swap, it will impact the termination payment due on the swap owed by any Corporate that pre-pays a Floating Rate Loan while out-of-the-money on the hedge’s position (or, alternatively, the amount a Corporate would receive if the Corporate’s position is in-the-money). For Middle Market Banks, the same is true, but with the added complexity of wanting to ensure that any related hedge, such as the MMB Hedge, is using the same discount rate to ensure that any

termination payments owed by the Middle Market Bank on one swap are at least equal to the termination payment received on the related swap. *Supra*, Endnote 26 (discussion of the MMB Hedge—i.e., how Middle Market Banks may execute two swap transactions, concurrently, whenever providing a hedge to a borrower).

<sup>34</sup>For example, see ARRC’s “Title VII Letter” to multiple U.S. Regulators, including the CFTC, available at <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-July-16-2018-titleviiletter>.

<sup>35</sup>*Supra*, Endnote 26 (discussion of the MMB Hedge—i.e., how Middle Market Banks may execute two swap transactions, concurrently, whenever providing a hedge to a borrower).

<sup>36</sup>*Supra*, Endnote 11 (provides web address for downloading the.pdf providing the Hardwired Approach and the Amendment Approach).

<sup>37</sup>The Benchmark Replacement Waterfall provides Step 1a: Term SOFR + Adjustment; Step 1b: Next Available Term SOFR + Adjustment; Step 2: Compounded SOFR + Adjustment; and Step 3: Lender Selected Rate + Adjustment. Regarding the Adjustment, there is also a spread adjustment waterfall which provides Step 1: ARRC Selected Adjustment; Step 2: ISDA Fall-back Adjustment; and Step 3: Lender Selected Adjustment.

<sup>38</sup>The ARRC Recommendation noted that a “break-the-glass” feature is a possible future feature parties may agree to that “is triggered during times of credit market stress pursuant to which the all-in interest rate is increased to reflect lenders’ increased cost of funds during such times. Key aspects of how a feature like this would work have not been fleshed out . . .” ARRC Recommendation, p. 30.

<sup>39</sup>ARRC Recommendation, p. 37.

<sup>40</sup>For example, a borrower could pay the Fixed Payment Amount on the hedge, but if interest rates increase over the life of the Floating Rate Loan and the floating rate payments on the hedge are not sufficient to cover the loan’s interest payments, then a borrower will have to make two payments: (1) one to continue paying the fixed

amount due under the hedge, and (2) then additional payments reflecting the increasing interest rate on the Floating Rate Loan exceeds the floating rate on the swap. In this situation, the hedge is now largely ineffective because the Corporate no longer has certainty regarding total

amounts owed on future payments.

<sup>41</sup>*See, supra*, Endnote 34 (provides a web address to ARRC's Title VII Letter in which ARRC raised regulatory concerns to multiple U.S. Regulators).

