

Interest Rates Watch: LIBOR Transition – Updated Fallback Language for USD LIBOR Syndicated and Bilateral Loans

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Welcome back to our Interest Rates Watch series, developed to provide timely updates and practical advice on developments related to interest rates and benchmarks on a regular basis. As always, we are here to help.

In connection with the recent announcements of ICE Benchmark Administration and the UK Financial Conduct Authority regarding the future cessation or loss of representativeness of LIBOR (see our commentary on these announcements here), the Alternative Reference Rates Committee (ARRC) has released updated recommended fallback language (2021 Hardwired Fallback Language) for credit documentation that utilizes USD LIBOR.¹

The 2021 Hardwired Fallback Language builds on the previous recommended fallback language (which was released in June 2020 for syndicated loans and August 2020 for bilateral loans (2020 Hardwired Fallback Language)) and addresses both (1) the replacement of USD LIBOR specifically and (2) the potential replacement of any future benchmarks generally.

Specific Provisions Addressing Replacement of USD LIBOR

The 2021 Hardwired Fallback Language now contains a stand-alone operative provision that specifically addresses the replacement of USD LIBOR (previously, this was included in a larger scheme addressing replacement of benchmarks generally) and reflects the fact that a Benchmark Transition Event has occurred and, as a result, the ARRC's recommended spread adjustments for the recommended replacement rate (which is to be based on the Secured Overnight Financing Rate (SOFR)) have been set. Accordingly, the replacement language relating to USD LIBOR has been simplified to (1) provide specifics around the date on which USD LIBOR will be replaced by the applicable benchmark replacement, (2) remove references to trigger events that have already occurred and (3) incorporate the now-set spread adjustments into the recommended benchmark replacement.

The updated language also details a two-step waterfall process for determining the benchmark replacement rate to be used:

- The first step of the waterfall process provides for a replacement rate of (a) term SOFR (as recommended by the relevant governmental body) plus (b) the applicable fixed spread adjustment. Although the ARRC intends to recommend a forward-looking term SOFR, the current level of liquidity in SOFR derivative markets is not sufficient to allow the ARRC to recommend a term SOFR rate with confidence at this time.
- If a recommended term SOFR rate is not available, the second step of the waterfall process provides for a replacement rate of (a) the daily simple SOFR plus (b) the applicable spread adjustment recommended by the relevant governmental body. To the extent the rate in this second step is applied, the recommended language also addresses the fact that an interest payment frequency would need to be selected (as, unlike the forward-looking term SOFR which features a tenor, the daily simple SOFR is a daily rate). In addition, where the rate in this second step is applied, the ARRC recommends (and the recommended fallback language provides for) a lookback period for determining the applicable daily SOFR rates. Such lookback period will shift the period of time over which interest rates are observed backwards by a set number of days, to allow for interest payments to be made on the last day of the applicable interest period.

Potential Replacement of Future Benchmarks

In addition to the specific provisions relating to replacement of USD LIBOR, the 2021 Hardwired Fallback Language continues to include fallback language to address the highly unlikely event that, during the term of the agreement, the successor for USD LIBOR ceases or becomes non-representative. In that case, parties would rely on the additional fallback language to choose a successor rate through a streamlined amendment process, the details of which are set out in the ARRC's recommended language.

Implications and Recommendations

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Going forward, for amendments to existing paper or for new originations, parties should either (a) include robust hardwired fallback language or (b) use a new reference rate (such as a SOFR-based rate) plus a spread adjustment to account for the differences between SOFR and USD LIBOR.

The 2021 Hardwired Fallback Language does not supersede the 2020 Hardwired Fallback Language. That being said, although the 2020 Hardwired Fallback Language is still effective and can continue to be used in credit documentation, it is recommended that the 2021 Hardwired Fallback Language be incorporated into loan agreements with USD LIBOR as a reference rate going forward as the updated language has been streamlined and provides clarity on the fallback adjustments to be applied.

For agreements that have not incorporated either the 2021 Hardwired Fallback Language or the 2020 Hardwired Fallback Language, prior to the date that USD LIBOR will cease or no longer be representative (January 1, 2022 or July 1, 2023, as applicable – see our commentary here for more information), such agreements should be amended to either (a) reflect the 2021 Hardwired Fallback Language or (b) replace USD LIBOR with a benchmark replacement. Failure to so amend will result in the automatic conversion of outstanding USD LIBOR loans into loans bearing a daily rate of interest (typically the USD base rate), assuming the agreement provides for such conversion. To the extent there is no existing fallback/conversion language, it is unclear how existing USD LIBOR loans would be treated. However, prior to the ARRC's release of recommended USD LIBOR fallback language, the market practice for fallback language in many credit agreements was intended to only address temporary market or technological disruptions in the publication of LIBOR.

We will be issuing further articles relating to interest rates. Find other articles in our Interest Rates Watch Series here.

¹ <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/arrc-supplemental-hardwired-recommendation>.

This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.