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LIBOR Transition: Business Loans SOFR Summer Wrap Up - McGuireWoods

It's been a busy summer in the land of LIBOR transition preparation. As part of the ARRC's ongoing efforts to prepare the cash product markets for the transition to SOFR and away from LIBOR as a benchmark interest rate, it posted ten separate releases between Memorial Day and August 7, 2020, in addition to hosting six "SOFR Summer Series" panel discussions on various SOFR topics (which were recorded and can be accessed [here](#)). This blogpost focuses on aspects of the ARRC's releases relating to business loans.

Read on for more details, but here are a few major takeaways: (1) don't expect any COVID related delays in the LIBOR sunset schedule - work on implementing hardwired LIBOR fallback language this fall and plan stop using LIBOR by mid-2021; (2) the ARRC now recommends simple SOFR in arrears as the best available fallback rate alternative for most business loans (at least until a term SOFR in advance market develops); and (3) feedback from the business loan market reflects a preference for following ISDA's lead on LIBOR to SOFR transition issues whenever practicable to facilitate consistency between swaps and business loans (e.g., spread adjustments and certain conventions).

ARRC Best Practices for Completing Transition from LIBOR

On May 27, 2020, the ARRC released its "[Best Practices for Completing Transition From LIBOR](#)," which set the table for its later releases over the summer. The key recommendations for business loans:

- To the extent not already utilized, all new business loans should include ARRC-recommended (or substantially similar) **hardwired** USD LIBOR fallback language (rather than relying on the "amendment approach" which has been more widely accepted to date) as soon as possible, but in no event later than September 30, 2020.
- Third-party technology and operations vendors relevant to business loans (including those with booking, trading, valuation, settlement, and accounting systems used for loans) should complete all necessary enhancements to support SOFR (including but not limited to simple, compounding in arrears, and term SOFR) by September 30, 2020.
- No business loans using USD LIBOR and maturing after 2021 should be originated after June 30, 2021.
- For business loans specifying that one or more parties will select a replacement rate for USD LIBOR at their discretion, the determining parties should disclose to relevant parties the replacement rate and any related spread adjustment methodology that they anticipate selecting to relevant parties at least 6 months prior to the date that a replacement rate would become effective.

The release also set forth recommendations for Floating Rate Notes, Consumer Loans, Securitizations and Derivatives. Click through above and check in with this blog for further detail on the ARRC's best practices recommendations for those products.

SOFR Spread Adjustments Revisited

In a June 30 release, the ARRC elaborated on its prior recommendation for a spread adjustment methodology in cash products, based on market participant feedback from its supplemental consultation on spread adjustment methodology. Recall that the ARRC had initially recommended a spread adjustment methodology based on a historical median over a five-year lookback period calculating the difference between USD LIBOR and SOFR, which matches the methodology recommended by the International Swaps and Derivatives Association (ISDA) for derivatives, with a 1-year transition period to this methodology for consumer products.

<<https://www.liborblog.com/2020/04/arrc-announce-recommendation-of-a-spread-adjustment-methodology-for-cash-products/>>.

After soliciting and receiving additional market feedback on the interaction of this methodology with ISDA's methodology and timing, the ARRC clarified in a [June 30 release](#) that:

- for cash products (other than consumer products), the ARRC would recommend that the value of USD LIBOR spread adjustment match the value of ISDA's spread adjustment spread adjustments (rather than merely using the same adjustment methodology to calculate a different spread adjustment for each potential fallback rate), while reserving on treatment for consumer products; and
- for all cash products, in the event of a pre-cessation trigger, the ARRC's recommended 5-year historical median spread adjustments will be determined at the same time as the ISDA's spread adjustments (which will be at the time of any announcement that LIBOR will or has ceased or will or has become no longer representative).

In short, the ARRC continues to respond to feedback from market participants that cash products should be closely aligned with the swaps and derivatives market in the transition from LIBOR to SOFR.

Updated Hardwired Fallback Language: This Time We Mean It

The ARRC also released updated recommended "Hardwired" fallback language for syndicated loans on June 30. Recall that in April 2019, the ARRC released both "Amendment" fallback language (adopting a streamlined but flexible amendment process to incorporate a to-be-determined substitute benchmark rate for LIBOR) and "Hardwired" fallback language (contemplating Compounded SOFR in Advance as the default substitute benchmark rate) for syndicated loans. The syndicated loan market responded by almost uniform adoption of some version (in some cases modified) of the "Amendment" language, with little uptake of the "Hardwired" approach.

In an effort to help foster adoption of a "Hardwired" approach beginning in Q4 2020 as recommended in its May 2020 "Best Practices" release, the June 30 ARRC release modifies its recommended "Hardwired" amendment language to account for market feedback and easier market adoption. "To the extent market participants continue to enter into LIBOR-based contracts, the ARRC recommends and endorses the fallback language and related guidance herein and believes the cash markets will benefit by adopting a more consistent, transparent and resilient approach to contractual fallback arrangements for new LIBOR products." It is a lengthy release containing both updated form contract language and an explanatory guide. A few highlights:

- *Available Tenors*: Refines the references to and transition between LIBOR tenors (forward looking periods (e.g., 30/60/90 days) of locked rates) and potential SOFR tenors (periods of interest accrual and interest payment periods).
- *Benchmark Replacement Triggers*: Clarifies that the "No Longer Representative" prong of the

benchmark replacement trigger will only be triggered when “all Available Tenors” of LIBOR are deemed unrepresentative of market conditions. This will prevent an unintended early benchmark transition trigger if only certain LIBOR tenors become unreliable (e.g., as we approach the formal LIBOR cessation date, longer LIBOR tenors may become unrepresentative while shorter LIBOR tenors remain viable), allowing administrative agents to “turn off” those LIBOR tenors that are deemed no longer representative.

- *Benchmark Replacement Waterfall*: Changes the “waterfall” of benchmark replacement rates (originally drafted as (1) forward looking term SOFR (plus a spread adjustment) (which does not currently exist and may not exist), then (2) compounded SOFR (either in advance or in arrears) (plus a spread adjustment), then (3) as selected by the Administrative Agent and Borrower (plus a spread adjustment)) **by replacing** compounded SOFR in arrears (step 2) with daily simple SOFR. The ARRC rationale for the change: the use of compounded SOFR in advance does not match the needs of business loans to accommodate frequent unscheduled balance changes (e.g., prepayments), and although compounded SOFR in arrears better matches the ISDA calculation convention, daily simple SOFR can be more easily implemented on bank systems now and historically only varies from compounded SOFR in arrears values by a few basis points. The ARRC release contains detailed explanations on when market participants might prefer to use daily compounded SOFR in arrears or compounded SOFR in advance, so it should be reviewed for further detail on the differences in these calculations.
- *Spread Adjustments*: Implements the revised ARRC approach to spread adjustments released on June 30 and summarized above, and defaults to available ISDA spread adjustments if ARRC approved spread adjustments are not available.

The revised language contains other modifications and should be reviewed in detail with the guidance that follows it in the June 30 release.

Down to Details: SOFR “In Arrears” Conventions for Syndicated Business Loans

In the June 30 ARRC release updating the “Hardwired” fallback language, the definition of “Daily Simple SOFR” provides that the administrative agent shall establish conventions for that rate in accordance with ARRC recommended conventions. On July 22, the ARRC released its initial guidance on conventions for “in arrears” structures ([Daily Simple SOFR and Daily Compounded SOFR](#)). To remind, these rate structures allow for interest accruals to be calculated daily, but they are not set in advance and not fixed during each interest period (both of which are true for forward-looking term LIBOR rates). The recommended ARRC conventions for “In Arrears” rate structures described in the July 22 release address both new loans that are originated using SOFR and legacy loans that “fall back” from LIBOR to SOFR upon LIBOR cessation or LIBOR being declared to be unrepresentative. The ARRC emphasized in its release that these convention recommendations are voluntary and may not be applicable to all segments of the business loan markets. Some highlights:

- *Compounding*: The release compares simple interest and compound interest, and describes different calculation approaches for compounding in arrears.
- *Lookback / Lockout / Payment Delay*: The release recommends using the business day “lookback” approach with no observation shift for SOFR loans. A five day “lookback” convention (different days can be selected by market participants) for a June 1 loan with a 30 day interest period, for example, would apply the May 25 SOFR rate to the June 1 balance, and so on throughout the interest period, so that by June 23, the administrative agent will know the daily rates through the end of the 30 day interest period. This would enable the administrative agent to determine the rate of interest for the interest period before the period ends and the payment is due, so that the administrative agent has time to invoice the borrower and the borrower has time to pay the interest on time. The ARRC rejected an observation shift for compounded SOFR in arrears (which

would weight the rate by the daycount weight of the “lookback” day in the compounding formula) for creating unnecessary complexity relative to the benefit gained in reduced hedging basis relative to a standard SOFR OIS contract.

- *Holiday and Weekend Conventions*: For Compound Interest, interest would be compounded on business days, and the preceding business day’s rate would be applied over weekends or holidays, weighted by the number of calendar days until the next business day. For Simple Interest, the preceding business day’s rate would be applied over weekends or holidays, weighted by the number of calendar days until the next business day. For payment dates, the release recommends a convention similar to that applicable to LIBOR today: if a SOFR loan is repaid to a UK lending office on a US Business Day that is not a UK Business Day, it would remain in the swift/clearing account of the UK lending office until the following UK Business Day when the lending office processes the payment. A borrowing notice for a USD borrowing sent to a UK Bank on any day other than a UK Business Day would be processed on the next succeeding UK Business Day.
- *Daycount*: actual / 360 (standard for US money markets).
- *Modified Following Business Day Convention*: payments dates that fall on a non-Business Day would be adjusted to the next succeeding business day, unless that business day falls in the next succeeding calendar month, in which case the interest payment date would be the preceding business day.
- *Rounding*: interest-rate calculations rounded (not truncated) to 5 decimal points; dollar amounts rounded to 2 decimal points (for example in an invoice or ledger reports), but recommends that calculations not be rounded internally.
- *Floors*: interest rate floors would be calculated daily and not at the end of an interest period because loans accrue interest daily and loan funds strike a daily net asset value based on this daily accrued interest.
Distribution of Interest: Daily accrued interest calculated on each lender’s share of principal that day, which is same convention currently used for LIBOR loans.
- *SOFR Index*: The release points out that the ARRC published SOFR Index is less useful for business loans than other cash products, such as floating rate notes, due to (1) use of an observation shift (as noted above, not recommended for business loans), (2) the possibility of frequent intra-period prepayments for business loans and (3) the possibility for interest rate floors in business loans, which are not compatible with the SOFR Index.
- *Compensation for Losses*: The release recognizes that typical “breakage” language found in LIBOR based loan agreements may not be applicable to Daily Simple SOFR or Daily Compounded SOFR, but that market participants may wish to include language that compensates lenders for funding losses due to intra-period prepayments.

Wrapping up the SOFR Summer with the SOFR Starter Kit

The ARRC wrapped up its busy “SOFR Summer” with the release of its “[SOFR Starter Kit](#)” on August 7. This release links to three factsheets covering (1) the History and Background of USD LIBOR, the ARRC and SOFR, (2) Key Facts about SOFR and (3) SOFR Next Steps. These convenient fact sheets consolidate current best practices and timelines for transitioning from LIBOR to SOFR, and link through to more detailed materials previously published by the ARRC and maintained on its website.

By Donald A. Ensing, Susan Rodriguez, Jennifer J. Kafcas & Barlow T. Mann on August 21, 2020

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