DerivativePATH

Update on LIBOR Transition
ISDA Protocol: Customer Swap Programs

Banks with a customer swap program have to be thoughtful around LIBOR transition for customer swaps as it is unlikely that the end-user bank customer will adhere to the ISDA Protocol due to its complex nature (albeit some Banks may be directing their end users to try to do so, and we continue to recommend our Banks do adhere – see link). Additionally, a review and potentially an amendment to the promissory note related to a customer swap maturing after June 2023 is recommended in order to support a proper transition away from LIBOR. Therefore, banks with customer swap programs will want to consider a few steps to incorporate LIBOR fallback language into their loans and swaps properly. Banks should consider the following guidelines when preparing their end-user bank customer transactions for LIBOR transition.

Loan and Swap Fallback Consistency

Each hedged bank customer loan and swap transaction contains three components where LIBOR fallback terms will impact the economics of the financing upon a LIBOR cessation event: promissory note, customer-facing swap transaction, and swap dealer facing swap transaction. Each of these instruments should contain LIBOR fallback provisions that are consistent with each other so that all three instruments transition simultaneously and in the same manner upon a LIBOR cessation event. As a bank assesses the guidance contained herein, it will encourage harmony between the loan, customer-facing swap transaction, and the swap dealer facing swap transaction upon a LIBOR cessation event.

If possible, banks should consider ensuring notes and other LIBOR definitions in loan documents substantially contain the following LIBOR fallback terms:

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> *Notwithstanding anything herein to the contrary, in the event that Lender determines that (i) LIBOR is permanently or indefinitely unavailable or unascertainable, or ceases to be published by the LIBOR administrator or its successor, (ii) LIBOR is determined to be no longer representative by the regulatory supervisor of the administrator of LIBOR, (iii) LIBOR can no longer be lawfully relied upon in contracts of this nature by one or both of the parties, or (iv) LIBOR does not accurately and fairly reflect the cost of making or maintaining the type of loans or advances under this Agreement and in any such case, such circumstances are unlikely to be temporary, then, at the election of the Lender, all references to the Interest Rate herein will instead be to a replacement rate determined by Lender in its sole judgment, including any adjustment to the replacement rate to reflect a different credit spread, term or other mathematical adjustment deemed necessary by Lender in its sole judgment. Lender will provide reasonable notice to Borrower of such replacement rate and the date it will become effective.*

If a bank has been using Derivative Path's recommended fallback language in new transactions consistent with the language above, the note will likely not require an amendment.

However, if a bank has been using different fallback language in its loan documents, the bank will want to ensure that fallback language allows the bank to do the following upon a LIBOR cessation event:

- Transition to the SOFR benchmark or grant to the lender broad discretion to select the new benchmark
- Ability for the lender to incorporate a spread adjustment
- Incorporate LIBOR cessation triggers for both permanent and pre-cessation triggers

Banks will also want to consider incorporating a provision that allows for these changes upon notice to the borrower, allowing the bank to act swiftly upon a LIBOR cessation event. That said, banks should consult with legal counsel to discuss the possible litigation risk associated with triggering the new fallback based on a customer notice versus a customer consent upon a LIBOR cessation event.

ARRC's Recommended LIBOR Fallback Language for Loans

Banks may be considering using one of the Alternative Reference Rates Committee's (ARRC's) recommended LIBOR Fallback Language provisions for their amendments to swapped (or other) loans. If a bank is considering using an ARRC recommended approach, the bank should work with advisors or counsel to understand the selected fallback language's compatibility with a swap hedge following the ISDA Protocol. In many cases, ARRC's recommended fallback approaches are not compatible with swap transactions due to a mismatch in the fallback waterfall between the two instruments. If a bank decides to use ARRC's recommended fallback language in a hedged loan, the bank should consider the "Hedged Loan Approach" as it most closely aligns to ISDA's LIBOR fallback mechanics. Unfortunately, the ARRC's "Hedged Loan Approach" does not directly align with ISDA's fallback because, as drafted, it incorporates a floor in the interest rate. Therefore, there is still potential for a mismatch between the loan and the swap if the bank uses the ARRC recommended language for hedged loans. If possible, we recommend using the LIBOR fallback language described above to have the best chance at mitigating the risk of a mismatch between the loan and the swap.

Bank Customer Swap Transaction Amendment

Assuming customers will not be adhering to the ISDA Protocol, bank customer swap transactions will likely need to be amended via a bilateral amendment to incorporate proper LIBOR fallback terms into existing LIBOR-based swap transactions. Therefore, we recommend presenting a simplified amendment to a bank customer to amend their LIBOR-based swap transactions to incorporate the terms of the ISDA 2020 IBOR Fallbacks Protocol by reference as if the bank customer had adhered to the Protocol directly. Banks can achieve this amendment by incorporating a provision similar to the following provision into either an amendment to the ISDA Schedule or an amended trade confirmation to present to the bank customer to execute:

> *"ISDA 2020 IBOR Fallbacks Protocol. The provisions and definitions of the ISDA 2020 IBOR Fallbacks Protocol (the "Protocol") are hereby incorporated by reference and the parties agree to be bound by the terms of the Protocol, as if each were an Adhering Party (as defined in the Protocol). For avoidance of doubt, this Agreement shall be a Protocol Covered Document (as defined in the Protocol)."*

Amending swap transaction terms with bank customers using the above-described language will ensure consistency between the bank customer swap transaction and the swap dealer swap transaction. Derivative Path can assist you in preparing the bank customer amendment. Please contact your DPI Sales representative to discuss how we can help.

Customer Outreach Communication

In our October 15 LIBOR Transition Update, we included a sample of the initial customer communication that you should consider sending. In that communication, the bank informs the customer that they have one or more LIBOR-based financial instruments under review for a possible amendment to incorporate proper LIBOR fallback terms. Once a bank is ready to amend the LIBOR-based swap (and loan as necessary), they should send the amendment documentation to the borrower for execution and consider the following accompanying communication:

> *Dear Customer,*
>
> *As you may be aware, banks and other financial institutions are preparing for the discontinuance of the London Interbank Offered Rate ("LIBOR") . Banks are in the process of preparing for the discontinuance of USD LIBOR in June 2023 and to transition to the use of the replacement benchmark, the Secured Overnight Financing Rate ("SOFR").*
>
> *Our preparations have concluded that you have a LIBOR-based swap transaction that requires an amendment to incorporate proper LIBOR fallback terms when LIBOR ceases to exist. By executing the amendment[s] included in this correspondence, you agree to incorporate the ISDA IBOR Fallback Protocol's terms into your existing swap transaction[s]. Here is a high-level Q&A to help you understand the terms of the ISDA Protocol:*
>
> *What do the Protocol terms do to amend my LIBOR-based swap transaction?*
>
> *For existing swap transactions referencing USD LIBOR, the terms of the Protocol incorporated via the attached amendment enable parties to amend the transaction terms to incorporate proper LIBOR cessation fallback terms into the swap transaction.*
>
> *What are the fallback terms?*
>
> *Upon a USD LIBOR cessation event, your LIBOR rate referenced in the swap transaction will convert to the SOFR rate plus a spread adjustment ("All-In Fallback Rate"). The spread adjustment is calculated based on a five-year historical median of the differences between USD LIBOR and SOFR to account for the difference between USD LIBOR and SOFR. The All-In Fallback Rate will be determined by the mechanics published in the Protocol. Additionally, Bloomberg will calculate and publish the All-In Fallback Rate. The bank does not independently determine the All-In Fallback Rate for the swap if you agree to this amendment. The new All-In Fallback Rate will not be effective until a LIBOR cessation event occurs.*
>
> *What are the LIBOR cessation events that would trigger a switch to the All-In Fallback Rate?*
>
> *Permanent and pre-cessation events will trigger conversion to the All-In Fallback Rate. A 'permanent cessation'*

event occurs when LIBOR will permanently cease to be published following a public statement or published announcement of such discontinuance. A 'pre-cessation' event is a public statement or publication of information by a regulatory supervisor for the administrator of LIBOR (currently, the U.K. Financial Conduct Authority) announcing that the regulatory supervisor has determined that USD LIBOR is no longer, or as of a specified future date, will no longer be representative of the underlying market and economic reality that USD LIBOR intends to measure and that representativeness will not be restored.

You can find the full ISDA IBOR Fallbacks Protocol here (http://assets.isda.org/media/3062e7b4/08268161.pdf/). Additional LIBOR Transition Resources can be found here. (https://www.derivativepath.com/resources/libor-transition-resources/).

If you have any questions regarding the included amendment, please contact your relationship manager or email [BANK CONTACT]. Please execute and return the amendment to [BANK] by [RETURN DATE].

Sincerely,

[BANK]

Questions?

Please contact our LIBOR Transition Team at 415-992-8200 or LIBORTransition@derivativepath.com.

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