



ARRC Pushes for Banks to Adopt Hardwired Approach to SOFR for LIBOR Cessation by October

Sep 11, 2020

Categories:

[Coronavirus Response Team](#)

Authors:

[Austin S. Conner](#)
[Rebecca M. Moore](#)

On August 27, 2020, the Alternative Reference Rates Committee (ARRC) published its [updated recommended fallback language](#) for new originations of U.S. London Inter-bank Offered Rate (LIBOR) denominated bilateral business loans. The update will make the recommended fallback language for bilateral business loans more consistent with the ARRC's recommended fallback language for new originations of syndicated loans. In line with the ARRC's [recommended best practices](#) published in May 2020, and updated August 27, the updated fallback language is only to the "hardwired approach" and the "hedged loan approach." It excludes the "amendment approach", which gives lenders and borrowers more flexibility regarding what rate is chosen and the spread. The ARRC recommends that lenders and borrowers implement the Secured Overnight Financing Rate (SOFR) fallback language for clarity and certainty rather than take an "amendment approach" where the market participants would have to agree upon a new reference rate upon LIBOR cessation. In its latest update, the ARRC says that the new "hardwired" fallback language or hedged fallback language should be incorporated for bilateral business loan contracts by October 31, 2020. However, many U.S. banks concerned that SOFR could lead to increased market volatility ultimately reducing banks' willingness to make credit available are still discussing and questioning whether another benchmark rate should replace LIBOR, with the concern

Push for Adoption of the Hardwired Approach

Under the "hardwired approach", where the replacement terms are "hardwired" into the documents, the loan documents set forth specific and defined LIBOR transition terms and conditions in the loan documents so that the parties agree upon the trigger event(s), the new reference rate and the rate spread at the time the loan is originated (i.e., the transition terms and conditions are "hardwired"

into the documents). There are permanent cessation and pre-cessation “trigger events” (e.g. an official public statement or publication of information from the Financial Conduct Authority (FCA) or the Intercontinental Exchange Benchmark Administration (IBA) that the actual cessation of LIBOR has occurred or is expected to occur) in the recommended fallback language. Once a trigger event occurs, the LIBOR replacement rate shall be established pursuant to a three-step waterfall. With its August 27 update, the ARRC modified the second step in the waterfall to utilize a Daily Simple SOFR rate (instead of a compounding rate), so that the waterfall now flows as follows: (i) Term SOFR plus Adjustment, (ii) Daily Simple SOFR plus Adjustment, and (iii) a Lender Selected Rate plus Adjustment. This updated waterfall means Daily Simple SOFR would be used if the ARRC determines that a robust forward-looking SOFR term rate is not available. With a Daily Simple SOFR loan, interest accrues in arrears based on SOFR for each day in the interest period. ARRC modified its recommendation to a Daily Simple SOFR instead of a Daily Compounded SOFR because implementing simple interest is more straightforward and the basis between simple and compounded SOFR, if any, is typically a few basis points or less. The third prong of the waterfall, the Lender Selected Rate, would only be used if ARRC decides that neither Term SOFR nor Daily Simple SOFR is available to be implemented.

The “hedged loan approach” is applicable for loans that utilize a replacement reference rate and where borrowers enter into interest rate swaps to hedge their floating rate interest exposure. The ARRC’s August 27 updated recommendation provides for a benchmark rate floor in the “hedged loan approach,” because ARRC assumes the parties would expect a negotiated rate floor to apply after the transition. For a discussion on the LIBOR transition and considerations for interest rate swaps, see our article entitled [U.S. Libor Cessation: How to Prepare](#).

With the amendment approach, the new reference rate specifics are not “hardwired” into the document or agreed upon by the parties in advance, but rather, the documents provide for amendment procedures in which the parties will agree upon the new reference rate terms and conditions (such as the rate itself and the spread) at a future date. Because of the desire to have flexibility

and the fact that lenders are not comfortable yet on using SOFR many opted to use the amendment approach.

The ARRC is pushing for lenders to start using the hardwired approach after seeing the widespread adoption of the amendment approach over the hardwired approach. The ARRC's reasons for requiring the adoption of the hardwired approach over the amendment approach are:

- Hardwired fallback language offers certainty as to what the replacement rate and spread will be and likely gets rid of the need to amend the loan at the time of the LIBOR transition.
- There will be no winners and losers due to different market cycles. In a borrower-friendly market, a borrower may be able to extract value from the lender by refusing to include a spread adjustment when transitioning to SOFR. In a lender-friendly market, a lender might block a move to a comparable rate, forcing the borrower to pay a higher interest rate for a period.
- The amendment approach may require the lender and borrower to agree on the replacement rate and amend the loan documents accordingly, which may be difficult to accomplish prior to LIBOR's cessation. Lenders may be overwhelmed by the large number of loans that would have to all be amended within the same timeframe upon LIBOR cessation, and that if such loans cannot be timely amended, there would be significant disruption in the financial markets.

Next Steps for Lenders and Borrowers

In spite of the recommendation by the ARRC to use the hardwired approach, lenders are continuing to adopt the amendment approach – at least for now – while they demand a different replacement rate. A group of regulator-convened U.S. regional banks part of the Credit Sensitivity Group met on July 22, 2020 and, based on the [minutes](#), claimed that a more credit sensitive rate is required as an alternative to SOFR with the currently contemplated spread adjustment. One bank presented that banks are worried that changing a pro-cyclical rate (such as LIBOR) to a counter-cyclical

rate (such as SOFR) would fundamentally change how banks allocate capital and ultimately increase lending costs and reduce credit availability. In addition to push back from lenders, borrowers unfamiliar with SOFR continue to utilize the “amendment approach” due to its flexibility.

The reality is that there is not a lot of time for market participants to support a different replacement rate. While lenders are still using the amendment approach, lenders may want to consider using a rate other than LIBOR on new loan originations. Lenders likely have already completed an inventory its loans with a LIBOR-based rate and determine which ones are based on the amendment approach or another approach different from the hardwired approach (such as a switch to base or prime). Lenders will want to put together a streamlined process for transitioning those loans from LIBOR and should consider going ahead and disclosing to those borrowers (through an amendment or notice depending on the terms in the documents) what the replacement rate will likely be or how the replacement rate will be chosen while the bank works out the details of its replacement interest rate product. Borrowers will want to reach out to their lenders to have the same discussion.

Although lenders may continue to use the amendment approach, lenders and borrowers alike need to become familiar with the ARRC recommended fallback language and discuss whether there are any issues with such language. It is best for all parties to have those discussions understanding that things may change and the ARRC language will continue to evolve. The ARRC recommendation is just that and ultimately lenders and borrowers are the ones that will decide whether to implement or adopt any of the suggested contract language.

ARRC’s full updated recommendations, including example definitions and hardwire language, can be found [here](#). Frost Brown Todd’s Financial Services industry team helps lenders and borrowers plan for and implement a strategy to deal with the end of LIBOR. Our team regularly analyzes and negotiates proposed LIBOR replacement language in documents and advises lenders and borrowers on loan documents, swap agreements, and other

agreements based on LIBOR.

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.