Considerations in hedging loans

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Numerous loan agreements require the borrower to enter into a hedge, at least for a proportion of the term facilities. to mitigate against interest rate or currency risks. However, there are various issues to consider for hedge counterparties and lenders when hedging a loan. The considerations for hedge counterparties are different from that of the lender. In this article, we will examine certain issues that the hedge counterparties should consider when entering into a loan linked hedge.

Documenting loan linked hedges

The hedging transaction will usually be documented under an ISDA Master Agreement and a confirmation reflecting the terms of the transaction. However, intercreditor provisions in the finance documents play an equally important role in determining the rights and obligations of hedge counterparties as well as the ranking of the hedging liabilities. In fact, the ISDA Master Agreement will follow the terms agreed in the finance documents to avoid any documentary conflicts.

Hedging terms

The hedging terms are agreed between the borrower and the lenders when entering into the facility. The hedging terms are usually documented as a part of the facility agreement or through a separate hedging strategy letter and typically include the minimum amount of the loan that needs to be hedged, the minimum tenor of the hedge and the process for selecting the hedge counterparties.

While the hedging terms usually specify only the minimum requirement and not the maximum, it is prudent to avoid hedging any amounts beyond the amount or term of the facility to avoid any speculative hedges.

Early termination

Ultimately, it is in the lenders' interests to not allow the hedge to fall away especially during periods of stress. Not only would the lenders' payments originating from the hedge counterparty be terminated, the borrower would also incur the additional liability of the hedge termination payments in such times. In light of this, the lenders typically agree to share the transaction security and the benefit of the guarantees with the hedge counterparty provided certain termination rights of the hedge counterparty are curtailed through the intercreditor provisions of the loan facility. This means that the hedge counterparty can terminate the hedge only upon certain limited events such as acceleration of the facility, enforcement of transaction security or a payment default under the relevant hedging agreement.

Ranking

Until recently, market convention has dictated that the hedge ranks *pari passu* with the senior loan facilities and benefits from the transaction security and guarantee. This approach reflected that usually it was the senior lenders who provided the hedge. However, this approach is changing with borrowers preferring to enter into hedges with financial institutions outside the senior lender group, perceiving that these financial institutions would provide better rates. While such hedges would still benefit from the transaction security and guarantees, senior lenders prefer that the hedge rank lower than the facility, with the ultimate result depending on negotiations between the senior lenders and the hedge counterparties.

Enforcement instructions

Another key concern when negotiating intercreditor terms is how an enforcement is implemented. The senior lenders prefer that they lead the enforcement. While the hedge counterparties share in the transaction security and guarantees, their role in voting during an enforcement scenario is limited in most cases, unless they have terminated their hedge and crystallised their hedging claim. It is in very rare cases that the mark to market of their outstanding hedges would be taken into account to determine the instructing group for enforcement instructions. Accordingly, whether the hedge counterparty can terminate and close out the hedges become crucial. While the hedge counterparty would prefer to close out and crystallise their claim and have a vote in the enforcement, the senior lenders would prefer to keep the voting to themselves leading to a divergence of interests. This is not an issue where the senior lenders and the hedge counterparties are the same. However, as mentioned earlier the trend has increasingly been for hedging counterparties to be outside the group of senior lenders.

IBOR issues

When borrowers execute interest rate swaps to hedge their interest rate risk in relation to a particular loan, they should take care to ensure that the floating rate in the hedging transaction (such as LIBOR) matches their loan. However, the brave new world for interest rates is approaching as LIBOR is being phased out at the end of 2021. The best solution for the hedged loans is for the loan and the hedging transaction to be replaced at the same time with the same rate. However, that is not assured at this stage.

International Swaps and Derivatives Association ('ISDA') published the ISDA 2020 IBOR Fallbacks Protocol and the Supplement to the 2006 ISDA Definitions (the 'IBOR Fallbacks Supplement'), which became effective on 25 January 2021, to address the fallbacks in the absence of LIBOR or when LIBOR is no longer representative of the market. On 5 March 2021, the Financial Conduct Authority (the 'FCA') announced the dates when all LIBOR settings will either cease or will no longer be representative. While most LIBOR rates (including for all rates in EUR and CHF and certain rates for GBP, JPY and USD LIBOR) will cease on 31 December 2021, certain tenors for USD LIBOR will continue till 30 June 2023. ISDA has confirmed that this announcement by the FCA will constitute an 'Index Cessation Event' in respect of all LIBOR rates under the IBOR Fallbacks Supplement and the ISDA 2020 IBOR Fallbacks Protocol. This means that from the date such index cessation is effective, the relevant LIBOR rate will be replaced by the relevant adjusted risk free rate.

However, while the approaches in the loan market and the derivatives market is similar, this approach does not necessarily represent the approach that will be taken for the loan and may potentially be divergent leading to a basis risk. Parties should identify any potential mismatches and consider whether it would be appropriate to document matching fallback for the entire financing transaction at the same time, so that such fallbacks are aligned across the loan and the related hedge. For hedge counterparties in particular, it is prudent to consider whether you are able to make the same changes in any back to back trade entered into to hedge this risk. Given FCA's announcement, it is now crucial to review readiness and start discussions with lenders or back to back hedge counterparties if a mismatch is perceived.

Conclusion

There are various factors to consider before participating in a loan linked hedge. While the issues raised in this note identify some of the more pressing issues to understand when entering into a loan linked hedge, they are certainly not exhaustive. Moreover, developments in the market have meant that both hedge counterparties and lenders are examining their positions again. Accordingly, it is important to seek guidance from the party's legal counsel when negotiating the terms of a loan-linked hedge.

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