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ARRC Releases Recommended Fallback Language for Floating Rate Notes and Syndicated Loans

ARRC Encourages Use of this Language in New Contracts, Which Aims to Minimize Market Disruptions if LIBOR is No Longer Usable

The Alternative Reference Rates Committee (ARRC) today released recommended contractual fallback language for U.S. dollar LIBOR denominated floating rate notes and syndicated loans. These provisions are for market participants' voluntary use in new contracts that reference LIBOR and were developed with the goal of reducing the risk of serious market disruption in the event that LIBOR is no longer usable. This recommendation is part of the ARRC's mandate to help address risks in contracts referencing LIBOR and it builds on its work developing the Paced Transition Plan, which outlines the steps for an effective shift to the ARRC's recommended alternative reference rate, the Secured Overnight Financing Rate (SOFR).

"It's no longer a question of if—but when—LIBOR will become unusable, yet most contracts referencing it don't adequately account for this eventuality. With LIBOR's possible 2021 expiration date looming, that obviously poses a massive risk to financial stability and market participants," said Tom Wipf chair of the ARRC and Vice Chairman of Institutional Securities at Morgan Stanley. "The fallback language issued today is a critical step in addressing that concern. We encourage market participants to incorporate this language into new contracts, and when possible, to begin writing contracts using SOFR instead of U.S. dollar LIBOR."

The final recommended language was prepared after full consideration of all comments received—over 60 in total—on the fallback language consultations for floating rate notes and syndicated loans. These provisions were endorsed by the ARRC and represent a consensus of its Floating Rate Notes and Business Loans working groups. Together, these working groups represent the collective work of more than 60 institutions and trade groups, including more than 250 individuals. Cadwalader, Wickersham & Taft LLP assisted the working group efforts as drafting counsel.

As described in the ARRC's guiding principles for fallback language, there are substantial benefits to aligning fallback provisions across different products so that they would operate similarly in the event that LIBOR is no longer usable. Recognizing, however, that financial products differ in critical ways, the ARRC's recommended fallback language is designed for specific products but seek general consistently in defining key terms, including:

- ***Benchmark Transition Events:*** the trigger events that start the transition away from LIBOR;

- ***Benchmark Replacement:*** the successor adjusted rate that would replace references to LIBOR throughout the contract following a Benchmark Transition Event; and
- ***Benchmark Replacement Adjustment:*** the spread adjustment component of the Benchmark Replacement that is applied to the successor rate to make it more comparable to LIBOR.

Floating Rate Notes

The ARRC's recommended fallback language for floating rate notes defines the trigger events that start the transition away from LIBOR and outlines a "waterfall" approach to determine the SOFR-based successor rate and spread adjustment that would apply to the successor rate.

Syndicated Loans

There are two separate, alternative fallback language approaches recommended for syndicated loans. The Amendment Approach could serve as an initial step towards the Hardwired Approach.

- ***Hardwired Approach:*** This approach provides certainty upfront and is similar to the recommended fallback provisions for floating rate notes described above. In the event that LIBOR is no longer usable, this approach would clearly specify which SOFR-based successor rate and spread adjustment to apply. Some market participants ultimately may be more comfortable with this approach because it could be executed more easily than the Amendment Approach if LIBOR becomes unusable.
- ***Amendment Approach:*** This approach would provide a streamlined amendment mechanism for negotiating a benchmark replacement and offers standard language, which provides specificity with respect to the fallback trigger events and explicitly includes an adjustment to be applied to the successor rate. Some market participants may be more comfortable with this approach initially because, unlike the Hardwired Approach, it does not reference rates or spread adjustments that do not yet exist.

The ARRC plans to release recommended fallback language for bilateral business loans and securitizations soon. It also expects to consult with a broad range of stakeholders on proposals for fallback language in consumer products in the future.

About the ARRC

The ARRC is a group of private-market participants convened by the Federal Reserve Board and Federal Reserve Bank of New York in cooperation with the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of Financial Research, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, the Securities and Exchange Commission and the U.S. Treasury Department. It was initially convened in 2014 to identify risk-free alternative reference rates for U.S. dollar LIBOR, identify best practices for contract robustness, and create an implementation plan with metrics of success and a timeline to support an orderly adoption. The ARRC accomplished its first set of objectives and identified SOFR as the rate that represents best practice for use in certain new U.S. dollar derivatives and other financial contracts. It also published its Paced Transition Plan, with specific steps and timelines designed to encourage adoption of SOFR. The ARRC was reconstituted in 2018 with an expanded membership to help to ensure the successful implementation of the Paced Transition Plan, address the increased risk that LIBOR may not exist beyond 2021, and serve as a forum to coordinate and track planning across cash and derivatives products and market participants currently using U.S. dollar LIBOR.

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