Guiding Principles and Scope of Work for the ARRC Consumer Products Working Group

Background

The Alternative Reference Rates Committee (ARRC) was reconstituted to ensure the successful implementation of its Paced Transition Plan and to serve a coordinating role intended to help minimize potential disruptions associated with a transition from or end to LIBOR.

In order to meet its mandate to serve as a forum for coordinating voluntary transition, the ARRC entered in to a several-year process evaluating a range of potential alternatives to U.S. dollar LIBOR and conducted an open and transparent process of market-wide consultation before selecting its recommended alternative. The ARRC considered a variety of factors in selecting the Secured Overnight Financing Rate (SOFR), including the depth of the underlying market and its likely robustness over time; the rate's usefulness to market participants; and whether the rate's construction, governance, and accountability would be consistent with the IOSCO Principles for Financial Benchmarks. The ARRC considered the input of a wide range of market participants, including feedback from its Advisory Group of end users, in making its recommendation.

In its Guiding Principles for contract fallback language in cash products (Guiding Principles), the ARRC recommended that market participants should seek to use SOFR, or a benchmark based on SOFR, in order to maintain alignment in outcomes and minimize basis risks between their products and any related loans and securities, securitizations, or hedges. This recommendation recognizes that the ARRC can best meet its mandate to minimize disruption by encouraging a coordinated transition path. It also recognizes that market participants will be best served by relying on a robust, transparent, and fully IOSCO compliant rate. This consideration is particularly applicable to consumer products, where any rate used in consumer lending should be able to demonstrably meet all of the IOSCO requirements for transparency, governance, and robustness.

In line with its mandate and the Guiding Principles, the ARRC and its working groups will seek to promote solutions based on SOFR incorporating active input from a wide range of market participants, consumer groups, and the public sector. However, the ARRC's Guiding Principles and its mandate fully recognize that individual market participants may freely choose solutions outside of the ARRC's processes or recommendations. The extent to which any market participant implements or adopts any of the ARRC's recommendations is purely voluntary. Each market participant will make its own independent decision about whether or to what extent any recommendation is adopted.

Guiding Principles

This is the only working group of the ARRC whose stakeholders include retail consumers. This leads to a unique set of circumstances that require additional consideration. The working group, like the other product working groups of the ARRC, will facilitate a robust market-wide consultation process to solicit feedback on any proposed recommendations. However, some of the principles for other cash products may not appropriately apply to consumer products or may apply differently for various consumer products; for example, the iterative development of contract language potentially envisioned for other cash products may be difficult to implement for consumer products and amendments to existing retail documents may not be feasible or desirable. Hence, we set out guiding principles here that we believe are uniquely applicable for consumer loan products:

- To ensure an orderly, fair, and transparent outcome for adjustable-rate US residential mortgages as well as other consumer products with loans indexed to LIBOR, transition planning should actively engage with stakeholders (including, lenders, servicers, investors, regulators, consumer groups) and comply with all applicable consumer protection laws and regulations.
- In determining proposed fallbacks for LIBOR in consumer products, the choice of the replacement benchmark, spread adjustment to the replacement benchmark, succession timing, and mechanics should be easily comprehensible in order to be effectively communicated to stakeholders in advance of the transition away from LIBOR, and should seek to minimize expected value transfer based on observable, objective rules determined in advance.
- Where flexibility or discretion are incorporated in fallback recommendations, it should be carefully considered and limited to the extent possible to ensure ease of application and to minimize the potential for disputes.
- While ensuring fair and transparent outcomes for consumers, stakeholders should seek to maintain alignment in outcomes for investors in order to minimize basis risk between their consumer loan products and any related loans and securities, securitizations, or hedges associated with them bearing in mind operational, tax, accounting and similar issues.

Scope of Work

The group's scope of work is the following:

- *Recommend models for using SOFR in consumer products.*
  - With active engagement from stakeholders, the working group will seek to find and recommend models of use of SOFR in consumer products that meet their needs.

- *Identify best practices for new LIBOR and SOFR based notes with retail consumers.*
  - Current contract language in mortgages and other consumer products generally allows lenders to replace the index if LIBOR is no longer available. Stakeholders may benefit from contract language that more clearly specifies what they should expect to happen if the LIBOR index stops or is materially disrupted. The group will:
    - Where applicable, recommend modified language for new loans to ensure contracts are resilient to a LIBOR discontinuance or disruption. Recommended language should include specific triggers that enact the shift to a successor rate based on SOFR and address the need for a replacement benchmark spread adjustment and outline the process to achieve the same.
    - Ensure that its recommended contract language incorporates the market's feedback, prioritizes clear and comprehensible descriptions, envisages likely scenarios for an end or disruption to LIBOR, and is feasible to implement.

- Recommend appropriate fallback contract language for use in SOFR based notes that will clearly specify what will occur if the SOFR index stops or is materially disrupted.

- *Identify best practices for execution of fallback contract language in existing notes with retail consumers. Existing notes allow lenders to replace the index if LIBOR is no longer available with an alternate index based on comparable information. The best practices should include guidelines that will:*
    - Enable the implementation of fallback procedures that are fair and equitable to stakeholders.
    - Enable consistent implementation of fallback clause language, including timing for implementation, to ensure consistency across the industry
    - Provide for specific triggers that enact the shift to successor rate(s)
    - Address the need for a replacement benchmark spread adjustment and outline the process to achieve the same
    - Prioritize transparency; provide clear communication and timelines
    - To the extent appropriate, provide guidelines for operational practices, including employee training and recommended systems changes
    - Manage potential litigation and reputational risk from the LIBOR transition

- *Create a strategic plan in anticipation of the LIBOR replacement. The plan will:*
    - *Identify the market segments where the ARRC can and should take the lead in helping to coordinate transition activities in consumer loan markets*
        - Given the special roles of the GSEs in U.S. mortgage markets, the working group will, where appropriate, coordinate options with the GSEs. The GSEs may also pursue options outside of the ARRC. The working group should also identify whether there are any other financial market participants and segments of the mortgage market that would benefit from and desire to coordinate within the ARRC as part of creating any work plan related to consumer mortgages.
        - The working group should identify other significant areas of retail LIBOR exposures and develop a work plan in conjunction with industry participants and consumer advocates active in those market segments.
    - Identify best practices for each market segment in which the ARRC takes a lead in coordinating.
    - Plan to proactively partner with consumer advocacy groups and the media to address retail consumer concerns (i.e., changes to payments, timing of the transition, etc.)
    - Plan to leverage this working group to consider new and/or modified products that would benefit the participants in the consumer loan industries and the retail consumers.