Summary of ARRC's LIBOR Fallback Language

Alternative Reference Rates Committee

November 2019

Executive Summary

The Alternative Reference Rates Committee (ARRC) continues to support and prepare market participants for the transition from U.S. dollar (USD) LIBOR to the Secured Overnight Financing Rate (SOFR).

BACKGROUND

- The **ARRC's Second Report** stated that most contracts referencing LIBOR may not have robust fallback language.
  - **Fallback language:** contractual provisions that specify the trigger events for a transition to a replacement rate, the replacement rate, and the spread adjustment to align the replacement rate with the benchmark being replaced—in this case USD LIBOR.
- The ARRC published Guiding Principles for More Robust LIBOR Fallback Contract Language in Cash Products, Guiding Principles and Scope of Work for the ARRC Consumer Products Working Group and has consulted on and issued recommended fallback language for floating rate notes, bilateral business loans, syndicated loans, securitizations, and residential adjustable rate mortgages.
- The ARRC's recommended fallback language is for market participants' voluntary use in contracts that reference USD LIBOR and was developed with the goal of reducing the risk of serious market disruption in the event that LIBOR is no longer usable.

ADOPTION OF FALLBACK LANGUAGE

- It is widely acknowledged that if LIBOR becomes unusable, much of existing fallback language could lead to significant changes to contract economics or uncertain outcomes.
- Firms should incorporate robust fallback language in new contracts referencing USD LIBOR to help facilitate a smooth transition to alternative reference rates.
- The ARRC has advocated for alignment of fallback language across cash products and has also been actively engaged in the work led by the International Swaps and Derivatives Association (ISDA) to consider best practices for contract robustness in derivatives contracts. ISDA is not expecting to analyze whether the fallbacks it anticipates implementing would be appropriate for non-derivatives.

Overview of Products

The ARRC released recommended contractual fallback language for floating rate notes, bilateral business loans, syndicated loans, securitizations, and residential adjustable rate mortgages. The interest rate for all the products defined below are tied to a benchmark rate.

FLOATING RATE NOTES

Debt instruments with a variable interest rate issued in the capital markets.

ARRC's fallback language recommendation finalized: April 25, 2019

BILATERAL BUSINESS LOANS

Bilateral loans are funds provided to a borrower by one lender.

ARRC's fallback language recommendation finalized: May 31, 2019

SYNDICATED LOANS

A syndicated loan is financing offered by a group of lenders who work together to provide funds to a borrower.

ARRC's fallback language recommendation finalized: April 25, 2019

SECURITIZATIONS

Pools of various individual assets, typically debt instruments, bundled together where resulting cash flows are structured into asset backed securities issued in the capital markets.

ARRC's fallback language recommendation finalized: May 31, 2019

ADJUSTABLE RATE MORTGAGES

A type of mortgage in which the interest rate applied on the outstanding balance varies after an initial fixed-rate period ends.

ARRC's fallback language recommendation finalized: November 15, 2019

Overview of Fallback Parameters

The ARRC recommended triggers, benchmark replacement rates and spread adjustments for the products noted.

The following slides include definitions of each and their applicability to each product.

Benchmark Transition Event (Trigger)	Triggers define the circumstances under which references to the benchmark rate in a contract will be replaced
Benchmark Replacement (Replacement Rate)	The benchmark replacement definition identifies the rate, or waterfall of rates, that would replace the current benchmark rate following a trigger event
Benchmark Replacement Adjustment (Spread Adjustment)	The spread adjustment (which may be positive, negative or zero) added to the replacement rate to account for differences with the current benchmark rate

Triggers

	FLOATING RATE NOTES	BILATERAL BUSINESS LOANS	SYNDICATED LOANS	SECURITIZATIONS
PERMANENT CESSATION TRIGGERS				
Administrator of the benchmark issues a public statement announcing that it has or will cease to provide the benchmark, and there is no successor administrator	✓	✓	✓	✓
The regulator with authority over the administrator of the benchmark issues a public statement announcing that the administrator has or will cease to provide the benchmark, and there is no successor administrator	✓	✓	✓	✓
PRE-CESSATION TRIGGERS				
The regulator with authority over the administrator of the benchmark announces that the benchmark is no longer representative	✓	✓	✓	✓
Asset Replacement Percentage Trigger: Percentage of underlying assets have been converted to the benchmark replacement or replaced by assets bearing interest based on the benchmark replacement	○	○	○	✓
EARLY "OPT IN" TRIGGERS				
Allows parties to move to a benchmark replacement if certain conditions are met	○	✓	✓	○

The Asset Replacement Percentage Trigger is intended to minimize basis risk between securities and the assets underlying these securities. It can be tailored to the specifics of a securitization transaction, including the structure, nature of the underlying assets as well as the specific reporting mechanics.

Hardwired Benchmark Replacement Waterfalls

The ARRC has proposed the following benchmark replacement waterfalls. Some [users](#) may fallback to an average of SOFR, rather than a term rate, or a simple average rather than a compounded average.

	FLOATING RATE NOTES	BILATERAL BUSINESS LOANS	SYNDICATED LOANS	SECURITIZATIONS
01 **Term SOFR[1] + spread adjustment** *Forward-looking term SOFR for the applicable corresponding tenor. Note: Loan recommendations allow use of next longest tenor term SOFR rate if the corresponding tenor is unavailable.*	✓	✓	✓	✓
02 **Compounded SOFR[A] + spread adjustment** *Compounded average of daily SOFRs over the relevant period depending on the tenor of USD LIBOR being replaced.*	✓	✓	✓	✓ [A] 'in arrears' or 'in advance'
03 **Relevant selected rate[B] + spread adjustment** *Rate selected by the Relevant Governmental Body[2], lender, or borrower & administrative agent*	✓ [B] Governmental body	✓ [B] Lender	✓ [B] Borrower & admin agent	✓ [B] Governmental body
04 **Relevant ISDA replacement rate + spread adjustment** *The applicable replacement rate (without any spread adjustment) that is embedded in ISDA's standard definitions*	✓	○	○	✓
05 **Issuer, designated transaction representative, or note holder replacement rate[C] + spread adjustment** *An identified party will select a replacement rate, in some cases considering any industry-accepted rate in the related market. Note: In certain circumstances this step could be omitted*	✓ [C] Issuer	○	○	✓ [C] Designated representative

Floating Rate Notes and **Securitizations** generally have long maturities and a larger number of participants which makes the agreements more difficult to modify, while loan agreements typically involve a smaller set of counterparties and are often amended during the life of the loan by borrowers & lenders. As a result, the ARRC has proposed additional waterfall steps for Floating Rate Notes and **Securitizations** to ensure a replacement rate is identified.

[1] Forward-looking term SOFR does not currently exist. The ARRC's Paced Transition Plan calls for the "creation of a term reference rate based on SOFR derivatives markets once liquidity has developed sufficiently to produce a robust rate."

[2] The ARRC currently qualifies as a "Relevant Governmental Body." This term is defined as the Federal Reserve Board and/or the Federal Reserve Bank of New York, or a committee officially endorsed or convened by the Federal Reserve Board and/or the Federal Reserve Bank of New York or any successor thereto.

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Hardwired Benchmark Replacement Spread Adjustments

	FLOATING RATE NOTES	BILATERAL BUSINESS LOANS	SYNDICATED LOANS	SECURITIZATIONS
01 ARRC Selected Spread Adjustment *Spread adjustment that has been selected or recommended by the Relevant Governmental Body*	✓	✓	✓	✓
02 ISDA Fallback Spread Adjustment *Spread adjustment that would apply to the replacement rate for a derivative transaction referencing ISDA’s standard definitions*	✓	✓	✓	✓
03 Other Selected Spread Adjustment	✓ Issuer or its designee selected adjustment	✓ Lender selected adjustment	✓ Borrower & admin agent selected adjustment	✓ Designated transaction representative selected adjustment

Residential, Closed-End Adjustable Rate Mortgages (ARMs)

The ARRC's final recommendation for ARMs is intended to be consistent with its recommendations for other cash products, but it recognizes the need for plain and direct contract language in consumer products. The final recommendation for ARMs refers to a replacement index "selected or recommended for use in consumer products, including residential adjustable-rate mortgages, by the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, or a committee endorsed or convened by the Board of Governors of the Federal Reserve System or the Federal Reserve Bank of New York."

	ADJUSTABLE RATE MORTGAGES[1]	OTHER CASH PRODUCTS
TRIGGERS		
Permanent Cessation and Non-Representativeness Pre-Cessation Triggers *The ARMs fallback language would trigger if LIBOR stops or is found to no longer be representative.*	✓	✓
BENCHMARK REPLACEMENT AND SPREAD ADJUSTMENT		
Replacement rate + spread adjustment recommended by Relevant Governmental Body *Like the ARRC's hardwired recommendation for other cash products, ARMs would fall back to a rate and spread adjustment that have been selected or recommended Relevant Governmental Body. Other hardwired cash product fallbacks have more complex waterfalls that explicitly lay out that the Replacement rate would be a term SOFR Rate or Compound Average. ARMs language is plain and direct but would similarly fallback to a SOFR rate and spread adjustment (published as a single, spread-adjusted SOFR rate) recommended by the ARRC.*	✓	✓
LOWER WATERFALL LEVELS		
In the event that a Relevant Government Body has not selected or recommended a replacement rate and spread adjustment, the ARMs fallback allows the Noteholder to name a replacement rate and margin. This is similar in spirit to the lower levels for the waterfalls for other cash products.	✓	✓

Hardwired vs. Amendment Approach for Loan Products

The ARRC has also offered an alternative "amendment approach" fallback language for bilateral business and syndicated loan products, as reflected by the chart below. Loan agreements typically involve a known set of parties and are often amended. This approach recognizes this feature of the loan market, creating a streamlined amendment process to select a replacement rate and spread adjustment. Market participants may find the flexibility offered in this language to be appropriate in the current stage of the transition; however it may not be feasible to use the amendment approach to negotiate thousands of loans simultaneously in the event of LIBOR becoming unusable. Market participants who choose the amendment approach should therefore expect that future amendments to adopt a more "hardwired" approach may be desirable.

	BILATERAL BUSINESS LOANS	SYNDICATED LOANS
AMENDMENT APPROACH TRIGGERS	Lender	Admin Agent
Permanent Cessation Triggers and Pre-Cessation Trigger	✓	✓
Early "Opt In" Trigger[3]	✓	✓
SELECTION OF BENCHMARK REPLACEMENT RATE AND SPREAD ADJUSTMENT	Lender	Borrower & Admin Agent
Relevant replacement rate + spread adjustment After trigger occurs, lender (bilateral loans) or borrower & administrative agent (syndicated loans) may propose a replacement rate & spread adjustment	✓	✓
CONSENT TO REPLACEMENT RATE AND SPREAD ADJUSTMENT	Borrower	Required Lenders
Effectiveness of proposed replacement rate and spread depends on negative consent (mandatory triggers) or affirmative consent (early opt-in triggers) of the required lenders	○	✓
Effectiveness of proposed replacement rate and spread may depend on negative consent of borrower	✓	○

[3] For syndicated loans, in addition to the administrative agent, Required Lenders can also determine an early "opt in" trigger.

About ARRC*. The ARRC is a group of private-market participants working to help ensure a successful transition from USD LIBOR to a more robust reference rate, its recommended alternative, SOFR. It is comprised of a diverse set of private-sector entities, each with an important presence in markets affected by USD LIBOR, and a wide array of official-sector entities, including banking and financial sector regulators, as ex-officio members. It was initially convened in 2014, to identify risk-free alternative reference rates to USD LIBOR, identify best practices for contract robustness, and create an implementation plan for an orderly adoption. It accomplished that initial set of objectives, and today, the ARRC is working to help ensure the successful implementation of the Paced Transition Plan, address the increased risk that LIBOR may no longer be usable beyond 2021, and serve as a forum to coordinate and track planning across cash and derivative products and market participants currently using USD LIBOR.*

For more details, see the ARRC's website: https://www.newyorkfed.org/arrc.