# ARRC LIBOR Fallback Roundtable

## NYU Stern School of Business

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| **Moderator:** | Lary Stromfeld | *Partner*, Cadwalader, Wickersham & Taft LLP |
| **Speakers:** | Ann Battle | *Assistant General Counsel*, ISDA |
| | Hu Benton | *Vice President*, American Bankers Association |
| | Agha Mirza | *Managing Director*, CME Group Global Head of Interest Rate Products |
| | Alexis Pederson | *Senior Company Counsel*, Wells Fargo |
| | Lisa Pendergast | *Executive Director*, CRE Finance Council |
| | Tess Virmani | *Associate General Counsel & Senior Vice President, Public Policy* - LSTA |

**June 3, 2019**

# ISDA 2018 Consultation on Approaches to Term and Spread Adjustments

- On July 12, 2018, ISDA launched a **market consultation (of ISDA members and non-members)** to inform final decisions regarding the approaches to **term and spread adjustments** for derivatives fallbacks
  - It is necessary to address these issues because the fallback RFRs are overnight and risk-free (or nearly risk-free) whereas the relevant IBORs have term structures and incorporate a bank credit risk premium and a variety of other factors (*e.g.*, liquidity, fluctuations in supply and demand)
  - The consultation covered GBP LIBOR, JYP LIBOR, CHF LIBOR, JPY TIBOR, Euroyen TIBOR and BBSW. It asked preliminary questions about USD LIBOR, EUR LIBOR and EURIBOR
- On December 20, 2018, ISDA published the consultation results and an aggregated and anonymized summary of the responses received
  - For the benchmarks covered by the consultation, ISDA is developing fallbacks based on the **compounded setting in arrears rate** and the **historical mean/median approach** to the spread adjustment. **Preliminary feedback supported use of these approaches for other IBORs, including specifically USD LIBOR**
  - For additional information: https://www.isda.org/2018/12/20/isda-publishes-final-results-of-benchmark-fallback-consultation/

# ISDA IBOR Fallbacks: May 2019 Consultations

- ***Supplemental Consultation on Spread and Term Adjustments for Fallbacks in Derivatives Referencing USD LIBOR, CDOR and HIBOR and Certain Aspects of Fallbacks for Derivatives Referencing SOR***
  - Builds on July 2018 *Consultation on Spread and Term Adjustments for Fallbacks in Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW*
  - Seeks input on the approach for addressing certain issues associated with adjustments that will apply to alternative risk-free rates (RFRs) if the fallbacks take effect
  - Adjustments are necessary because of the differences between the IBORs and the RFRs
- ***Consultation on Pre-Cessation Issues for LIBOR and Certain Other IBORs***
  - Relates to pre-cessation issues and seeks comments on how derivatives contracts should address a regulatory announcement that LIBOR or certain other IBORs categorized as critical under the EU Benchmarks Regulation are *no longer representative of an underlying market*

**During the consultation periods, please submit questions to fallbackconsult@isda.org**

**For additional information, go to https://www.isda.org/2019/05/16/may-2019-benchmark-fallbacks-consultations/**

# ISDA: Timeline Going Forward

- Selection of vendor to publish term and spread adjustments: *Expected in Q2 2019 (RFP in process)*
- Supplemental consultation on the term and spread adjustments for USD LIBOR, CDOR and HIBOR: ***Responses due by July 12, 2019***
- Supplemental consultation on the term and spread adjustments for EUR LIBOR and EURIBOR: *TBD, but cannot be until after trading in €STR (likely Q4 2019 or Q1 2020)*
- Market outreach and feedback on open issues associated with the final parameters of the term and spread adjustments: *Expected in* ***August 2019*** *(internal work underway to analyze feedback received on these points and perform sensitivity analysis that we will publish along with questions about open issues)*
- Consultation on pre-cessation events: *Responses due by* ***July 12, 2019***
- Publication of amended definitions and protocol for all benchmarks except EUR LIBOR and EURIBOR: ***December 2019*** *(with expected effective date in* ***March 2020****)*

**Please submit questions to fallbackconsult@isda.org**

# CME Response

- **20 Dec 2018**
  ISDA publishes "*Anonymized Narrative Summary of Responses to the ISDA consultation on Term Fixings and Spread Adjustment Methodologies*"

- **21 Dec 2018**
  **CME Group** issues the following statement:

- "CME Group is fully supportive of efforts by the official sector, ARRC, ISDA and their industry-wide working groups to improve and strengthen LIBOR Fallbacks. We intend to align with ISDA to include revised fallback language in our rules at a time which is concurrent with amendments or New Definitions being adopted across the OTC derivative marketplace that reference the six indices across four currencies referenced in their recent consultation: GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW. CME reserves the right to make necessary adjustments based on consultations with our clients. We will keep all participants informed throughout the process.

- Beyond the four currencies referenced thus far by ISDA, CME remains in close consultation with ARRC, ISDA and our clients, and we will communicate our plans regarding other currencies at the appropriate times in relation to ISDA's work to achieve consensus across the industry.

- CME Group's views relating more broadly to LIBOR transition are summarized in our white paper, What's Next for LIBOR and Eurodollar Futures."

# CME Response

**16 May 2019**

ISDA publishes *"Consultation on Pre-Cessation Issues for LIBOR and Certain Other Interbank Offered Rates (IBORs)"*, available at: https://www.isda.org/a/t6tME/Pre-cessation-issues-Consultation.pdf. This contains the following statements regarding CCPs and pre-cessation triggers:

- [Page 6] "…CME and LCH have each communicated to ISDA and regulators that, subject to the detail and feedback on this consultation, they believe that market efficiencies could be achieved by alignment of how cleared derivatives operate with a pre-cessation trigger for fallbacks in non-cleared contracts if the 2006 ISDA Definitions were to include such a trigger."
- [Page 9] "CME and LCH have each communicated to ISDA and regulators that pre-cessation events may trigger or prompt them to use their discretion to use an alternative reference rate (if, for example, LIBOR was found to be non-representative)"

- CME Group operates several Designated Contract Markets (DCMs) regulated by the Commodity Futures Trading Commission ("CFTC"). CME Group operates CME Inc. which is a registered Derivatives Clearing Organization ("DCO") primarily regulated by the CFTC, and has been designated systemically important by the Financial Stability Oversight Committee ("FSOC").
- CME Group supports alignment of fallback language where possible between bilateral and cleared derivatives to mitigate potential systemic disruptions and to facilitate orderly markets.
- CME Group believes that it is in the best interest of the marketplace to have consistency of approach in both triggers and fallback methodology between cleared derivatives and ISDA's recommendations for fallbacks, to the extent possible and as supported by our clients.

# ARRC Fallback Language for Cash Products

- **Floating Rate Notes** typically have a fallback to a reference bank poll seeking quotes for LIBOR and then, if that fails, revert to the last published LIBOR
- After **Andrew Bailey's 2017 speech**, market participants across asset classes, and the ARRC, determined that more robust fallback language for cash products was needed
- What does robust fallback language look like?
  - Clear, predetermined **trigger events**
  - A **successor rate** (or successor rate waterfall)
  - An **adjustment** to make the successor rate more comparable to LIBOR
- On September 24, 2018, the ARRC launched a **consultation** on fallback language for new LIBOR floating rate notes
- On April 25, 2019, the ARRC released **recommendations** for fallback language for new LIBOR floating rate notes
- The recommendations, along with a narrative that includes a **user's guide**, can be found on the ARRC's website

# ARRC Triggers for FRNs

**Cessation Triggers (ISDA Triggers)**

- A **public statement** or publication of information by or on **behalf of the administrator** of the Benchmark announcing that **such administrator has ceased or will cease to provide the Benchmark permanently or indefinitely**, provided that, at the time of the statement or publication, there is no successor administrator that will continue to provide the Benchmark.
- A **public statement** or publication of information **by the regulatory supervisor for the administrator of the Benchmark**, the central bank for the currency of the Benchmark, an insolvency official with jurisdiction over the administrator for the Benchmark, a resolution authority with jurisdiction over the administrator for the Benchmark or a court or an entity with similar insolvency or resolution authority over the administrator for the Benchmark, which states that the **administrator of the Benchmark has ceased or will cease to provide the Benchmark permanently or indefinitely**, provided that, at the time of the statement or publication, there is no successor administrator that will continue to provide the Benchmark.

**Pre-Cessation Trigger (LIBOR Is “No Longer Representative”)**

- A public statement by the regulatory supervisor for the administrator of the Benchmark announcing that such Benchmark is no longer representative.

# ARRC Benchmark Replacement Waterfall for FRNs

**(first Interpolate, if applicable)**
**Step 1: Term SOFR + Adjustment**
"Term SOFR" is a forward-looking term SOFR endorsed by the Relevant Governmental Body. Transaction parties may choose not to include this step in their document because it will not align with the ISDA fallback rate (expected to be Compounded SOFR)

**Step 2: Compounded SOFR + Adjustment**
"Compounded SOFR" is a compounded average of daily SOFR rates during an interest period. The definition allows for either a lookback or suspension period based on future guidance from ARRC or market-accepted convention **(Alternative: Simple Average SOFR)**

**Step 3: Relevant Government Body Selected Rate + Adjustment**
The Relevant Governmental Body selected rate is one chosen as a fallback by the Fed/ARRC

**Step 4: ISDA Fallback Rate + Adjustment**
If the Fed/ARRC has not recommended a replacement rate, the fallback provisions embedded in the ISDA Definitions would be used to establish the replacement rate

**Step 5: Issuer or its Designee Selected Rate + Adjustment**
If steps above fail, an alternate rate may be selected by the issuer or its designee giving "due consideration" to any industry accepted practice

# ARRC Adjustment Waterfall for FRNs

**Step 1: ARRC Selected Adjustment**
If the ARRC endorses a “Term SOFR” as a fallback rate for cash products, it will also endorse a spread adjustment to Term SOFR for cash products

**Step 2: ISDA Fallback Adjustment**
ISDA is consulting on an adjustment for derivatives that reference ISDA Definitions. This adjustment is expected to be the historical average difference between LIBOR and SOFR frozen at the time of the trigger event. The ISDA Fallback Adjustment only applies to FRNs if the fallback rate is equivalent to the ISDA Fallback Rate

**Step 3: Relevant Government Body + Adjustment**
If the first two steps fail, the spread adjustment will be selected by the Issuer or its Designee giving due consideration to any industry-accepted spread adjustment.

# Differences Across Products

- **Triggers**:  FRN Fallbacks include a Pre-Cessation Trigger and ISDA is consulting on whether to add a pre-cessation trigger
- **Primary Fallback Rate**:  The first fallback is Term SOFR + Adjustment which will not be the fallback for derivatives, which is why modifications to remove Term SOFR are explicitly allowed
- **Waterfall Length**:  FRN Fallbacks have longer waterfalls than certain other products (e.g. loans) because they are long dated and difficult to amend
- **Amendment Approach**:  Loan Fallbacks have an “Amendment Approach” because of the relative ease of amending loans

# Notable Differences in the Hardwired Approach For Loans

- Very few points of difference between the hardwired approach for loans and the recommended fallback language for floating rate notes and securitizations
- **Early Opt-in Trigger** – The Amendment and Hardwired Approaches each have an “early opt-in” trigger.
  - An “early opt-in” trigger could reduce the inventory of loans that would have to be transitioned upon LIBOR cessation. Thus, this could reduce systemic risk.
  - In the hardwired approach, the early opt-in trigger is drafted so that, if a loan transitions as a result of an “early opt-in”, the successor rate will be Term SOFR plus Benchmark Replacement Adjustment
- **Compounded SOFR** – Similar but the definition would allow for in advance or in arrears; if RGB-recommended rate or conventions are not available, next step in waterfall is the rate or conventions found in five, publicly available USD-syndicated loans.
- **Amendment** – If the pre-determined rate plus spread adjustment is not available, the hardwired approach falls back to an amendment process (looks like amendment approach)
- **ISDA Spread Adjustment** – ISDA spread adjustment is available to use with both Term SOFR and Compounded SOFR
- **Screen Rates**
  - Replacement Benchmark and Benchmark Replacement Spread (in most cases) to be published on a screen.
  - Because syndicated loans typically allow for borrowings in different tenors, Administrative Agent can remove (and later reinstate) Term SOFR tenors which are not available as screen rates.

# Amendment Approach For Loans Follows What Has Already Been Adopted by the Loan Market

- Sets forth a process for transitioning to a successor rate without selecting the successor rate and spread adjustment now (*i.e.*, no waterfalls)
- Largely follows the fallback language that has developed in the syndicated loan market
  - About 71% of 1Q19 institutional loans use a structure where the Borrower and Administrative Agent select a rate with Required Lenders having an objection right (*Covenant Review, April 2019*)
- **Triggers** - Mandatory and early “opt-in” triggers
  - Early “Opt-in” Trigger: USD-denominated syndicated loans are being executed or amended to incorporate or adopt a new benchmark to replace LIBOR
- **Successor rate**
  - Alternate benchmark rate selected by the borrower and administrative agent giving due consideration to any recommendation by the Relevant Governmental Body (RGB, *i.e.*, ARRC or Fed) or evolving or then prevailing market convention for USD-denominated syndicated loans
  - Not prescriptive
- **Spread adjustment**
  - Selected by the borrower and administrative agent, considering recommendation by RGB or evolving or then prevailing market convention for USD-denominated syndicated loans
  - Not prescriptive
- **Lender consent**
  - “Required Lenders”, *i.e.*, a majority, get objection rights in the case of mandatory triggers; affirmative vote in the case of the opt-in trigger
  - Five business day window for objection/consent

# Pros and Cons Of Libor Fallback Options For Loans

## Amendment Approach

- Pros
  - Relies on loans' amendment flexibility
  - Familiar and similar to what is occurring today
  - Doesn't rely on a rate/spread adjustment that isn't known today
- Cons
  - May be subject to gamesmanship by borrower or lenders at trigger depending on economic environment
  - As the replacement rate is not known today, difficult to begin operationalizing it
  - May not actually work if thousands of loan agreements have to be amended at LIBOR cessation

## Hardwired Approach

- Pros
  - Same approach as being taken by other cash products, derivatives
  - Because terms are agreed upfront, it's less susceptible to gamesmanship at cessation
  - Can begin to be operationalize
  - Because lender consent is not needed, should be executable en masse at LIBOR cessation
- Cons
  - Relies on a rate and spread adjustment that is not known today

# Differences between Bilateral Loans and Syndicated Loans

- The bilateral loan language contains more optionality around certain provisions than the syndicated loan language, reflecting the significant diversity of transaction terms in the bilateral business loan market, including:
  - which parties have consent rights for benchmark replacement rates and spread adjustments selected under the Amendment Approach (or the "streamlined amendment" step in the waterfall for the Hardwired Approach), including an option for no borrower consent rights,
  - whether borrower consent is needed to trigger an Early Opt-In Election, and
  - whether the lender must give due consideration to Relevant Governmental Body selections or recommendations or market conventions when determining benchmark replacement rates.
- A requirement that there be at least [five] outstanding U.S. dollar-denominated syndicated or bilateral credit facilities that contain a replacement benchmark rate in order for the lender to trigger the Early Opt-in Election under the Amendment Approach.
- Recommended language that would allow parties to automatically synchronize the rates under their bilateral loans to standard ISDA successor rates and spread adjustments upon an index cessation event specified in the ISDA definitions, to fully align the loan product with ISDA fallbacks.

# Securitizations: Trigger Events

**Two “permanent cessation” events**

*A public statement by (1) the administrator of LIBOR or (2) the regulator or other body having jurisdiction over the administrator that it will has ceased or will cease to provide LIBOR, permanently or indefinitely*

- designed to be objective observable events, effective on permanent or indefinite cessation of LIBOR
- same triggers as in fallback language for derivatives and other cash products

**One “pre-cessation” trigger event**

*A public statement by the FCA the LIBOR is “no longer representative”*

- same as other cash products
- ISDA just published a consultation about whether to include in derivatives

**One “structural” trigger event**

*The “Asset Replacement Percentage” is greater than [50%] according to the most recent servicer report*

- measures the ratio of assets indexed to LIBOR over all assets
- unique to securitizations
- designed to address mismatch in timing between trigger of assets vs trigger of securitization

# Securitizations: Benchmark Replacement Rate “Waterfall”

- On the effective date of a trigger event, LIBOR will be replaced by the highest available replacement:
  - Term SOFR + spread
  - Compounded SOFR + spread
  - ARRC-selected replacement + spread
  - ISDA-selected replacement for derivatives + spread
  - Designated transaction representative-selected replacement + spread
- Note: The first bucket- “Term SOFR”- *does not exist today*
  - There is no assurance that it will exist by the time a trigger event occurs
  - Derivatives plan to use Compounded SOFR, *not Term SOFR*, in their LIBOR fallback provisions
  - The ARRC believes that compounded or simple average SOFR should be used when possible
- Note: “Compounded SOFR” can be done “in advance” or “in arrears”
  - Derivatives and Floating Rate Notes plan to use “in arrears”
  - Standard conventions for compounding are now being developed
- Transaction Parties may prefer to use “simple average SOFR” instead of Compounded SOFR

# Securitizations: Other Key Fallback Provisions

**Benchmark Replacement Adjustment (aka "spread")**

- On the effective date of a trigger event, the applicable spread will be determined according to a waterfall:
  - the spread selected by the ARRC for the applicable Benchmark replacement rate
  - the spread selected by ISDA for derivatives, if the applicable Benchmark replacement rate is equivalent to the applicable ISDA successor rate, which is currently expected to be Compounded SOFR in arrears.
  - the spread selected by the designated transaction representative for the applicable Benchmark replacement rate

**Benchmark Replacement Conforming Changes**

- Because conventions may evolve over time, the Designated Transaction Representative can make certain conforming changes to the securitizations in order to appropriately implement and apply the successor rate
  - Intended to accommodate *technical, administrative or operational changes* that are substantially consistent with market practice

**Certain Decisions and Determinations**

- Decisions made by the Designated Transaction Representative to implement the fallback provisions may be made in its "sole discretion" and are "conclusive and binding absent manifest error"
  - *e.g.*, whether a trigger has occurred and what is the applicable successor rate and spread adjustment

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