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WHITE PAPER

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ARRC Publishes Final LIBOR Transition Recommendations for Securitizations and Bilateral Business Loans

Financial institutions around the world are addressing the probable cessation of "LIBOR" interest rates before 2022 by, among other things, developing language designed to substitute an industry-approved successor rate (most likely to be based on the "Secured Overnight Financing Rate," or "SOFR," for the U.S. dollar) seamlessly in the event of such a cessation. The Alternative Reference Rates Committee ("ARRC") has recently released its final "fallback language" recommendations for USD-denominated securitizations ("Securitizations") and bilateral business loans ("Bilateral Loans"). While the recommended language is "final," it leans heavily on future market developments to provide fundamental calculation conventions. We would expect to see the recommendations for Bilateral Loans to be implemented relatively quickly for new and amended loans, but it remains to be seen to what extent the "Hedged Loan Approach" will be adopted in the market. The recommended language for Securitizations has already been implemented in a Ford auto loan securitization.

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The Alternative Reference Rates Committee ("ARRC") published final recommended LIBOR fallback language (the "Recommendations") for newly issued (and amended) Securitizations and Bilateral Loans on May 31, 2019. The Recommendations, like those for Floating Rate Notes and Syndicated Loans, reflect elements of both growing industry consensus as well as fundamental differences between the products. Most notably, the language for Securitizations (the "Securitization Language") includes an additional "pre-cessation trigger" based on conversion away from LIBOR of underlying assets, while the Bilateral Loan language (the "Bilateral Loan Language") adds an additional "Hedged Loan Approach" to the "Amendment Approach" and "Hardwired Approach" the ARRC had previously recommended for Syndicated Loans (the "Syndicated Loan Language").

SECURITIZATION TRIGGER EVENTS

The Securitization Language continues a consistent theme in ARRC documentation of having "Benchmark Transition Events" (which commence the process of rate replacement) include the two "ISDA cessation events" and an additional "non-representativeness" trigger. Under the Securitization Language, it is the responsibility of the "Designated Transaction Representative" (defined to mean "the party identified by the transaction documents to perform" a "particular obligation to be performed in connection with [benchmark] transition") to determine the occurrence of a Benchmark Transition Event. ISDA has recently launched a market consultation to determine the feasibility and appropriateness of inclusion of such a "non-representativeness" trigger in its Definitions in an effort to seek to reduce "trigger basis risk." The "Designated Transaction Representative" concept is designed to remove any ambiguity concerning responsibility for benchmark transition, which has been a "hot button" issue for trustees and other non-economic transaction participants.

The Securitization Language includes an additional optional "Asset Replacement" trigger, which is designed to meet the unique concerns when investors face a pool of financial assets on a non-recourse basis, many of which financial assets, like commercial loans in CLOs and CMBS and residential mortgages in RMBS, will themselves be subject to their own benchmark transition processes. The "Asset Replacement" triggers occurs upon the "Asset Replacement Percentage" reaching a specified level (the Securitization Language posits a level of 50 percent as an example but is careful to distance itself from recommending any particular Asset Replacement Percentage for any given structure or asset class). The Asset Replacement Percentage definition must be carefully considered and drafted, as the exemplar language will likely turn out to be fit for purpose only in the most simple situations.

SECURITIZATION BENCHMARK REPLACEMENT WATERFALL

The fallback waterfall under the Securitization Language contains five stops, with an intervening interpolation "stop" at the top of the waterfall. The waterfall is run upon the occurrence of a Benchmark Transition Event, with optional language for the waterfall to be re-run periodically to check for Term SOFR when the applicable rate is "Step Two" (see below). The waterfall has also been "future-proofed" to make its provisions applicable equally to the demise of LIBOR and of any replacement rate(s), including SOFR.

The Securitization fallback waterfall runs as follows:

- Interpolation between LIBOR (or then-operative fallback rate) tenors

  If LIBOR for a given interest period is unavailable but that period is bracketed by periods for which LIBOR is determinable, LIBOR as "interpolated" on a linear basis between the two would serve as the replacement benchmark.

- Term SOFR plus Benchmark Replacement Adjustment

  "Term SOFR" is a placeholder in both the Securitization Language and the Bilateral Loan Language for a forward-looking SOFR-based term rate to be selected or recommended by the ARRC or another "Relevant Governmental Body." Although the ARRC has committed to attempt to endorse a "Term SOFR" rate (subject to sufficient liquidity developing), the ARRC has utilized the publication of the Recommendations to remind the market again that there can be no assurance that Term SOFR (or any other forward-looking rate) will be approved by the time of LIBOR cessation (if ever). The Recommendations accordingly admonish market participants not to await the approval of a Term

SOFR but to start utilizing Compounded SOFR or other daily SOFR accrual as the primary benchmark rate in amendments and new financings *immediately*.

The "Benchmark Replacement Adjustment" (discussed further below) is an element common to all stops on the fallback waterfall (other than the interpolation "stop").

- "Step Two" under the Securitization waterfall has (arguably) two options:

  i. Compounded SOFR plus Benchmark Replacement Adjustment

     Despite strong suggestions to the contrary in the "User's Guide" in Part III, the actual Securitization Language is perfectly agnostic as between compounding in arrears and compounding in advance and leaves that choice, together with ancillary calculation conventions for "lookback" and/or "suspension" periods and other technical matters, to be either specifically agreed between the parties or as recommended by the ARRC or another Relevant Governmental Body. If Compounded SOFR cannot be determined on the basis of the foregoing, then Compounded SOFR will be determined in accordance with conventions selected by the Designated Transaction Representative, "giving due consideration to any industry-accepted market practice." The ARRC has published "A User's Guide to SOFR" that provides a detailed explanation of some of the options, mechanisms, and other conventions that could be employed for calculating Compounded SOFR.

     Compounded SOFR in arrears is also the rate ISDA plans to use as the primary fallback to LIBOR. The ARRC recommends removing the "Term SOFR" item from the waterfall when cohesion with hedging instruments (i.e., lack of basis risk) is paramount.

  ii. "Simple Average" SOFR plus Benchmark Replacement Adjustment

     The "Simple Average" option in the actual Securitization Language has been relegated to a footnote, but the User's Guide in Part III elevates it to a separate "Option 2" and supplies language for this purpose.

- Rate Endorsed by Relevant Governmental Body plus Benchmark Replacement Adjustment

  Because SOFR already exists and it is already possible to average SOFR over various interest periods to derive compound or simple SOFR averages, the remaining fallbacks cater to the situation in which SOFR is no longer being published. Because the ARRC selected SOFR as the primary fallback rate for LIBOR, one can anticipate that the ARRC or a similar industry body would be convened to select SOFR's successor.

- The "ISDA Fallback Rate" plus Benchmark Replacement Adjustment

  This stop refers to the SOFR fallbacks under the yet-to-be-finalized revisions to the "2006 ISDA Definitions" (the "ISDA Definitions"). The revisions as currently proposed contemplate the Overnight Bank Funding Rate, which is published by the Federal Reserve Bank of New York, and the "effective federal funds" rate or range midpoint targeted by the Federal Reserve's Open Market Committee, in that order, to serve as SOFR fallbacks.

  The Securitization Language also contains a variant to allow parties to "skip over" the ISDA Fallback Rate.

- Designated Transaction Representative Selection plus Benchmark Replacement Adjustment

  The final stop on the Securitization fallback waterfall is for the Designated Transaction Representative to select an alternative reference rate "giving due consideration to any industry-accepted rate of interest as a replacement for the then-current Benchmark."

SECURITIZATION BENCHMARK REPLACEMENT ADJUSTMENT

The Benchmark Replacement Adjustment is necessary to equalize the (nearly) risk-free SOFR rate with LIBOR, which implicitly incorporates a bank credit risk spread. Thus far, ISDA is the farthest along among industry groups in developing a means for calculating this "spread adjustment" and intends to compare the forward curves for SOFR and LIBOR for each tenor on each day during an extended period (five or ten years) and to use the mean or median spread between the two to fix the spread adjustment for each tenor permanently.

The Benchmark Replacement Adjustment waterfall under the Securitization Language operates identically no matter which fallback is selected under the Securitization fallback waterfall. The spread adjustment waterfall runs as follows: (i) the spread adjustment selected or recommended by the ARRC or another Relevant Governmental Body; (ii) the spread adjustment as determined under the ISDA Definitions; and (iii) the spread adjustment selected by the issuer (or a designee) "giving due consideration to any industry-accepted spread adjustment."

Ford Motor Credit announced during the week of June 10 that it had launched an auto loan securitization with a floating rate tranche reflecting the Securitization Language.

BILATERAL LOAN TRIGGER EVENTS

The Bilateral Loan Language includes the same three Benchmark Transition Events as the Syndicated Loan Language and the Securitization Language. Similar to the Syndicated Loan Language, the Amendment Approach under the Bilateral Language recognizes that time may be needed to amend an extensive number of credit agreements in the case of a preannounced LIBOR cessation and suggests a window (up to 90 days) prior to the actual LIBOR transition date in which amendments can take place.

The Bilateral Loan Language also provides an "Early Opt-In Election" to implement replacement rate provisions based on certain market developments, as determined by the lender and notified to the borrower, prior to the occurrence of a Benchmark Transition Event. There are slight differences in this opt-in trigger between the Hardwired Approach and the Amendment Approach, with the Hardwired Approach applying a more objective trigger tied to a minimum amount of deals using Term SOFR being executed. However, to limit lender discretion, the Hardwired Approach includes proposed optional language requiring such deals to be publicly available for review.

BENCHMARK REPLACEMENT WATERFALL—HARDWIRED APPROACH

Like the Syndicated Loan and Securitization fallback waterfalls, the fallback waterfall under the Hardwired Approach for bilateral loans is "future-proofed" and applies both to LIBOR cessation and to cessation of any replacement rate(s), including SOFR. The waterfall has three stops, with an interim stop between Term SOFR and Compounded SOFR, and runs as follows:

- Term SOFR plus Benchmark Replacement Adjustment (discussed below)

- Next Available Term SOFR plus Benchmark Replacement Adjustment

  With "Next Available Term SOFR," if Term SOFR for the existing tenor does not exist, the lender has the ability to apply Term SOFR for the next longest tenor, if available, without having to proceed to Compounded SOFR. This interim stop allows the lender to use the longest existing Term SOFR that is shorter than a given tenor (plus that shorter tenor's corresponding Benchmark Replacement Adjustment).

- Compounded SOFR plus Benchmark Replacement Adjustment

  As with Syndicated Loans, no market-standard methodology for calculating Compounded SOFR currently exists in the bilateral loan market, so the recommended language allows for then-existing market convention to direct the determination of Compounded SOFR. This involves a two-step analysis that first looks to any recommendations or selections by the ARRC as to rate, methodology, and/or conventions and, if none then exist, then to those determined by the lender that are consistent with at least [five] publicly available syndicated or bilateral loans. Reflecting a growing market preference, the language specifically contemplates compounding in arrears with a lookback or lockout period but, like the Syndicated Loan Language, does not rule out the use of compounding in advance. It also acknowledges that there may be a preference for a simple (instead of compounded) average of SOFRs and provides alternative language for this purpose.

- Lender Selected Rate plus Benchmark Replacement Adjustment

  This last stop in the waterfall allows for the lender to determine the replacement rate and any related Benchmark Replacement Adjustment based on then-existing market conventions. The Bilateral Loan Language contemplates a "negative consent" mechanism after receiving notice of the replacement rate from the lender. If the borrower objects, the lender will continue proposing rates until one is acceptable to the borrower. An alternative mechanism is for the replacement rate to become effective automatically within an agreed number of days after notice of such rate is provided to the borrower. This last stop represents roughly where the Amendment Approach commences.

BENCHMARK REPLACEMENT ADJUSTMENT—HARDWIRED APPROACH

The Benchmark Replacement Adjustment under the Hardwired Approach (like the Syndicated Loan Language) is dependent on the then-applicable Benchmark Replacement. This operates as follows:

- If the Benchmark Replacement is Term SOFR, Next Available Term SOFR, or Compounded SOFR, the spread adjustment selected by the ARRC or another Relevant Governmental Body, or (if not available) the spread adjustment as determined under the 2006 ISDA Definitions, applies.

- If the Benchmark Replacement is a Lender Selected Rate, then a spread adjustment selected by the lender that gives "due consideration" to (i) any adjustment selected by the ARRC or other Relevant Governmental Body or (ii) wany "evolving or then-prevailing market convention for determining a spread adjustment" for syndicated or bilateral loans applies.

AMENDMENT APPROACH FOR BILATERAL LOANS

Under the Amendment Approach, the lender selects the Benchmark Replacement and the Benchmark Replacement Adjustment after giving due consideration to (i) any rate and adjustment selected by the ARRC or another Relevant Governmental Body or (ii) any "evolving or then-prevailing market convention" for syndicated or bilateral loans. The rates and adjustments selected by the lender become effective in the case of a Benchmark Transition Event and an Early Opt-In Election. This happens automatically within an agreed upon number days after the lender has provided notice of such event and such selected rates and adjustments to the borrower unless, if the parties agree to include a negative consent right for all trigger events or just an Early Opt-In Election, the borrower has objected to such selected rates and adjustments within such period.

The Amendment Approach generally follows the "LIBOR replacement" language that is currently being used in the syndicated and bilateral loan markets but with a few material differences. The fallback language includes more specific trigger events as noted above and, although not prescribed, makes express reference to Term SOFR plus credit spread adjustment as the probable replacement rate. Consistent with current market language but unlike the Hardwired Approach language, it does not address any future reference rates that might exist and applies solely to the replacement of LIBOR and not SOFR or other replacement rates (i.e., it is not "future-proofed").

HEDGED LOAN APPROACH FOR BILATERAL LOANS

Unlike the Syndicated Loan Language, the Bilateral Loan Language includes an additional "Hedged Loan" amendment approach that effectively aligns the trigger events, replacement rate, and any spread adjustments under a borrower's bilateral loan with those as determined in accordance with the not-yet-finalized revisions to the ISDA Definitions. Borrowers that are concerned with "basis risk" upon LIBOR cessation may prefer this amendment approach since it is designed to eliminate any potential mismatch between the fallback and replacement rate terms in its bilateral loan(s) and any related interest rate swap(s). However, since the Hedged Loan Approach will incorporate the "non-representativeness" trigger only if it is included in the ISDA Definitions and will likely not include Term SOFR as an optional replacement rate, this approach may not track market convention in the bilateral loan market.

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