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Legal Update

The ARRC's Final Recommendations for New Fallbacks for LIBOR Floating Rate Notes

On April 25, 2019, the Alternative Reference Rates Committee ("ARRC") published "ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Floating Rate Notes" ("ARRC Recommendations").[1] The ARRC Recommendations resolved two key elements for LIBOR fallback language, and left some items to be resolved in the future. The ARRC Recommendations include a definition of what constitutes a cessation of LIBOR and provide a "waterfall" of replacement rates to be used when LIBOR is no longer published or is no longer representative. The waterfall of spread adjustments, designed to adjust for the differences between the replacement rate and LIBOR, was also finalized, although the method of calculation for two of the adjustments has not yet been fully determined.

LIBOR Cessation Definitions

There are three "Benchmark Transition Events," the occurrence of any of which will trigger a move from LIBOR to the replacement rate.

The first two Benchmark Transition Events are triggered on a permanent cessation of LIBOR and align with the LIBOR triggers in the International Swaps and Derivatives Association, Inc. ("ISDA") 2018 Consultation. These two triggers require that the LIBOR administrator (currently ICE Benchmark Administration), the LIBOR regulatory supervisor of the LIBOR administrator (currently the U.K. Financial Conduct Authority), the U.S. Federal Reserve System (as the central bank for the currency of USD LIBOR) or a bankruptcy/resolution official or court with jurisdiction over the administration of LIBOR publicly state or publicize information that LIBOR has actually ceased or is expected to cease. These Benchmark Transition Events will not trigger a change from LIBOR until the date that LIBOR ceases to be published, if that date is later than the date of the relevant announcement. In contrast, for the pre-cessation trigger described below, the change from LIBOR would begin on the date of the announcement or publication.

The ARRC Recommendations added a pre-cessation trigger predicated on "a public statement or publication of information by the regulatory supervisor for the administrator of the Benchmark announcing that the Benchmark is no longer representative." This and two other pre-cessation triggers were proposed by the ARRC in its

September 24, 2018 consultation, but only the current pre-cessation trigger was retained.[2]

ARRC has tried to be consistent with LIBOR replacement provisions in other products, such as derivatives and loans. The ARRC Recommendations note that while ISDA has proposed the same permanent cessation triggers, it is considering adding a pre-cessation trigger, which may be the same as ARRC's pre-cessation trigger. However, the ARRC Recommendations warn that if ISDA's cessation triggers do not match those used for floating rate notes and a Benchmark Replacement occurs based on ARRC's pre-cessation trigger, the related hedges may not match the terms of the floating rate note.

Benchmark Replacement Waterfall

ARRC also finalized the order of replacement rates for LIBOR floating rate notes in a Benchmark Replacement Waterfall:

- Step 1: Term SOFR + Adjustment
- Step 2: Compounded SOFR + Adjustment
- Step 3: Relevant Governmental Body Selected Rate + Adjustment
- Step 4: ISDA Fallback Rate + Adjustment
- Step 5: Issuer or its Designee Selected Rate + Adjustment

An issuer may not move down the Benchmark Replacement Waterfall in the event that some LIBOR tenors have become subject to a Benchmark Transition Event but both shorter and longer tenors are available. In that event, the missing LIBOR tenor would be interpolated based on the nearest tenors that can be determined. For example, if 3-month USD LIBOR has ceased publication but 1-month and 6-month USD LIBOR are still being published, the issuer would use an "Interpolated Benchmark" (*i.e.*, interpolated USD LIBOR) before proceeding to the Benchmark Replacement Waterfall.

Each step is accompanied by helpful commentary.

Term SOFR + Adjustment: This would be a forward-looking term rate with a tenor matching the LIBOR tenor selected or recommended by the "Relevant Governmental Body" (the ARRC for USD LIBOR). As the ARRC has previously noted, it is not expected that a term Secured Overnight Financing Rate ("SOFR") that is IOSCO-compliant and based on a broad derivatives market will be available prior to the expected LIBOR cessation.[3] Also, because ISDA is not expected to reference a forward-looking term rate, the use of this rate in floating rate notes may cause a hedging mismatch. Consequently, the ARRC confirms that issuers may wish to delete term SOFR from the Benchmark Replacement Waterfall and adjust other terms accordingly.

Compounded SOFR + Adjustment: Compounded SOFR, which was discussed extensively in the ARRC's "A User's Guide to SOFR," is a method to create an interest rate for a period by using a compounded average of the daily SOFR rates during the interest period. The interest calculation is done "in arrears," *i.e.*, at the end of the interest period. The definition of Compounded SOFR specifically allows for a lookback or suspension period and flexibility for change in the future due to direction from the ARRC or market-accepted conventions. The ARRC Recommendations also allow users to use a simple average of SOFR, rather than compounded SOFR, plus an adjustment, if desired.

Compounded SOFR requires a lookback or suspension period because SOFR is a backward-looking rate, and the rate announced each day is actually the rate that was used the previous day. The plumbing issue here is that a normal floating rate note interest period begins on the settlement date or the previous interest payment date, and interest accrues from that date to but excluding the next interest payment date or the maturity date, as applicable. If an interest payment date falls on a Friday, the rate announced on that Friday would be Thursday's rate, allowing the interest rate to be calculated on Friday but with no advance notice to holders and insufficient time to ensure that the paying agent can receive funds from the issuer and then pay the interest payment to holders on that day.

The ARRC's answer is to use a lookback or suspension period. Using a suspension or "lockout" method, the daily SOFR rate would "lock in" a certain number of business days before the last day of the interest period. For example, if the interest payment date was Friday, with interest accruing through Thursday, and a four business day lockout period was in effect, the SOFR rate for the Friday before the interest payment date, which would be published on the Monday prior to the interest payment date, would hold to and including Thursday. Consequently, on Monday morning, the issuer, paying agent and the holders would have advance notice of the interest payment to be made on Friday. Similar results can be obtained with a lookback period, pursuant to which each day's daily SOFR rate is the rate published a certain number of days previously.

Relevant Governmental Body Selected Rate + Adjustment: This choice is designed to address a situation in which a SOFR-based rate has been discontinued and the ARRC or other similar governmental committee selects or recommends a replacement rate.

ISDA Fallback Rate + Adjustment: Failing steps one through three, an issuer would look to the fallback rate used by ISDA in the 2006 ISDA Definitions (the "ISDA Definitions") in effect at the time of the LIBOR cessation. The current ISDA Fallback Rate, included in "USD-SOFR-COMPOUND" and published in ISDA Supplement No. 57, is a sequence that first looks to the ARRC's recommended replacement for SOFR, next the Overnight Bank Funding Rate published by the Federal Reserve Bank of New York, then the FOMC Target Rate published by the Board of Governors of the Federal Reserve System. However, these specific current ISDA fallback rates are not enumerated in the definition of "ISDA Fallback Rate" because the ARRC Recommendations allow for changes by ISDA in the future.

Issuer or its Designee Selected Rate + Adjustment: This final step allows an issuer or its designee to choose a replacement rate for the corresponding LIBOR tenor that "gives due consideration to any industry-accepted rate of interest as a replacement for the then-current Benchmark for U.S. dollar denominated floating rate notes at such time ...." The ARRC Recommendations also allow for an issuer to skip Step 4 (ISDA Fallback Rates) and go directly to Step 5 if the ISDA Fallback Rate is not an industry-accepted successor rate for floating rate notes at that time.

Benchmark Replacement Adjustments

Because SOFR is backward-looking, secured, has no tenors and does not reflect credit risk, as does LIBOR, which is an unsecured forward-looking rate, there will have to be an adjustment to the Benchmark Replacement to compensate for the differences. These adjustments may be positive, negative or zero. There are three elements in the Benchmark Replacement Adjustment Waterfall:

- ARRC Selected Adjustment
- ISDA Fallback Adjustment
- Issuer or its Designee Selected Adjustment

The method of calculation of the first two Benchmark Replacement Adjustments has yet to be determined.

ARRC Selected Adjustment: This adjustment is designed to be used with Term SOFR to correlate with the related LIBOR tenor. Because the ARRC acknowledges that market participants may want to skip Term SOFR as a Benchmark Replacement, going straight to Compounded SOFR to achieve greater alignment with derivatives, in doing so issuers should also remove the ARRC Selected Adjustment from their documentation.

ISDA Fallback Adjustment: This adjustment is designed to be used only if the Benchmark Replacement is the ISDA Fallback Rate. The ARRC Recommendations note that ISDA has not analyzed, and will not analyze, whether its fallbacks, including any spread adjustments, are appropriate in a non-derivative context.

Issuer or its Designee Selected Adjustment: Much like the Issuer or Designee Selected Benchmark Replacement, this Adjustment allows an issuer or its designee to choose an adjustment that gives "due consideration to any industry-accepted spread adjustment, or method for calculating or determining such spread adjustment, for the replacement of the then-current Benchmark with the applicable Benchmark Replacement for U.S. dollar denominated floating rate notes at such time."

Some Helpful Definitions and Other Provisions

The ARRC Recommendations contain a number of helpful provisions for issuers, allowing issuers, calculation agents and others to make conforming changes to terms such as day count conventions and other administrative matters. These provisions add flexibility for issuers of LIBOR floating rate notes, particularly if they are using the Issuer or its Designee Selected Rate as a Benchmark Replacement, and/or the Issuer or its Designee Selected Adjustment.

For example, the definition of "Benchmark Replacement Conforming Changes" reads:

[w]ith respect to any Benchmark Replacement, any technical, administrative or operational changes (including changes to the definition of "Interest Period," timing and frequency of determining rates and making payments of interest … and other administrative matters) that the issuer or its designee decides may be appropriate to reflect the adoption of such Benchmark Replacement in a manner substantially consistent with market practice (or, if the issuer or its designee decides that adoption of any portion of such market practice is not administratively feasible or if the issuer or its designee determines that no market practice for use of the Benchmark Replacement exists, in such other manner as the issuer or its designee determines is reasonably necessary).

These conforming changes can be made by the issuer or its designee from time to time in connection with a Benchmark Replacement.

The provisions under "Effect of Benchmark Transition Event," which clarify the effect of a Benchmark Replacement and the rights of the issuer and note holders in connection with that replacement, are helpful to issuers, calculation agents and other designees:

(a) *Benchmark Replacement*. If the issuer or its designee determines that a Benchmark Transition Event and its related Benchmark Replacement Date have occurred prior to the Reference Time in respect of any determination of the Benchmark on any date, the Benchmark Replacement will replace the then-current Benchmark for all purposes relating to the Notes in respect of such determination on such date and all determinations on all subsequent dates.

(b) *Benchmark Replacement Conforming Changes*. In connection with the implementation of a Benchmark Replacement, the issuer or its designee will have the right to make Benchmark Replacement Conforming Changes from time to time.

(c) *Decisions and Determinations*. Any determination, decision or election that may be made by the issuer or its designee pursuant to this Section titled "Effect of Benchmark Transition Event," including any determination with respect to a tenor, rate or adjustment or of the occurrence or non-occurrence of an event, circumstance or date and any decision to take or refrain from taking any action or any selection, *will be conclusive and binding absent manifest error, may be made in the issuer or its designee's sole discretion, and, notwithstanding anything to the contrary in the documentation relating to the Notes, shall become effective without consent from any other party*.

[Emphasis added.][4]

The ARRC Recommendations also note that including general disclaimer language with respect to LIBOR or any successor rate (such as risk factors) would not be inconsistent with the ARRC's principles.[5]

Effect on New LIBOR Floating Rate Note Issuances

With the publication of the ARRC Recommendations, issuers of LIBOR floating rate notes likely will update the old LIBOR fallbacks. As stated by ARRC, the "ARRC recommendation for FRNs provides a complete fallback solution."[6]

Because LIBOR is currently being quoted, documentation for a new LIBOR floating rate note should reference the current disclosure regarding taking the LIBOR rate from the Reuters screen page, and related terms, such as the LIBOR interest determination date, the definition of London banking day, the index currency and the index maturity (tenor).

However, in the unlikely event that the LIBOR rate is not available onscreen as so described and a Benchmark Transition Event has not occurred, issuers should not reference the fallback provisions from the ISDA Definitions. These provisions involve polling banks for quotes for loans and deposits in the same tenor as the LIBOR floating rate note. As noted by the ARRC, the existing waterfall for obtaining a LIBOR quote by polling is not feasible.[7] It would be unlikely that LIBOR would cease publication, even for a short period of time, without causing a Benchmark Transition Event to occur.

At least one large, frequent issuer took a new approach in a recent issuance of LIBOR floating rate notes. In the event that LIBOR of the relevant tenor was not published onscreen, but a Benchmark Transition Event and its related Benchmark Replacement Date had not yet occurred, then the calculation agent may determine LIBOR of the relevant tenor after consulting any sources comparable to the relevant screen page, or any source it deems reasonable from which to estimate the relevant LIBOR rate for U.S. Dollar deposits. However, if a Benchmark Transition Event and its related Benchmark Replacement Date have occurred, the floating rate note would transition from LIBOR to the Benchmark Replacement and related Replacement Adjustment in accordance with the provision of the ARRC Recommendations.

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Endnotes

[1] The ARRC Recommendations are available at: https://nyfed.org/2PEacxu.

[2] The ARRC Consultation Regarding More Robust Fallback Language for new Issuances of Floating Rate Notes (Sept. 24, 2018) (the "2018 Consultation") is available at: https://nyfed.org/2PIOh8p.

[3] *See* "A User's Guide to SOFR" at: https://nyfed.org/2USOC9v.

[4] ARRC Recommendations at p. 4.

[5] ARRC Recommendations at p. 21.

[6] *Id.*

[7] *See generally* the 2018 Consultation at p. 5.