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Legal Update

The ARRC's Final Recommendations for New Fallbacks for LIBOR Securitizations

On May 31, 2019, the Alternative Reference Rates Committee ("ARRC") published "ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Securitizations" ("ARRC Recommendations").[1] 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 four "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 UK Financial Conduct Authority), the US 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 (referred to as a "Benchmark Replacement Date" in the ARRC Recommendation) 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 also added two pre-cessation triggers. The first is 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 December 7, 2018 consultation, but only the current pre-cessation trigger was retained.[2]

The second pre-cessation trigger is predicated on an "Asset Replacement Percentage" being greater than a specified percentage, as reported on the most recent servicer report. We note that the ARRC Recommendation provides the transaction parties with flexibility to set the appropriate trigger percentage. The Asset Replacement Percentage is defined as the outstanding principal balance of the assets that were indexed to LIBOR (or other relevant original benchmark) as a percentage of the outstanding principal balance of all relevant assets. This trigger is meant to minimize basis risk between securities and the assets underlying such securities by providing a conversion event if a set percentage of the underlying assets have converted to the replacement benchmark or have been replaced by assets accruing interest at the replacement benchmark. The ARRC Recommendation notes that the transaction parties may elect not to include this pre-cessation trigger if the particular structure of the securitization transaction makes this trigger unnecessary or inappropriate or, if included, the trigger should be specifically tailored to the particular transactions (including the specific reporting mechanics). This Benchmark Trigger Event will not trigger a Benchmark Replacement Date from LIBOR until a specified number of business days selected by the transaction parties after the date of the relevant servicer report showing such trigger event.

The ARRC has tried to be consistent with LIBOR replacement provisions in other products such as derivatives, loans and floating rate notes. 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 the ARRC's pre-cessation trigger regarding LIBOR no longer being representative. However, the ARRC Recommendations warn that if ISDA's cessation triggers do not match those used for securitizations and a benchmark replacement occurs based on one of the ARRC's pre-cessation trigger, the related hedges may not match the terms of the securitization.

Benchmark Replacement Waterfall

The ARRC also finalized the order of replacement rates for LIBOR securitizations 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: Designated Transaction Representative Selected Rate + Adjustment

If a benchmark replacement is selected pursuant to Step 2, then the ARRC recommends that on the first day of each calendar quarter (or other period selected by the transaction parties) following such selection, if a redetermination of the benchmark replacement on such date would result in the selection of a benchmark replacement under Step 1, then (x) the Adjustment will be redetermined on such date utilizing the unadjusted benchmark replacement corresponding to the benchmark replacement under Step 1 and (y) such redetermined benchmark replacement shall become the benchmark on each determination date on or after such date. If redetermination of the benchmark replacement on such date as described in the preceding sentence would not result in the selection of a benchmark replacement under Step 1, then the benchmark shall remain the benchmark replacement as previously determined pursuant to Step 2.

A Designated Transaction Representative[3] 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 a 3-month USD LIBOR has ceased publication but a 1-month and a 6-month USD LIBOR are still being published, the Designated Transaction Representative 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.[4] Also, because ISDA is not expected to reference a forward-looking term rate, the use of this rate in securitizations may cause a hedging mismatch. Consequently, the ARRC confirms that Designated Transaction Representatives may wish to delete the 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 or compounding of SOFR in advance, 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 securitization 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 allow use of 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 include 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.

The ARRC Recommendation is also allowing for Compounded SOFR to be compounded in advance, which would allow SOFR to be calculated by compounding the overnight

SOFR for the previous relevant period. The ARRC Recommendation provides an example whereby, with a 30-day SOFR security with an interest period beginning on April 1, the rate could be overnight SOFR compounded daily from March 2 to March 31.

The ARRC Recommendation is also allowing for retesting of such benchmark replacement on a periodic basis. Comments received by the ARRC to the 2018 Consultation indicated that the working group believed that a Term SOFR is a superior benchmark to Compounded SOFR, so the ARRC Recommendation permits the benchmark to ultimately fall back to Term SOFR should Term SOFR not be available at the time of the Benchmark Trigger Event. The ARRC Recommendation notes that, in determining whether to allow for retesting, the transaction participants should consider the impact it may have on the ability for investors to hedge the issued securities and any other operations impacts.

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, a Designated Transaction Representative 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.

Designated Transaction Representative Selected Rate + Adjustment: This final step allows a Designated Transaction Representative to choose a replacement rate for the corresponding LIBOR tenor that giving "due consideration to any industry-accepted rate of interest as a replacement for the then-current Benchmark for U.S. dollar denominated securitizations at such time …." The ARRC Recommendation notes that, given the disparate asset classes subject to securitizations, the transaction parties should tailor the particular language so that it is appropriate for the particular securitization transaction and the subject assets.

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
- Designated Transaction Representative 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. The ARRC acknowledges that market participants may want to skip Term SOFR as a Benchmark Replacement, instead 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.

Designated Transaction Representative Selected Adjustment: Much like the Designated Transaction Representative Selected Benchmark Replacement, this Adjustment allows a Designated Transaction Representative 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 securitization transactions at such time." The ARRC Recommendation notes that transactions parties may view this responsibility as too burdensome and, therefore, gives flexibility to exclude this final step if the transaction parties are unable to select a designated representative willing to select an Adjustment.

Some Helpful Definitions and Other Provisions

The ARRC Recommendations contain a number of helpful provisions for Designated Transaction Representatives, allowing Designated Transaction Representatives to make conforming changes to terms such as day-count conventions and other administrative matters. These provisions add flexibility for Designated Transaction Representatives of securitization transactions, particularly if they are using the Designated Transaction Representative Selected Rate as a Benchmark Replacement and/or the Designated Transaction Representative 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 Designated Transaction Representative decides may be appropriate to reflect the adoption of such Benchmark Replacement in a manner substantially consistent with market practice (or, if the Designated Transaction Representative decides that adoption of any portion of such market practice is not administratively feasible or if the Designated Transaction Representative determines that no market practice for use of the Benchmark Replacement exists, in such other manner as the Designated Transaction Representative determines is reasonably necessary).

These conforming changes can be made by the Designated Transaction Representative from time to time in connection with a Benchmark Replacement.

The ARRC Recommendations caution that inclusion of the recommended fallback language will likely require other changes to the securitization documents to ensure any fallback language functions within the existing provisions of the securitization documentation. For example, modifications may be required to notice and amendment provisions to ensure that Benchmark Replacement Conforming Changes can be made without the requirement of complying with existing amendment provisions.

The provisions under "Effect of Benchmark Transition Event," which clarify the effect of a

Benchmark Replacement and the rights of the Designated Transaction Representative and securityholders in connection with that replacement, are helpful to the Designated Transaction Representative and other relevant transaction parties:

a) **Benchmark Replacement.** If the Designated Transaction Representative 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 securitization 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 Designated Transaction Representative 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 Designated Transaction Representative 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 Designated Transaction Representative's sole discretion, and, notwithstanding anything to the contrary in the documentation relating to the securities, shall become effective without consent from any other party*.

[Emphasis added.][5]

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.[6]

Effect on New LIBOR Securitizations

With the publication of the ARRC Recommendations, securitization transactions indexed to LIBOR may update the old LIBOR fallbacks. As stated by the ARRC, the "ARRC recommendation for securitizations provides a thorough fallback solution."[7]

Because LIBOR is currently being quoted, documentation for new securitization transactions indexed to LIBOR should reference the current disclosure with respect to taking the LIBOR rate from the relevant Reuters or Bloomberg 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).

Prior to the uncertainty around the continued availability of LIBOR, it had been common practice in auto and equipment loan and lease, floorplan, credit card and other non-mortgage ABS securitizations in the term market space that, upon the unavailability of published LIBOR, the relevant interest calculation would first revert to the average of quotes obtained by a number of reference banks and, if such quotes were not made available, a fallback to the last published value of LIBOR. Given the relatively short maturity dates of the LIBOR-based securities that have been issued in many of these asset classes, this methodology has continued to be used in many of these ABS transactions. However, towards the end of 2018 and the beginning of 2019, certain new issuances of credit card, floorplan and auto loan and lease securitization transactions in the term marked space began to include LIBOR fallback language, albeit in a different form than the ARRC Recommendations. In such transactions, the servicer is generally given authority to select a successor or replacement benchmark that the servicer determines is the industry-accepted substitute or successor base rate without the need to obtain securityholder consent or follow the amendment standards under the transaction documents. Warehouse and other private securitization transactions have taken a different approach, where the administrative agent on the transaction has discretion over LIBOR and the related fallback language.

There is not yet a consistent view in the securitization space as to whether the ARRC Recommendations will be adopted in full.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

James J. Antonopoulos
+1 312 701 8019
jantonopoulos@mayerbrown.com

Amanda L. Baker
+1 212 506 2544
amanda.baker@mayerbrown.com

Lindsay M. O'Neil
+1 312 701 8933
loneil@mayerbrown.com

Endnotes

[1] The ARRC Recommendations are available at: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Securitization_Fallback_Language.pdf.

[2] The ARRC Consultation New Issuances of LIBOR Securitizations (Dec. 7, 2018) (the "2018 Consultation") is available at: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Securitizations-Consultation.pdf.

[3] The ARRC Recommendation defines a Designated Transaction Representative to mean "with respect to a particular securitization transaction and a particular obligation to be performed in connection with the transition to a Benchmark Replacement, the party identified by the transaction documents to perform that obligation."

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

[5] ARRC Recommendations at p. 4.

[6] ARRC Recommendations at p. 24.

[7] ARRC Recommendations at p. 23.

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