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US DOLLAR LIBOR TRANSITION: CHALLENGES FOR SECURITIZATIONS AND NOTE ISSUERS

On January 21, 2020, the Alternative Reference Rates Committee (the "**ARRC**") published a consultation regarding spread adjustments for cash products such as floating rate notes and securitizations (available here). This consultation solicits input from market participants regarding calculation methodologies for spread adjustments. The ARRC has committed to recommending spread adjustments as part of its efforts to provide robust contractual fallback provisions to facilitate the transition from US Dollar LIBOR-based floating rates to SOFR-based floating rates. The year 2020 is a critical year for preparing for LIBOR cessation. This briefing discusses benchmark transition challenges related to LIBOR-based floating rate notes and securitizations and related issues to be considered by floating rate note issuers, securitization sponsors and servicers.

Highlights

- U.K. regulatory support for LIBOR is expected to cease at the end of 2021. Taking steps during 2020 to prepare for benchmark transition is critical.
- ARRC published recommended fallback provisions for floating rate notes and securitizations during the first half of 2019 to promote consistency and provide guidance.
- Market uptake of the ARRC's recommended fallback provisions has varied by asset class.
- Market conventions for how to calculate SOFR-based replacement rates are still developing.
- Value transfers may occur after the transition date if the replacement rate with spread adjustment fails to provide an economically equivalent rate.
- Market participants may be adversely impacted if fallback provisions for floating rate notes or securitizations fail to match up with fallback provisions for any related interest rate swaps or securitized assets.

BACKGROUND

The U.K.'s Financial Conduct Authority ("**FCA**") has announced that, after 2021, it will no longer compel certain banks to provide the quotes that are used in the production of LIBOR. This could result in LIBOR rates no longer being published. Even if LIBOR continues to be available during 2022, the FCA may determine that it is no longer representative of its underlying market. In response to these risks, regulators of major financial markets have expressed a preference to move from LIBOR to near "risk-free rates", anchored in active, liquid underlying markets. The U.S. Federal Reserve Board and Federal Reserve Bank of New York established the ARRC to identify alternative reference rates to US Dollar LIBOR, and the ARRC selected the Secured Overnight Financing Rate ("**SOFR**") as its preferred replacement rate.

In July 2019, staff of the U.S. Securities and Exchange Commission issued a statement (available here) encouraging market participants to identify, evaluate,

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and mitigate the consequences that the discontinuation of LIBOR may have on their business. In addition, they recommended that market participants consider whether any new contracts that reference LIBOR include effective fallback provisions. In December 2019, the U.S. Commodity Futures Trading Commission's Chairman Heath P. Tarbert declared 2020 to be crucial for the transition away from LIBOR and said that failing to take appropriate steps could be a source of risk to individual firms as well as the global financial system. In light of these and other regulatory communications urging market participants to prepare for LIBOR cessation, failure to engage in appropriate benchmark transition planning and mitigation could pose reputational risks and may be construed as negligent.

Key differences between LIBOR and SOFR

LIBOR and SOFR are fundamentally different rates. The following table highlights key differences that are relevant to the effectiveness of contractual fallback provisions.

LIBOR	SOFR
A **forward-looking** term rate	A **backward-looking** overnight rate
Quoted **in advance** of the period to which it relates	Quoted **after** the expiration of the period to which it relates
Based on bank submissions of the estimated cost to borrow short-term **unsecured** loans, reflecting bank credit and liquidity risk	Based on overnight transactions **secured** by US Treasury securities, reflecting minimal credit risk

As a result of these differences, SOFR has historically been **lower** than LIBOR. To smooth out the occasional volatility of this overnight rate, the ARRC has supported using a compounded average of SOFR over a specified period. To minimize the difference between a secured rate (SOFR) and an unsecured rate (LIBOR), the ARRC's recommended fallback provisions (discussed in more detail below) contemplate adding a spread adjustment to the replacement rate to yield rates comparable to US Dollar LIBOR. The ARRC's recent consultation on spread adjustments contemplates a **spread adjustment** based on historical data for a specified time period (for example, five years) ending before a benchmark replacement trigger event. This spread adjustment would be static – set at the time of a benchmark replacement trigger event and not varying during the remaining term of the note or other obligation.

The ARRC's recommended fallback provisions

The ARRC recommended fallback provisions for floating rate notes in April 2019 (available here) (the "**FRN Fallback Provisions**") and for securitizations in May 2019 (available here) (the "**Securitization Fallback Provisions**"). These fallbacks provide a hardwired "waterfall" approach for determining a SOFR-based successor rate that would apply upon the occurrence of a benchmark replacement trigger event. While use of the ARRC's recommended fallback provisions is voluntary, they provide guidance as to what type of provisions should constitute robust fallbacks in light of the anticipated cessation of LIBOR.

During the second half of 2019, we saw significantly more acceptance of the ARRC's recommended fallback provisions for unsecured floating rate notes as compared to securitizations. Issuers of unsecured floating rate notes using the FRN Fallback Provisions have included many of the financial institutions that have been serving as members of the ARRC.

By contrast, we saw less uniform adoption of the Securitization Fallback Provisions during 2019. Toward the end of the year, however, pressure from key investors led to increased use of some version of these provisions. We have also observed that securitization issuers are more likely to adopt the Securitization Fallback Provisions when there are a relatively small number of assets in the portfolio and the servicer, collateral manager or similar stakeholder has at least some control over amending the terms of the securitized assets (for example, when an affiliated entity is acting as the servicer).

Alternative fallback approaches

Some securitizations, especially CLOs, used alternatives to the Securitization Fallback Provisions that gave the collateral manager or a servicer greater discretion. Under this language, a collateral manager or servicer is able to choose and automatically shift to a replacement rate for LIBOR (at its sole discretion if it is an accepted market benchmark replacement rate, but otherwise requiring certain investor consent) upon the occurrence of specified trigger events. We have also seen hybrid fallback provisions that amalgamate certain features of the Securitization Fallback Provisions with this discretionary approach. These hybrid provisions typically require the collateral manager or servicer to first consider the replacement rate supplied by the Securitization Fallback Provisions but also permit the selection of an alternative rate if certain conditions are satisfied (for example, if more than a specified percentage of the underlying assets use that replacement rate).

KEY CONSIDERATIONS FOR DRAFTING OR REVIEWING FALLBACK PROVISIONS

Issuer and sponsor considerations

- ***Compounded average or simple average of SOFR?*** The ARRC's fallback recommendations contemplate "Term SOFR" as the first replacement benchmark rate option when no tenors of LIBOR are available for interpolation. We understand that the ARRC may not have endorsed a term SOFR in time for the expected benchmark rate transition. The ARRC's fallback recommendations specify "Compounded SOFR" as the replacement benchmark if Term SOFR cannot be determined on the benchmark replacement date. Compounded average interest reflects the time value of money more accurately than simple average interest, and it may allow for more accurate hedging. Some market participants may be uncomfortable including Compounded SOFR in fallback provisions while market conventions for its determination are still evolving (discussed in more detail below). Those parties may choose to specify Simple Average SOFR instead of Compounded SOFR when drafting their fallback provisions.
- ***Possible elections regarding calculation methodology***. Although a significant number of SOFR-based floating rate notes have already been

issued, market conventions for the calculation of Compounded SOFR are still developing. To address current uncertainty around the conventions that the market will adopt for purposes of determining SOFR-based interest, the ARRC's recommended definitions of "Simple Average SOFR" and "Compounded SOFR" have been flexibly designed to allow parties to implement prevailing methodology and conventions at the time of transition. The ARRC encourages market participants, however, to adjust the definition of "Compounded SOFR" (or "Simple Average SOFR", as applicable) in their particular fallback provisions to specify the calculation methodology or conventions to be used at the time of transition regardless of any recommendations made by the ARRC. For example, if an issuer wants to use a two business day lockout period for purposes of determining interest payable, this can be explicitly stated as part of the fallback provisions. In response the ARRC's consultation on the topic, respondents generally preferred compounded SOFR calculated in arrears.

SOFR interest accrued for an entire interest rate period using the in-arrears approach can only be calculated at the end of the relevant period. This feature, combined with the one-day lag for SOFR rate publication, creates administrative difficulties that can be mitigated using a variety of conventions including:

- **Payment Delay**: Payment is made a number of days after the interest period concludes
- **Lockout**: One of the daily SOFR rates is a cut-off rate, meaning that it is repeated for several days, typically at the end of an interest period
- **Lookback**: The SOFR rate used to calculate a rate for each day in an interest period is based on the SOFR that represents repo trading on a prior day
- **Observation period shift**: In respect of each interest period, the compounded SOFR rate is calculated based on SOFR published during an observation period that begins on a date that is a specified number of business days preceding the first date in such interest period and ends on date that is a specified number of days preceding the interest payment date for such interest period (e.g., with a two-business day shift, the observation period would start and end two U.S. business days prior to interest period start and end dates)

The ARRC's SOFR Floating Rate Conventions Matrix (November 2019), available here, is a resource meant to provide clarity regarding possible compounding calculation conventions for SOFR-based floating rate notes, including term sheets with key provisions.

- ***Potential for mismatches with related interest rate swaps.*** Issuers or borrowers with floating rate debt obligations may use interest rate swaps to hedge their exposure to floating interest rate risk. If they do, they will need to avoid a mismatch between the fallback provisions for a floating rate loan or note and the fallback provisions in the related interest rate swap. Current fallback provisions for ISDA agreements do not include the same pre-

cessation triggers as those included in the ARRC's recommended fallback provisions. ISDA has announced that it plans re-consult market participants in late February 2020 on the question whether the 2006 ISDA Definitions should be amended to include a "non-representative" pre-cessation event as a benchmark transition trigger. In addition, a spread adjustment mismatch could occur if the ARRC recommends a one-year transition period for spread adjustments or there is a difference in trigger date. Replacement benchmarks may also be mismatched if Term SOFR is available at time of benchmark replacement, because ISDA's fallback provisions do not include Term SOFR (while the ARRC's fallback provisions do). In this regard, we note that some alternative fallback approaches contemplate switching from Compounded SOFR to Term SOFR once it becomes available. Such a subsequent benchmark transition would similarly risk a hedging mismatch.

- ***Potential for mismatches with interest rates applicable to securitized assets***. For securitizations, sponsors also will need to avoid mismatches with the replacement rate that will apply to LIBOR-based underlying assets. To the extent that transaction participants are uncertain about the replacement rates that will be used for the relevant underlying assets, they will seek to use fallback provisions that allow for more discretion and flexibility in selecting a replacement base rate than contemplated by the ARRC' Securitization Fallback Provisions. We expect that sponsors will focus during 2020 on ensuring that, to the extent possible, fallback provisions for any new LIBOR-based underlying assets will match the fallback provisions used for the related securitization-level notes.
- ***Other risks to consider***. Sponsors will also need to consider other risks, including litigation, tax and accounting risks. To manage litigation risk, sponsors will need to:
    - minimize value transfers at the time of a benchmark rate transition; and
    - use fallback provisions that are precise enough to avoid being susceptible to contradictory interpretations.

Relevant governmental agencies have been developing regulatory relief related to potentially adverse tax or accounting results. Sponsors will need to ensure that their fallback provisions qualify for any such regulatory relief.

Challenges regarding appointment of designated transaction representative

The ARRC Securitization Fallback provisions introduces the concept of a Designated Transaction Representative (defined to mean the party contractually designated to perform a “particular obligation to be performed in connection with [benchmark] transition”) responsible for implementing the benchmark replacement process, who would be given discretion to determine whether a replacement trigger event has occurred and to designate the replacement benchmark rate and implement any conforming document changes. By contrast, the FRN Fallback Provisions contemplate the issuer (or its designee) performing this role. The ARRC suggests that such a role would be fulfilled by an affiliate of the issuer or other agent, but does not provide further guidance on the appropriate party to

undertake the role. In practice, service providers may be asked to act as the Designated Transaction Representative for securitizations. Given the discretion that this role involves, a third party service provider may require substantial protection in the form of exculpatory language and possible indemnification prior to making any decisions relating to the benchmark replacement process.

Operational challenges

The backward-looking nature of SOFR means that interest payment amounts are calculable later than would be the case with LIBOR, which is a forward-looking term rate. Market participants need to consider what changes to payment mechanics and other operational processes may be necessary to accommodate this difference. A key challenge in this area is that conventions for the determination of alternative benchmark rates, such as Compounded SOFR, are still developing and any required changes to operational processes may involve lead time and an investment of significant resources to achieve implementation in time for the expected benchmark transition. Failure to develop and implement appropriate operational processes could result in an inability to timely calculate and arrange for payment of interest after LIBOR cessation. Not only could this constitute a payment default under the related indenture, it may seriously damage the reputations of the involved parties and their affiliates.

Investor challenges

Investors evaluating proposed fallback provisions for offerings of new FRNs or securitizations will want to evaluate the risk of value transfers to the benefit of sponsors or borrowers. Another key risk for investors is whether the terms of any non-standard fallback provisions compromise the future marketability and liquidity of the offered securities. Lack of standardization of fallback provisions itself risks constituting a value transfer from investors back to the sponsor at the time of transition. As a result, some institutional investors require that the ARRC's fallback language be included in all capital market transactions in which they invest.

In addition, investors may need to modify their IT systems to be able to verify that the right amounts of interest are received after the fallback provisions are triggered. It may be difficult for investors to estimate reliably the amount of interest which will be payable on SOFR-based notes following benchmark transition, and some investors may be unable or unwilling to trade such notes without changes to their IT systems. As a result, benchmark transition related challenges could adversely impact the liquidity of floating rates notes following benchmark transition.

Concept of New York legislative solution to address legacy LIBOR-linked contracts

New York-law governed indentures typically unanimous consent of all affected noteholders to change the amount or timing of any payments payable under the notes. As a result, it is likely that unanimous consent would be required to amend legacy indentures that do not effectively address a permanent cessation of LIBOR. This unanimity requirement is likely to thwart many attempts to replace LIBOR.

The ARRC has been considering a potential legislative solution for legacy LIBOR-linked contracts without adequate fallback provisions. As currently contemplated,

the legislative solution would apply an ARRC-recommended SOFR rate and spread adjustment to LIBOR-linked contracts governed by NY law if the legacy contract is silent as to fallbacks or would fall back to a LIBOR-based rate (such as last-quoted LIBOR). The statutory trigger events for cash products would be based on the ARRC's recommended benchmark replacement trigger events. It could also provide a statutory safe harbor for a party granted the right to exercise discretion or judgment regarding the fallback.

It is unclear whether a legislative solution will be sought or passed, and in what form. If passed, it risks being subject to constitutional challenges. If a New York legislative solution is enacted, those who seek to rely on it will need to ensure that they meet any relevant conditions. Until a satisfactory legislative solution is adopted, parties to these types of legacy contracts will need to consider other means to address permanent LIBOR cessation, such as refinancing, redemption, tender offers or exchange offers.

CONCLUSION

Failure to engage in effective benchmark transition planning and mitigation could pose reputational and litigation risks to issuers and sponsors. As part of transition planning, new LIBOR-based issuances should include robust fallback provisions to minimize the risk of value transfers as well as support the marketability and liquidity of these cash products. In addition, fallback provisions may need to be tailored to match the fallback provisions included in any related interest rate swaps or securitized assets. Even while conventions for the determination of alternative benchmark rates (such as Compounded SOFR) are still evolving, market participants need to begin developing appropriate operational processes to ensure they will be able to calculate and pay interest on legacy floating rate notes and securitizations after LIBOR cessation. Lack of appropriate planning and implementation could lead to payment defaults. Accordingly, it is critical for floating rate note issuers and sponsors to stay abreast of related market and regulatory developments and take appropriate steps during 2020 to address the challenges posed by the impending cessation of LIBOR.

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