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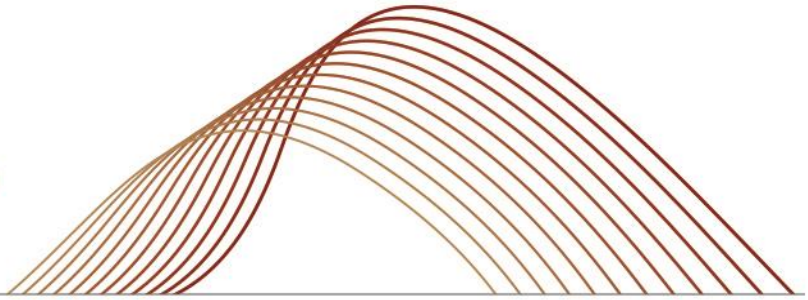

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ARRC Releases Consultation on LIBOR-to-SOFR Spread Adjustment Methodologies

By Paul Hastings LIBOR Transition Task Force

On January 21, 2020, the Alternative Reference Rates Committee (the "ARRC") released a consultation seeking market feedback on calculation of the spread to account for the differences between a pre-existing USD LIBOR contract rate and the SOFR rate selected as its replacement (the "Consultation").[1]

I. Background

Prior to the Consultation, the ARRC had published recommended fallback language for market participants to consider for new issuances or originations of floating rate notes ("FRNs"), syndicated and bilateral business loans, securitizations, and closed-end, residential adjustable rate mortgages ("ARMs") referencing USD LIBOR.[2] The ARRC-recommended fallback language sets out mechanisms (including a potential inclusion of hardwired waterfalls) for transitioning from the contractual LIBOR rate to a SOFR-based successor rate with a spread adjustment. In the Consultation, the ARRC notes both the strong public support for it to recommend and publish spread adjustments and its commitment to do so following the Consultation.

II. Applicability

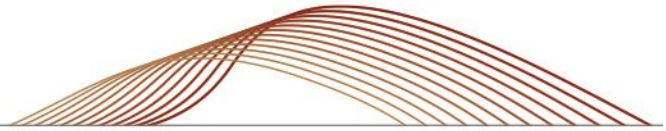
Any ARRC-recommended spread adjustments are intended for (x) new LIBOR contracts with ARRC-recommended hardwired fallback language or (y) legacy LIBOR contracts where parties have selected a spread-adjusted SOFR rate as a fallback. The recommended spread adjustments are not intended for new contracts or new issuances referencing SOFR.

III. Potential Adjustment Methodologies

The Consultation seeks public input on potential spread adjustment methodologies with the aim of formulating spread adjustments that will minimize the economic impact of the transition from the unsecured LIBOR to the secured SOFR rate.

A. Static vs. Dynamic Spread Adjustments

The ARRC intends to recommend a static spread adjustment (i.e., one that would be determined upon the occurrence of a trigger event at a specific time on or before that trigger event). The ARRC states in the Consultation that it is not considering dynamic spread adjustments, citing lack of liquidity in the unsecured funding markets as the reason.



B. Parameter and Calculation Choices

The Consultation provides background data on different historical rates and mean absolute errors across different potential spread adjustment methodologies for the various cash instruments to help inform market participants in their evaluations. It also sets forth certain preliminary conclusions the ARRC has made based on such data. After providing the background analysis, the Consultation seeks input from market participants on several key considerations, including the following:

1. whether the International Swaps and Derivatives Association, Inc. ("ISDA") methodology of a 5-year median of historical differences between LIBOR and SOFR or an alternative method would be the best choice for cash products;

2. the appropriate adjustment method for a forward-looking term rate that lacks the 5-year historical data;

3. whether to adopt a 1-year transition period to mitigate a "cliff effect;"

4. the need for the ARRC's recommendations for 1-week or overnight LIBOR and for simple averages of SOFR; and

5. whether consistency in the spread adjustment methodology is needed across products and currencies.

C. Potential Divergence—Pre-cessation Triggers and Transition Period

The ARRC stresses in the Consultation the importance of aligning spread adjustments for fallbacks across cash and derivatives products. The ARRC notes that such alignment would reduce basis risk and may also reduce operational, legal, tax, accounting, and similar issues between cash products and any related hedges. The Consultation discusses the existing divergence between the ARRC and ISDA recommendations; unlike the ARRC's recommendations, ISDA's proposed fallback language currently only includes a trigger event related to the permanent cessation of LIBOR and does not include a pre-cessation trigger (i.e., a public statement by LIBOR's regulator that LIBOR is no longer representative).[3] The Consultation also acknowledges a potential additional discrepancy if respondents to the Consultation favored incorporating a 1-year transition period for cash products, given that ISDA's recent consultation results showed a general lack of support for such a transition period for derivatives products.

IV. Conclusion

Public comments to the Consultation are due by March 6, 2020. Following this comment period, the ARRC plans to publish spread adjustment recommendations for FRNs, securitizations, business loans, and consumer products.

Given that a significant proportion of legacy products include a hardwired fallback that defaults to the spread adjustments recommended by the ARRC, the results of the Consultation will have a significant economic effect on the transition away from LIBOR; thus, market participants are encouraged to provide input to the Consultation and keep track of the final results once published by the ARRC.

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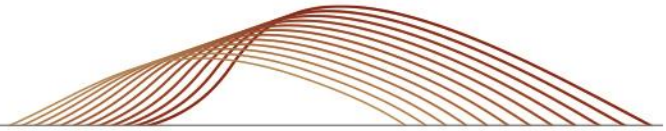

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings New York lawyers:

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[1] The full text of the Consultation can be found here.

[2] The ARRC released a summary of the five sets of recommended fallback language it has issued, available here. For more information on the ARRC's recommended fallback language for FRNs and syndicated loans and for residential ARMs, please see our recent publications, "ARRC Releases Recommended Fallback Language for Floating Rate Notes and Syndicated Loans," available here, and "ARRC's Fifth Set of Recommended Fallback Language: Residential Adjustable-Rate Mortgages," available here.

[3] The ARRC's fallback recommendations include a pre-cessation trigger. While ISDA is still considering including such a trigger, it has not made any decision to do so.