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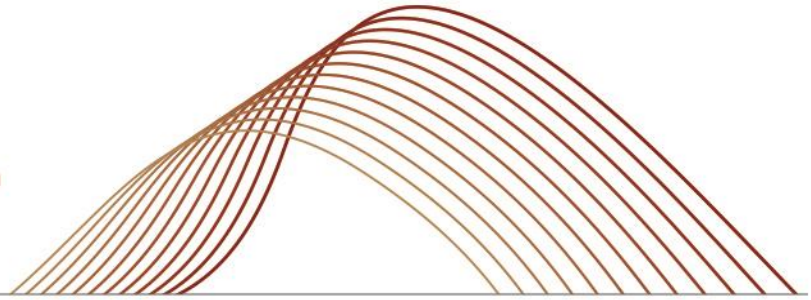

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ARRC's Fifth Set of Recommended Fallback Language: Residential Adjustable-Rate Mortgages

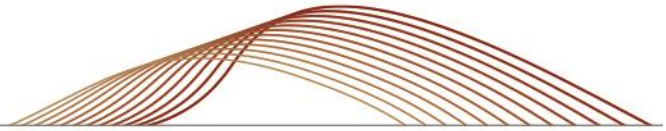
By Joyce Sophia Xu, Michael Spafford, Jonathan Ko, Holly Snow, Nicole Skalla, Diona Park, Daren Stanaway & Matthew Smith

On November 15, 2019, the Alternative Reference Rates Committee (the "ARRC") released its recommended contractual fallback language for U.S. dollar LIBOR denominated closed-end, residential adjustable-rate mortgages ("ARMs") in anticipation of the phasing-out of LIBOR and the transition to a spread-adjusted index based on the Secured Overnight Financing Rate ("SOFR").[1] The ARRC's recommended fallback language for residential ARMs marks the fifth set of recommended fallback language that the ARRC has released to date.[2] In addition to the provisions for residential ARMs, the ARRC also has issued recommended fallback language for bilateral business loans, floating rate notes, securitizations, and syndicated loans.[3]

In making its recommendation with respect to residential ARMs, the ARRC sought to provide greater clarity and specificity with respect to a LIBOR cessation and implementation of a replacement index, because current contractual language in the Fannie Mae/Freddie Mac uniform residential ARM notes does not adequately describe the process for making any such adjustment.[4] The ARRC's recommended fallback language for residential ARMs is intended to be generally consistent with its previous recommendations for other cash products, as well as the International Swaps and Derivatives Association, Inc.'s ("ISDA") approach (with some differences discussed below), but recognizes the need for plain and direct contract language in consumer products. The ARRC's recommended fallback language generally addresses the following key terms: (1) Triggers (i.e., permanent cessation and pre-cessation events with respect to LIBOR), and (2) Replacement Index and Margin (i.e., the benchmark rate that replaces LIBOR and the corresponding spread adjustment applied to the successor rate to preserve the economics of the transaction).

Triggers

A trigger is intended to capture an objective, observable event that will cause the replacement of the relevant benchmark rate or "Index" (e.g., LIBOR) with a new reference rate. The ARRC's recommended fallback language for residential ARMs includes two triggers: (1) when the administrator has permanently or indefinitely stopped providing the Index to the general public, and (2) when the administrator or its regulator issues an official public statement that the Index is no longer reliable or representative. Both triggers are consistent with the ARRC's recommended fallback language with respect to other cash products. However, only the first trigger is consistent with ISDA's anticipated



fallback language for derivative products, given that ISDA currently is contemplating whether to include pre-cessation triggers in its fallback provisions and has not yet indicated whether it will do so.

Replacement Index and Margin

Upon the occurrence of a trigger, the ARRC's recommended fallback provisions contain a waterfall for the parties to use for determining the replacement rate for the relevant Index. The waterfall runs as follows:

- Step 1: Replacement index selected or recommended by Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, or a committee endorsed or convened by the Board of Governors of the Federal Reserve System or the Federal Reserve Bank of New York (e.g., the ARRC).

- Step 2: Replacement index determined by the note holder, with possible adjustments to the loan's margin to account for differences between LIBOR and the chosen replacement index.

With respect to Step 1, the ARRC's successor rate for residential ARMs will not match ISDA's successor rate, a compounded average of SOFR in arrears, since the latter would be incompatible with current consumer regulations, which require advance notice of any payment change. Instead, the ARRC anticipates recommending a forward-looking SOFR-based rate as the successor rate for residential ARMs and the corresponding spread adjustment to account for the economic differences between LIBOR and SOFR that it will develop and publish after consulting with market participants. The ARRC has committed to make publicly available any such successor rate and spread adjustment it recommends for residential ARMs in order to minimize impact to the borrowers of such consumer products.

Conclusion

As recently stated by Tom Wipf, the ARRC's Chair: "There's no question about it: in a mere 778 days, we cannot rely on LIBOR still being available for use. That's why it is mission critical that all institutions prepare for this inevitability."[5] While incorporating the ARRC's recommended fallback language is completely voluntary, market participants are strongly encouraged to take inventory of their existing agreements referencing LIBOR and to start implementing plans to amend those agreements.

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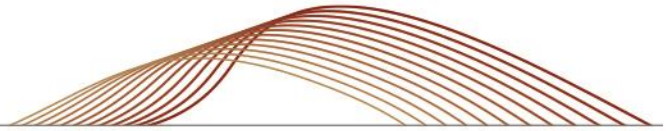

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[1] The Alternative Reference Rates Committee, ARRC Recommendations Regarding More Robust LIBOR Fallback Contract Language for New Closed-End, Residential Adjustable Rate Mortgages (2019), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARM_Fallback_Language.pdf.

[2] On November 15, 2019, the ARRC also released a summary of the five sets of recommended fallback language it has issued, available here.

[3] For more information on the ARRC's recommended fallback language for floating rate notes and syndicated loans, please see our recent publication, "ARRC Releases Recommended Fallback Language for Floating Rate Notes and Syndicated Loans," available here.

[4] Fannie Mae and Freddie Mac already have announced that they plan to publish updates to their uniform ARM notes, incorporating the ARRC's recommended fallback language for all newly-originated ARMs, in the first quarter of 2020. *See* Press Release, The Alternative Reference Rates Committee, ARRC Welcomes Fannie Mae and Freddie Mac's Decision to Use ARRC Recommended Fallback Language in New Adjustable Rate Mortgages (November 15, 2019), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC_Fannie_Freddie_Press_Release.pdf.

[5] Press Release, The Alternative Reference Rates Committee, ARRC Releases Recommended Fallback Language for Residential Adjustable-Rate Mortgages (November 15, 2019), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARM_Fallback_Language_Press_Release.pdf.