Frequently Asked Questions

ARRC Consultation Regarding More Robust Libor Fallback Contract Language For New Issuances of Libor Floating Rate Notes

Version: October 29, 2018

Please note: These Frequently Asked Questions were prepared by the ARRC for use by market participants in connection with the ARRC Consultation Regarding More Robust Libor Fallback Contract Language For New Issuances of Libor Floating Rate Notes ("FRN consultation") and are current as of the version date noted above. However, this document may evolve over time as new developments take place and new questions are raised. If you have a question to which you are seeking an answer, general ARRC inquiries can be directed to the ARRC Secretariat at ARRC@ny.frb.org. Please also visit the ARRC's website or sign up to receive alerts from the ARRC. Capitalized terms used herein and not defined have meanings set forth in the FRN consultation. Thank you.

1. **The FRN consultation primarily focuses on "new" transactions. Does the ARRC intend to conduct a future consultation that would cover the amendment of fallback language of existing FRN transactions maturing after 2021?**

   At this time, the ARRC does not intend to produce consultations specifically related to amending outstanding FRNs or other cash products. The current ARRC consultations focus on proposing more robust fallback contract language for new transactions because the ARRC believes it is important for market participants to not add additional transactions with inadequate fallback provisions. While that fallback language could be helpful for parties who wish to amend their legacy transactions, the amendment of legacy FRNs generally requires the unanimous consent of noteholders.

2. **The following questions focus on the spread adjustment:**

   a. **Is there a reason that the Replacement Benchmark Spread is not explicitly referred to as a "credit" spread adjustment?**

   b. **The Replacement Benchmark waterfall may lead to selection of an overnight rate without a term structure or term adjustment (e.g. Step 3 and potentially Steps 4, 5 and 6). In that scenario, do you envisage the Replacement Benchmark Spread would address both term and credit, or will the Replacement Benchmark Spread only adjust for credit spread irrespective of the selected Replacement Benchmark rate?**

   c. **The FRN consultation states on page 11 that the Replacement Benchmark Spread can be positive or negative. Given that the fallback rates proposed do not include bank-credit risk premium and, therefore, the spread is most likely to be positive, what was the logic in including the possibility of a negative spread?**

   The first priority in the spread waterfall is a spread adjustment (or its methodology) selected, endorsed, or recommended by the "Relevant Governmental Body" (i.e. the ARRC) for LIBOR FRNs. The applicable spread adjustment would intend to make the two rate levels comparable. Consistent with its mandate to minimize potential disruptions and to support market functioning in the transition from LIBOR, the ARRC intends to recommend or endorse a spread adjustment (or methodology). In order to best meet this mandate, the ARRC felt that it would not be appropriate to create boundaries or criteria at this time for such spread adjustment or methodology. Therefore, the language intends to allow maximum flexibility so that an ARRC recommended spread adjustment (or the spread adjustments that would apply pursuant to Steps 2 and 3 of the waterfall) could take into account any differences between LIBOR and the selected SOFR-based fallback rate and not be restricted to any particular outcome. While the spread adjustment would intend to address the bank credit risk premia embedded in LIBOR, which is not a component of SOFR, it would also intend to make adjustments for a number of other differences between the benchmark and its successor, including a transition from a term rate to an overnight rate (if applicable). The ARRC would conduct a related market consultation on this spread adjustment to solicit the views of market participants.

3. **If the ARRC does not recommend a spread adjustment, what is the second priority in the spread waterfall?**

   The ARRC expects to recommend a spread adjustment. If it does not, then the ISDA fallback spread adjustment for LIBOR derivatives would only be applicable under the second step of the spread adjustment waterfall, if the fallback rate for FRNs is equivalent to the fallback rate selected by ISDA. The FRN consultation asks whether this approach is correct, and asks for feedback on whether the ISDA spread adjustment should apply in Step 2 more broadly (even when the FRN successor rate is not equivalent to the ISDA fallback rate).

4. **Does the ARRC intend to recommend a forward-looking term SOFR rate?**

   The ARRC currently intends to evaluate the production and governance structures of potential forward-looking term SOFR rates and to recommend such a rate, provided that the ARRC concludes that SOFR derivatives markets have developed to a sufficient level and an administrator has created a sufficiently sound governance structure to produce a robust, IOSCO compliant, transaction-based term benchmark.

5. **Could there be a mismatch in the trigger events and the replacement rate/spread between FRNs and derivatives?**

   Market participants are striving to create consistency across the cash and derivatives markets. However, if some or all of the proposed “pre-cessation” triggers are adopted by the FRN market, FRNs could fall back to a successor rate when there is no corresponding trigger for derivatives incorporating the standard ISDA definitions. There could also be a difference between the replacement rates and spread adjustments (e.g. the first replacement rate in the ARRC FRN fallback language proposal is to term SOFR, while derivatives would fall back to either a compounded or overnight SOFR). The ARRC is seeking feedback on these matters to help determine whether the differences between cash products and derivatives makes it necessary to account for this type of potential mismatch.

6. Why is the ARRC planning to recommend fallbacks for FRNs and certain other cash products this year when there are many unknowns, including the fallback rates and spread adjustments the ARRC intends to recommend for certain cash products?

The ARRC believes that one of the most important ways market participants can mitigate risk today is by implementing more robust fallback provisions into any new LIBOR products. With this in mind, the ARRC brought together members from all segments of the FRN market to propose fallback language that is flexible enough to work despite the unknowns and would reduce the systemic risks related to fallbacks that are economically inappropriate, ambiguous or allow one party to act unilaterally. For example, although the specific ARRC recommended rate and spread adjustment are unknown, the ARRC has proposed that FRN market participants prospectively acknowledge through the proposed fallback language that the ARRC recommended rate and spread would be appropriate fallbacks if they are available at the appropriate time, because this would create greater contractual certainty and reduce the risk of disputes.