ARRC CONSULTATION
REGARDING MORE ROBUST LIBOR FALLBACK CONTRACT LANGUAGE FOR NEW CLOSED-END, RESIDENTIAL ADJUSTABLE RATE MORTGAGES

July 12, 2019

Questions about Triggers

Question 1: Should fallback language for ARMs include either of the pre-cessation triggers (triggers 4(G)(ii) and 4(G)(iii))? If so, which ones?

Response:

In a January 28, 2019 speech, Edwin Schooling-Latter of the Financial Conduct Authority ("FCA") indicated his concern that the FCA might be required to make a determination that LIBOR was no longer representative. There is a possibility that at some point in the future one or more LIBOR panels have shrunk so significantly that the relevant rate is no longer capable of being representative. Due to the uncertainty of the continuing integrity of LIBOR as the end of 2021 approaches, we think it is important to have a back up determination in the event the Administrator or its regulator determines that LIBOR is no longer reliable or representative, as is set forth in 4(G)(ii).

We recommend, though, that the pre-cessation trigger in 4(G)(ii) become effective only when the regulator makes an official or formal declaration that it is either no longer reliable or representative. This would eliminate the possibility that an informal statement from an officer or employee of the FCA would be seen as the required trigger.

Question 2: Please indicate whether any concerns you have about these pre-cessation triggers relate to differences between these triggers and those for standard derivatives or relate specifically to the pre-cessation triggers themselves.

Response: *Our concerns as expressed above related specifically to the pre-cessation triggers themselves, as opposed to difference between these triggers and those for standard derivatives.*

Question 3: If pre-cessation triggers are not included, what options would be available to market participants to manage the potential risks involved in continuing to reference a Benchmark whose regulator has publicly determined that it is not representative of the underlying market?

Response: *Given that the existing language in the Fannie/Freddie forms only authorizes a replacement index if LIBOR is no longer available, note holders would* *not have an effective way to manage the risks without the pre-cessation trigger in 4(G)(ii). If a note holder notified a borrower that a replacement index would be replacing LIBOR when LIBOR is still "available", even though not reliable or representative, there is a definite risk of liability, especially in the litigious U.S. environment. If LIBOR, however, is not reliable or representative, either the borrower or the lender stands to lose what was intended to be the cost and value of the loan when the loan was executed, thus resulting in unanticipated financial loss, which may be significant is some cases, to one or the other.*

Question 4: The ARM language proposed uses simplified language in an effort to be more comprehensible for the consumer market. Is the simplified language appropriate or are there concerns with the language not matching ISDA or other cash product language precisely?

***Response**: Given that many borrowers are unsophisticated consumers, especially with regard to some of the difficult concepts surrounding a replacement index, we believe using simplified language is the better approach and is a better approach than matching ISDA or other cash product language precisely.*

One of the guiding principles for the ARRC working group was that, in determining proposed fallbacks for LIBOR in consumer products, the language should be easily comprehensible in order to be effectively communicated. Simplified language helps accomplish that goal.

***Question 5:** Is the replacement index determined by the Federal Reserve Board, the Federal Reserve Bank of New York, or a committee endorsed or convened by the Federal Reserve Board or the Federal Reserve Bank of New York the best choice as the first step of the waterfall? Why or why not?*

***Response:** The determination by a regulator, rather than the note holder, is the best choice as the first step. It would be seen by consumers as a fairer and more independent determination than a determination by each particular note holder, as the note holder stands to financially gain or lose by the decision. Consistency across the industry is also a much better approach.*

The ARRC has committed to selecting or recommending the replacement index at the appropriate time. The only change we would make to the language is to simplify this provision by asking that a determination be made now as to which particular federal entity is going to select or recommend the replacement index. Rather than naming the different regulatory entities in the proposed language, the provision would read better and be shorter and simpler if the federal regulators decide which particular entity is the appropriate entity to select or recommend the rate (e.g., a committee endorsed or convened by the Federal Reserve Board).

***Question 6:** As noted in the narrative, the ARRC has committed to recommending spread adjustments for cash products that reflect the general difference between various tenors of LIBOR and SOFR. In addition, the ARRC has committed to seeing all-in, "spread-adjusted" rates published for use in cash products (e.g., a SOFR-based* *spread-adjusted replacement index for 1-year LIBOR). Should the ARRC recommend a spread adjustment for LIBOR ARMs and other consumer products, and should the corresponding spread-adjusted rate be the replacement index for the LIBOR ARMs?*

Response: *The ARRC should recommend and publish a SOFR-based spread-adjusted replacement index to replace the 1-year LIBOR, to be considered the replacement index used across the industry. The spread adjustment is needed to ensure that the replacement rate is similar to the original rate with respect to the cost and value of the loan as anticipated by the parties when the loan was made.*

Question 7: *As noted in the narrative, in addition to recommending SOFR, the ARRC may recommend forward-looking term SOFR rates if it is satisfied that a robust, 10SCO-compliant term rate that meets its criteria can be produced. If the ARRC recommends forward-looking term rates (e.g., 1-month, 3-month, 6-month, etc.) and a corresponding spread adjustment, should a spread-adjusted term rate be the replacement index for LIBOR ARMs, or would a spread-adjusted average (simple or compounded) of SOFR be more appropriate? Please provide support for your answer.*

Response: *A spread adjusted forward looking term rate structure, driven by a robust market, is more appropriate for consumer ARMs. A forward looking term SOFR would be based on market expectations of SOFR over an upcoming accrual period, and would be available at the beginning of the accrual period. The forward looking term SOFR can be derived from transaction prices for SOFR future contracts. For consumer ARMs, such a rate is superior to a simple or compounded average SOFR.*

Question 8: *Should the Note Holder have the responsibility as the 2nd and last step of the waterfall? Why or why not?*

Response: *Yes, if there is a replacement event and the regulator has not issued a replacement index, the note holder would be the most appropriate party at that point to determine the replacement index. It is not practical to leave that determination to a negotiation for consumer mortgages and, given that there is a standard set forth for making that determination, the note holder is in the best position to do so.*

Question 9: *Should the Note Holder have the ability to make adjustments (positive or negative) to the loan's margin to more closely approximate LIBOR at the time of replacement? Why or why not? If you do not believe the Note Holder should make adjustments to the loan's margin, and potential replacement indices diverge from the value of the current Index, what provision or step should be taken to preserve that consistency?*

Response: *It is essential that the Note Holder have the ability to make adjustments, just as the regulator has that ability in Step 1, as there is no replacement index that currently matches LIBOR. Without the ability to adjust the rate, either the note holder or the borrower will not receive the cost and value of what was intended at the outset.*

Question 10: *If the Note Holder is a trust (for example, as may occur in private label MBS), is there some entity other than the Note Holder that should be responsible for identifying the Replacement Index if Step 1 of the waterfall fails? Please provide sufficient rationale for your answer.*

Response: *Unless the terms of the trust dictate otherwise, the note holder should be responsible for identifying the Replacement Index if Step 1 fails.*

Question 11: *Will this language have unintended consequences not considered by the ARRC working group, such as title insurance restrictions, state law endorsement or filing restrictions, etc.? If so, please explain and provide information about why this language would present challenges. If there are concerns with this proposed language, please be sure to specify if concerns relate to this proposed language, or index replacement language in general.*

Response: *We are aware of no unintended consequences or other concerns.*

Question 12: *Is there any provision in the proposal that would significantly impede ARM originations? If so, please provide a specific and detailed explanation.*

Response: *We do not believe that any provision in the proposal would significantly impede ARM originations.*

Question 13: *Please provide any additional feedback on any aspect of the proposal.*

Response: *Since it is expected that the Federal Reserve Board will publish the Replacement Index on its website, we recommend that the third sentence of 4(b) be revised to say "The Index is published in, or on the website of, The Wall Street Journal or on the website of the Federal Reserve Board." This would provide another reference if for some reason the Replacement Index is not published in The Wall Street Journal.*

Also, to lessen customer confusion, it would be helpful for the industry to move in a consistent manner with respect to the timing and use of fallback language in the Fannie/Freddie forms.