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ARRC Releases Recommended Fallback Language for Residential Adjustable-Rate Mortgages

ARRC Also Releases Summary of the Five Sets of Recommended Fallback Language Issued To Date

The Alternative Reference Rates Committee (ARRC) today released recommended contractual fallback language for new U.S. dollar (USD) denominated closed-end, residential adjustable-rate mortgages (ARMs). These provisions are for market participants' voluntary use in new residential ARMs that reference USD LIBOR, and were developed with the goal of reducing the risk of serious market disruption in the event that LIBOR is no longer available. The recommendations provide clear language that would replace USD LIBOR with a spread-adjusted index based on the Secured Overnight Financing Rate (SOFR), which had been recommended by the ARRC for consumer products.

Current contract language in residential ARMs typically allows note holders to select a replacement index if USD LIBOR is no longer available. However, it does not describe the process for making any such replacement. The ARRC's recommended contract language is meant to provide greater clarity to consumers on when and how a replacement index will be chosen.

The ARMs fallback language marks the fifth set of recommended contractual fallback language that the ARRC has released, which are all part of the ARRC's mandate to help address risks in contracts referencing LIBOR. The ARRC expects to consult with a broad range of stakeholders on proposals for fallback language in other consumer products in the future.

The ARRC also today released a summary of the five sets of recommended fallback language it has issued to date. In addition to the ARMs provisions, the ARRC has issued recommended fallback language for bilateral business loans, floating rate notes, securitizations, and syndicated loans. The summary provides an overview of the triggers, benchmark replacement rates, and spread adjustments included in the fallback language for these products. The summary aims to educate market participants about the fallback language that the ARRC has released.

"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," said Tom Wipf, ARRC Chair and Vice Chairman of Institutional Securities at Morgan Stanley. "The ARMs fallback language will provide greater transparency for mortgage consumers. I urge all market participants to incorporate this language into new residential ARMs."

The recommended ARMs fallback language was endorsed by the ARRC and represent a consensus of its Consumer Products Working Group, which includes a diverse array of lenders, consumer groups, investors, and servicers. The recommended language was prepared after consideration of all comments received on the ARMs fallback language consultation.

This language aims to balance several key principles that the ARRC established to guide work on transitioning from LIBOR related to consumer loan products, specifically:

- In determining recommended fallbacks for LIBOR in consumer products, the choice of the replacement index, spread adjustment to the replacement index, succession timing, and mechanics should be easily comprehensible in order to be effectively communicated to all stakeholders in advance of the transition away from LIBOR, and should seek to minimize expected value transfer based on observable, objective rules determined in advance.
- Where flexibility or discretion is incorporated in fallbacks, it should be carefully considered and limited to the extent possible to ensure ease of application and to minimize the potential for disputes.

The ARRC's recommendation for residential ARMs is consistent with its recommendations for other cash products, while recognizing the greater importance of having clear and straightforward contract language in consumer products. The residential ARMs fallback language sets out clear and observable triggers and uses a replacement index selected or recommended by the Federal Reserve or a body convened or endorsed by the Federal Reserve.

It is anticipated that the ARRC will work with all stakeholders to develop and recommend a spread adjustment and corresponding spread-adjusted SOFR-based replacement index that reflects and adjusts for the differences between USD LIBOR and the SOFR. Once developed and finalized, these will minimize the impact to the borrower's interest rate if LIBOR is no longer available. The ARRC has committed that any rates and any spread adjustments it recommends are published and made publicly available, including seeing the rate and spread adjustment published jointly as a single "spread-adjusted" index.

About the ARRC

The ARRC is a group of private-market participants convened by the Federal Reserve Board and Federal Reserve Bank of New York in cooperation with the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of Financial Research, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, the Securities and Exchange Commission and the U.S. Treasury Department. It was initially convened in 2014 to identify risk-free alternative reference rates for USD LIBOR, identify best practices for contract robustness, and create an implementation plan with metrics of success and a timeline to support an orderly adoption. The ARRC accomplished its first set of objectives and identified the Secured Overnight Financing Rate as the rate that represents best practice for use in certain new USD derivatives and other financial contracts. It also published its Paced Transition Plan, with specific steps and timelines designed to encourage adoption of SOFR. The ARRC was reconstituted in 2018 with an expanded membership to help to ensure the successful implementation of the Paced Transition Plan, address the increased risk that LIBOR may not exist beyond 2021, and serve as a forum to coordinate and track planning across cash and derivatives products and market participants currently using USD LIBOR.

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Contact for ARRC Chair Tom Wipf
Mark Lake and Paige Mandy
Morgan Stanley

Contact for the Board of Governors
Darren Gersh

Contact for the ARRC's Outreach/Communications Working Group
Andrew S. Gray
JPMorgan Chase

Contact for the Federal Reserve Bank of New York
Suzanne Elio and Betsy Bourassa