ARRC CONSULTATION
REGARDING MORE ROBUST LIBOR FALLBACK CONTRACT LANGUAGE
FOR NEW VARIABLE RATE PRIVATE STUDENT LOANS
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Part I: Background on the ARRC and Its Recommendations for Fallback Language

The Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York convened the Alternative Reference Rates Committee ("ARRC") in 2014 to identify alternative reference rates for U.S. dollar (USD) LIBOR ("LIBOR"), identify best practices recommendations for contract robustness in interest rate markets that currently use LIBOR, and create an implementation plan to support an orderly adoption of new reference rates. After accomplishing its initial set of objectives by selecting a recommended alternative reference rate (the Secured Overnight Financing Rate, "SOFR") and setting out a Paced Transition Plan with respect to derivatives, the ARRC was reconstituted in 2018 with an expanded membership to help ensure the successful implementation of the Paced Transition Plan and to serve as a forum for market participants to address the risks of severe market disruption that could result from the cessation of LIBOR and develop and support liquidity in SOFR-based products across cash and derivatives markets.

The ARRC's Second Report noted that most contracts referencing LIBOR do not appear to have envisioned a permanent or indefinite cessation of LIBOR and have fallbacks that would not be economically appropriate if this event occurred. Current contract language in variable rate private student loans allows lenders to replace the index if LIBOR is no longer available but provides little guidance to the parties about the process for making any such replacement. As a result, both consumers and investors may benefit from contract language that more clearly specifies what they should expect to happen if LIBOR is no longer published or is materially disrupted.

To meet its mandate to act as a forum for developing recommendations for voluntary transition, the ARRC formed a number of working groups to focus on various types of financial products and published its Guiding Principles for More Robust LIBOR Fallback Contract Language to create a framework for fallback language in cash products. The ARRC has already consulted on and recommended fallback language for floating-rate notes, syndicated and bilateral business loans, securitizations, and closed-end residential adjustable-rate mortgages (ARMs). These recommendations set forth robust fallback provisions that define the relevant trigger events[1] and allow for the selection of a replacement index[2] and a spread adjustment between LIBOR and the replacement index to account for differences between these two benchmarks. The ARRC has produced for public review and comment a consultation on the methodology by which that spread adjustment might eventually be calculated.

The ARRC formed its Consumer Products Working Group (Working Group) in 2019. The ARRC also established a set of guiding principles that it believes are uniquely applicable for consumer loan products. In order to meet its mandate, the Working Group includes a diverse array of lenders, consumer groups, investors, and servicers.

The Working Group was tasked with recommending fallback language for new consumer loans. Several key principles were set out to guide that work:

- In determining recommended fallbacks for LIBOR in consumer products, the choice of the replacement index, spread or margin adjustment to the replacement index, succession

[1] A trigger event is an occurrence that precipitates the conversion from LIBOR to a new reference rate.
[2] The replacement index is the reference rate that would be used to replace LIBOR in contracts.

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 any possible value transfer based on observable, objective rules determined in advance.

- Where flexibility or discretion are 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.

In accordance with these principles and the results of the consultations discussed in ***Part IV: Summary of Responses to the ARRC's Consultations***, the ARRC is publishing recommended fallback language for market participants to consider for new private student loans. To the extent market participants continue to enter into LIBOR-based contracts, the ARRC recommends the fallback language and related guidance herein and believes the cash markets will benefit by adopting a more consistent, transparent, and resilient approach to contractual fallback arrangements for new LIBOR products. It is important to note that regardless of this recommendation, the extent to which any market participant decides to implement or adopt any suggested contract language is completely voluntary. Therefore, each market participant should make its own independent evaluation and decision about whether or to what extent any suggested contract language is adopted.

The ARRC's final recommendation for new variable-rate private student loans is intended to be consistent with its recommendations for other cash products, but recognizes the need for simple contract language in consumer products. The final recommendation refer to a replacement index "selected or recommended for use in consumer products, including private student or educational loans, by the 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." The ARRC's recommended spread adjustments for consumer products will be based on the 5-year historical median of the difference between LIBOR and the SOFR fallback rate, with a 1-year transition period to this fixed median spread. The ARRC worked with a broad set of stakeholders to develop and recommend this spread adjustment and corresponding spread-adjusted SOFR-based replacement to reflect and adjust for the differences between LIBOR and SOFR, thus minimizing the impact to the borrower's interest rate if LIBOR is no longer available. The ARRC will ensure that any rates and any spread adjustments it recommends are published and made publicly available, including the publication of the rate and spread adjustment jointly as a single "spread-adjusted" rate. These published spread-adjusted rates, which could be based either on averages of SOFR or on a SOFR term rate, would be the recommended replacement index for LIBOR in ARMs.

Part II: Fallback Language for New Variable-Rate Private Student Loans

The ARRC's recommended fallback language is in blue. The other text in this section represents an illustrative example of the terms and language that may be in a student loan agreement.

[Sections Intentionally Omitted]

2. INTEREST

Interest will be charged on unpaid principal until the full amount of Principal has been paid. I will pay interest at a rate of ____%. The interest rate I will pay may change in accordance with Section 4 of this Note.

The interest rate required by this Section 2 and Section 4 of this Note is the rate I will pay both before and after any default described in Section ____ of this Note.

[Sections Intentionally Omitted]

4. VARIABLE INTEREST RATE AND MONTHLY PAYMENT CHANGES

(A) Change Dates

The interest rate I will pay will change on [the first day of each month] in accordance with Section 4(C) of this note. The date on which my interest rate changes is called a "Change Date."

(B) The Index

Beginning with the Disbursement Date and following each Change Date, my variable interest rate will be based on an Index that is calculated and provided to the general public by an administrator (the "Administrator"). The "Index" is a benchmark, known as [the one-month] [U.S. dollar (USD) LIBOR] index. The Index is currently published in, or on the website of, [*The Wall Street Journal]*. The most recent Index value available as of the date ____ [e.g. 20] days before each Change Date is called the "Current Index," [provided that if the Current Index is less than zero, then the Current Index will be deemed to be zero for purposes of calculating my interest rate].

If the Index is no longer available, it will be replaced in accordance with Section 4(G) below.

(C) Calculation of Changes

Before each Change Date, the Note Holder will calculate my new interest rate by adding _____ percentage points (___ %) (the "Margin") to the Current Index. The Margin may change if the Index is replaced by the Note Holder in accordance with Section 4(G)(2) below. The Note Holder will then round the result of the Margin plus the Current Index to [the nearest one-eighth of one percentage point (0.125%)]. Subject to the limits stated in Section 4(D) below, this rounded amount will be my new interest rate until the next Change Date.

The Note Holder will then determine the amount of the [monthly] payment that would be sufficient to repay the unpaid principal that I am expected to owe at the Change Date in full on the Maturity Date at my new interest rate in substantially equal payments. The result of this calculation will be the new amount of my [monthly] payment.

(D) Limits on Interest Rate Changes

[The interest rate I am required to pay at the first Change Date will not be greater than _____% or less than _____%.] [Thereafter, my variable interest rate will never be increased or decreased on any single Change Date by more than __ percentage points from the rate of interest I have been paying for the preceding month.] [My interest rate will never be greater than _____% or less than _____%].

(E) Effective Date of Changes

My new interest rate will become effective on each Change Date. I will pay the amount of my new [monthly] payment beginning on the [first monthly] payment date after the Change Date until the amount of my [monthly] payment changes again.

(F) Notice of Changes

[The Note Holder will deliver or mail to me a notice of any changes in my variable interest rate before the effective date of any change.] The notice will include the amount of my [monthly] payment, any information required by law to be given to me, [and also the title and telephone number of a person who will answer any question I may have regarding the notice.]

(G) Replacement Index and Replacement Margin

The Index will be deemed to be no longer available and will be replaced if any of the following events (each, a "Replacement Event") occur: (i) the Administrator has permanently or indefinitely stopped providing the Index to the general public; or (ii) the Administrator or its regulator issues an official public statement that the Index is no longer reliable or representative.

If a Replacement Event occurs, the Note Holder will select a new index (the "Replacement Index") and may, if needed under subsection (2) also select a new margin (the "Replacement Margin"), as follows:

(1) If a Replacement Index has been selected or recommended for use in consumer products, including private student or educational loans, by the 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 at the time of a Replacement Event, the Note Holder will select that index as the Replacement Index.

(2) If a Replacement Index has not been selected or recommended for use in consumer products under Section (G)(1) at the time of a Replacement Event, the Note Holder will make a reasonable, good faith effort to select a Replacement Index and a Replacement Margin that, when added together, the Note Holder reasonably expects will minimize any change in the cost of the loan, taking into account the historical performance of the Index and the Replacement Index.

The Replacement Index and Replacement Margin, if any, will be operative immediately upon a Replacement Event and will be used to determine my interest rate and monthly payments on Change Dates that are more than ____ days [*e.g.*, 20 days] after a Replacement Event. The Index and Margin may be replaced again during the term of my Note, but only if another Replacement Event occurs. After a Replacement Event, all references to the "Index" and "Margin" shall be deemed to be references to the "Replacement Index" and "Replacement Margin."

The Note Holder will also give me notice of my Replacement Index and Replacement Margin, if any, and such other information required by applicable law and regulation.

[Sections Intentionally Omitted]

Part III: User's Guide to Fallback Language for New Variable Rate Private Student Loans

A. General Approach of the Fallback Provisions

Based on the recommendations of its Consumer Products Working Group, the ARRC is proposing an approach to more robust fallback language for new variable rate private student loans. The proposed fallback language for variable rate private student loans is set forth in the Appendix. This ***Part II*** contains a description of the variable rate private student loan fallback provisions and specific questions that market participants are asked to consider.

Note that most existing variable rate private student loan notes or variable rate private student loan riders contain fallback language that specifies that the Note Holder may choose a new index if the existing index becomes unavailable. However, 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 recommended variable rate private student loan fallback provisions try to balance several goals of the ARRC principles described in *Part I*. To provide clarity and consistency, the variable rate private student loan fallback provisions use clear and observable triggers and a replacement index selected or recommended by the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, or a committee convened or endorsed by the Board of Governors of the Federal Reserve System or the Federal Reserve Bank of New York, if such a rate is available. If such a rate is not available, the Note Holder will continue to be responsible for choosing a replacement index, as is the case in current fallback language for variable rate private student loans. However, the ARRC's recommendation includes language addressing any necessary adjustment of a loan's margin and provides a standard of reasonableness and good faith for the Note Holder's choice of the replacement index and margin.

Investors often enter interest rate swaps to offset or hedge their floating rate exposure. In order to reduce a mismatch between variable rate private student loans and swap instruments, the recommended fallback language for variable rate private student loans is generally consistent with the approach ISDA presently anticipates implementing for derivatives.

Future-Proofing: It is important to note that the fallback provisions refer to the "Index" throughout and define the Index as, initially, USD LIBOR; provided that if LIBOR has been replaced in the contract, then the term "Index" means the applicable "Replacement Index." This drafting is intended to allow the fallback provisions to apply again in the unlikely event that the replacement to LIBOR is later discontinued during the term of a variable rate private student loan. Nonetheless, since most variable rate private student loans are 10-year term contracts, the language must be able to stand the test of time.

Furthermore, although the language in Part II refers to USD LIBOR as the current Index, the language is bracketed to indicate that it could be adopted to refer to other Indexes. This bracketing is intended to facilitate implementation of the recommended fallback provisions in any variable rate private student loan, including those that do not reference LIBOR.

B. <u>Triggers</u>

A "trigger" is an objective, observable event that will require the Note Holder to convert from LIBOR (or another "Index")[3] to a new reference rate. The triggers are set out in the definition of "Replacement Events" in the proposal (Part II, section 4(G)). The ARRC's recommendation sets out two separate triggers that define when an Index is no longer available for the purpose of calculating the interest rate on a variable rate private student loan.

As described in greater detail below, the first trigger would only be invoked if LIBOR ceased publication. The second trigger would apply in situations in which LIBOR may still be published, but its quality had

[3] In the recommended fallback provisions, "Index" is defined as LIBOR or its replacement, including any spread adjustments thereto (the "Replacement Index").

materially deteriorated.

Index is Unavailable

The first trigger in the ARRC's recommended variable rate private student loan fallback provisions ("Replacement Event" clause 4(G)(i)) would move the loan to a replacement index in the event that the Administrator of the current Index has stopped providing the Index to the general public. This approach is similar to the first trigger for adjustable-rate mortgages (ARMs) and is intended to be consistent with the first two fallback triggers in the ARRC's recommended fallback language for other cash products and language that ISDA anticipates incorporating into its definition for USD LIBOR. The ARRC-recommended fallback triggers for those cash products would move those products to a replacement index in the event that the Administrator of the current Index *has ceased or will cease to provide the Benchmark, permanently or indefinitely, provided that, at the time of such statement or publication, there is no successor administrator that will continue to provide the Benchmark*. Relative to the ARRC's recommended language in other cash products (excluding ARMs) or ISDA documents, the recommended variable rate private student loan fallback trigger is written more simply and emphasizes the need for the Index to be provided to the general public if it is to be used in a variable rate private student loan product.

Index is No Longer Reliable or Representative

The second trigger in the ARRC's recommended variable rate private student loan fallback provisions ("Replacement Event" clause 4(G)(ii)) would occur if the Administrator of the Index or the regulator with authority over the Administrator of the Index were to announce that the Index is no longer reliable or representative. This trigger is modeled after language in Article 20(3) of the EU Benchmark Regulation, under which EU-supervised entities may be prohibited from new use of a Benchmark if it is determined that the Benchmark is *no longer representative of the underlying market or economic reality*. In the case of LIBOR, the relevant regulator is the U.K. Financial Conduct Authority (FCA).

This trigger is consistent with the pre-cessation trigger included in the ARRC's recommended fallback language for other cash products. ISDA has also stated that it will include a similar pre-cessation trigger in its updated definitions for derivatives.

C. Replacement Index and Margin

In the recommended contract language, references to LIBOR are replaced by references to an alternative rate upon a "Replacement Event." As described below, the recommended variable rate private student loan fallback provisions contain a waterfall within the defined term "Replacement Index" to select the particular index to be used as a replacement.

The following table displays the variable rate private student loan fallback replacement index waterfall:

Variable Rate Private Student Loan Replacement Index Waterfall
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
Step 2**:** Replacement index determined by the Note Holder, with possible adjustment to the loan's margin to account for differences between LIBOR and the chosen replacement index

Step 1: ARRC Replacement Index

The first step of the recommended waterfall is the adoption of a replacement index selected or recommended for use in consumer products, including variable rate private student loans, by the 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).

The ARRC has consulted with a wide set of stakeholders and has indicated that it intends to recommend a spread-adjustment to SOFR based on a 5-year median of the historical difference between LIBOR and SOFR with a one-year transition period to that fixed median spread adjustment. This adjustment will be combined with the SOFR fallback rate to create and publish a spread-adjusted SOFR-based replacement that reflects and adjusts for the differences between LIBOR and SOFR in order to minimize the impact to the borrower's interest rate at resets following a Replacement Event.

Step 2: Note Holder-Determined Replacement Index and Possible Adjustment to the Loan's Margin

If there is not a rate selected or recommended as outlined in the first step, then the second step of the recommended waterfall would require the Note Holder to choose a replacement index, a step that is similar to the language in current LIBOR fallbacks for variable rate private student loans. The recommended variable rate private student loan fallback provision explicitly spells out the possibility that the Note Holder may determine an adjustment to be made to the loan's margin to bring the overall interest rate calculated using the replacement index (or a future index and its replacement) more in line with the overall interest rate calculated using LIBOR.

Part IV: Summary of Responses to the ARRC's Consultation

In this section, we discuss the feedback the ARRC received to its consultation and the ARRC's responses to the feedback. As noted, the ARRC's Consumer Products Working Group includes a diverse array of lenders, consumer groups, investors, and servicers. The draft language presented in the consultation reflects the input of these groups and represents the broad consensus of the group. The ARRC received further input in from 11 institutions that responded to the ARRC's consultation. Of these responses, three responses were from consumer advocacy groups, three responses were from lenders or loan servicers active in the student loan market, two responses were from associations representing education finance organizations, one response was from a buyside firm, and two were from other institutions.

The following section summarizes the key points of the feedback received:

Of those responding, 70 percent believed that the fallback language should include a “pre-cessation” trigger to allow loans to transition from LIBOR if it was declared to be no longer representative or reliable by its regulator; the remaining 30 percent instead believed that the language should allow the Noteholder or lender to move away from LIBOR based on their own reasonable judgement as to whether LIBOR had become unreliable.

Of those who responded to the question, 75 percent believed that a spread-adjusted rate recommended by the Federal Reserve or a group convened by the Federal Reserve (the ARRC) should be the designated fallback rate. The three consumer-advocacy groups responding noted that they strongly preferred the selection of SOFR as the fallback rate and expressed concern about the possibility that any other rate might be chosen in this step. In contrast, two respondents argued that the lender should have broad discretion to select a replacement rate based on reasonable judgement regardless of any ARRC recommendation and one wondered whether SOFR was appropriate for student loans although they did not specify why it might not be.

If the ARRC had *not* selected a fallback rate, then all respondents agreed that the Noteholder should be allowed to select the replacement rate and to adjust the margin of the loan in a manner that the Note Holder reasonably expects will minimize any change in the cost of the loan, taking into account the historical performance of the Index and the Replacement Index, although one respondent argued that the lender should have discretion to adjust the margin based solely on a reasonable, good faith effort to select a comparable rate.

A few respondents commented on other matters related to the language. As noted in the narrative, the ARRC’s language is intended to be “future proof” by providing a clear fallback rate to LIBOR, but also to the replacement index (presumably SOFR), if that index also eventually ceases or is found to be no longer reliable. One respondent argued that the language should only apply to a fallback for LIBOR and that recommending language that provided fallbacks to the replacement index was outside the ARRC’s scope. Because student loans contracts may be long lived, the ARRC believes that future proofing is appropriate. Another respondent recommended adding language noting that Note Holder actions must be consistent with applicable consumer lending law requirements and contractual commitments. The ARRC acknowledges the strict importance of meeting all applicable federal or state laws and regulations, but notes that these laws or regulations would supersede any provision of the recommended fallback language and that it would be superfluous to add such language.

In line with the majority of responses and the ARRC’s Guiding Principles, the ARRC’s final recommendations have retained the language proposed in the consultation. However, the ARRC has made certain technical adjustments to Part II of this document. Two respondents argued that the ARRC’s recommended language should refer only to clause 4(G), the proposed new clause stipulating the fallback waterfall, and that other clauses that had been included in the consultation for illustrative purposes should either be omitted, as these clauses contained terms or conventions that may not appear in all student loans. In response, the ARRC has adjusted the introduction to Part II to make it clear that the ARRC’s fallback recommendations relate to section 4(G) of the section and that other terms and language are for

illustrative purposes only and are included in order to demonstrate how the fallback recommendations in 4(G) may be embedded in a student loan contract, and the ARRC has bracketed many of these other terms to make clear that the lender should adapt them to the particular contract as appropriate.