Guiding Principles for More Robust Fallback Language in Cash Products

Brian Grabenstein

Managing Director and Head of LIBOR Transition Office

Wells Fargo

Key Decisions in Contractual Fallback Language

- The Fallback "Triggers"
  - What events trigger the conversion from LIBOR to a new reference rate?
  - Is it only at LIBOR cessation or can it be earlier?
- The "Replacement Rate"
  - What rate replaces LIBOR?
- The "Spread Adjustment"
  - How do you determine a spread adjustment if LIBOR and the Replacement Rate are significantly different?

Contract Language Evolution and Moving from Discretion to Specificity

- Market participants should look to minimize the time before more robust contract language is widely incorporated, which may involve being willing to change language over time rather than forgoing any improvements until the absolutely most robust language possible has been identified. Continuing to issue new deals without more robust replacement language will increase the size of the risk to the financial system.

- Efforts should evolve iteratively, utilizing market information and developments from other products to inform standard interest rate language in new agreements. Suggested contract language may initially include higher degrees of flexibility or discretion in order to facilitate quicker incorporation of more robust fallback language where none currently exists, but should be expected to evolve to more specific language that leaves less ambiguity as to how fallback rates and spread adjustments will be selected. This process will be facilitated by the longest possible parallel run between LIBOR and alternative fallback reference rates. Unnecessary variability in fallback language should be reduced as soon as market consensus emerges. This includes, without limitation, specific triggers, the successor rate, the spread adjustment mechanism, and the term structure.

- Where flexibility or discretion are incorporated, it should be done in the most limited manner possible to ensure ease of application and to minimize the potential for disputes, and it should not unduly preclude the mechanisms and outcomes thought likely to be included in future more specific language.

Consistency Between Asset Classes as Appropriate

- Suggested contract language should bear resemblance to contract language in other asset classes and liabilities – including derivatives – as feasible and appropriate. To extent consensus does not exist across all asset classes, individual sectors should seek to maintain consistency of approach within their particular asset class.
- Market participants should strive to maintain alignment in outcomes and minimize basis risks between their products and any related loans and securities, securitizations, or hedges bearing in mind operational, tax, and accounting issues.
- Market participants should also seek an alignment of outcomes, where possible, with contract language in other jurisdictions in order to simplify transition and minimize value transfer in multi-currency facilities and minimize basis risks in other agreements or interrelated transactions involving multiple currencies.
- In order to promote consistent outcomes, market participants should seek to use SOFR, or a benchmark based on SOFR, as the primary basis for a replacement rate where this is considered appropriate and practicable.

Feasibility and Fairness of Implementation

- Mechanics for determining successor rates, spread adjustments and term structures should be feasible from an operational perspective.
- Suggested contract fallback language should incorporate feedback from a broad range of market participants to, among other things, ensure that it is feasible and fair, does not advantage any market participant to the disadvantage of another, and could be implemented practically.
- Market participants should inform themselves so as to understand the ramifications of current fallback language and the potential ramifications of any proposed successor rates or other contractual details, including how any successor rate may behave relative to LIBOR in different stages of the economic cycle and in different economic conditions.
- The choice of successor rate, spread adjustment and succession timing and mechanics should be clear enough to be effectively communicated to borrowers and investors.
- Contract language should seek to minimize expected value transfer over the lifetime of the contract. To the extent that value transfer may occur, fallback language should be based on observable, objective facts and rules set forth in the contract. Such language should provide adequate protections to the extent an Administrative Agent, Trustee, Collateral Agent or other party is responsible for making any determinations with respect to such adjustments.
- Contract fallback language should not impede, to the extent possible, any efforts towards voluntary transition that may be negotiated by contract parties independent of standardized contract fallback language.
- Suggested contract fallback language should seek to minimize litigation risk as well as judicial and regulatory risks for all market participants.