Frequently Asked Questions: LIBOR-Linked Loan Fallback Language Reporting

May 20, 2021

LIBOR Transition

The LIBOR transition continues with the March 5, 2021, announcement by the U.K.'s Financial Conduct Authority. The announcement was another milestone in the phasing out of LIBOR with 1-week and 2-month LIBOR ceasing at the end of the year and the other tenors either ceasing permanently or ceasing to be representative after June 30, 2023.

In order to better understand the risks in pledged member collateral, the Federal Home Loan Bank of Chicago (FHLBank Chicago) is requesting that members report data on the fallback language used in their LIBOR-linked loans starting July 1, 2021, when Q2 2021 collateral reporting begins.

The purpose of this FAQ is to address and answer questions around this data collection effort and provide clarity around the various types of fallback language and how to classify them. Our goal is to ensure all FHLBank Chicago members have the information they need to make the new data collection request as smooth as possible. If you have any questions on the transition, feel free to reach out to your Sales Director.

LIBOR-Linked Loan Fallback Language Reporting Frequently Asked Questions

1. What is fallback language and why is it important?

Adjustable rate loans feature coupon rates that are recalculated periodically by adding a fixed margin to the level of a reference index. The fallback language within the note or loan agreement details what happens when the reference index is not available for use in calculating the next coupon rate of the loan.

Newer fallback language typically contains details on 1) the trigger event (including permanent cessation and pre-cessation triggers), 2) the path to selecting the new benchmark, and 3) any spread adjustment considerations. Legacy fallback language is often missing one or more of these components. For example, spread adjustments are not contemplated in *Legacy Unilateral* fallback language. Furthermore, even if a component is included, it may be incomplete relative to newer fallback language. For example, *Legacy Unilateral* fallback language only includes a permanent-cessation trigger (i.e. the index ceases to exist or is no longer available) and does not include any pre-cessation triggers (i.e. the index continues to exist but is no longer reliable or representative).

2. Why is FHLBank Chicago requesting this data?

The implications of LIBOR benchmarking cessation are far-reaching, and advance preparation is needed. Collecting this information allows us to work with your member institution in providing guidance, so you are ready for LIBOR cessation. Furthermore, if the fallback language is lacking or is inadequate, it can give rise to uncertainty around how the interest rate on the loan should be calculated. In addition to placing strain on the lender/borrower relationship, this uncertainty can cause liquidity problems in the secondary market. By capturing data on the fallback language utilized in LIBOR-linked loans, we will be able to better identify the subset of loans that present the most risk to the cooperative.

3. How will this data be used?

This data will be used to help inform the overall risk of the LIBOR-linked loan portfolios pledged as collateral. Should liquidity for loans with certain types of fallback language begin to deteriorate in the future, the data could also be used to determine the extent to which haircut or valuation adjustments are needed to ensure the safety and soundness of the cooperative throughout the transition.

4. How do I report the LIBOR fallback language?

For listed loan collateral, you will be asked to report the type of fallback language utilized in each LIBOR-linked loan on the listing template.

For blanket reported loan collateral, you will be asked to complete a separate certification (the LIBOR Fallback Language Certification form) detailing the percentage of the LIBOR-linked loans in each asset class that contain each of the three types of fallback language highlighted above.

5. How frequently should I update the LIBOR Fallback Language Certification form?

The LIBOR Fallback Language Certification form should be filled out at least once. If you experience a material change in the mix of fallback language utilized in your LIBOR-linked loans due to maturities, renewals, modifications, etc., you may resubmit the form to ensure we are aware of your most up to date fallback language mix.

6. What does FHLBank Chicago consider to be "adequate" fallback language?

We have defined three types of fallback language: *Robust*, *Legacy Unilateral*, and *Other/None*. While we consider *Robust* fallback language to be adequate and *Other/None* fallback language to be inadequate, *Legacy Unilateral* fallback language is more nuanced.

As discussed below, this fallback language typically allows for the lender/noteholder to select a new index if the current index choice ceases to exist (permanent cessation trigger). For loans referencing overnight, 1-week, 2-month, or 12-month LIBOR, such language should be adequate as those tenors are not contemplated for continued publication on a synthetic, unrepresentative basis. On the other hand, loans with this language that reference 1-month, 3-month, or 6-month LIBOR present uncertainties. Regulatory guidance on how to handle such loans may be required if these indices continue to be published past the cessation date on a synthetic, unrepresentative basis.

7. Can FHLBank Chicago provide more details around the definition of *Robust* fallback language?

The core requirements for fallback language to be considered *Robust* are 1) that it includes both permanent cessation and pre-cessation triggers and 2) that it prescribes a clear path to the selection of both a new index and margin. While all of the Alternative Reference Rates Committee (ARRC) recommended language meets this criteria, other language does as well. Below is one example of *Robust* fallback language that is being used by multiple members along with an explanation of why it is classified as such.

> *If Lender determines, in its sole discretion, that the Index has become unavailable or unreliable, either temporarily, indefinitely, or permanently, during the term of this Note, Lender may amend this Note by designating a substantially similar substitute index. Lender may also amend and adjust the Margin to accompany the substitute index. The change to the Margin may be a positive or negative value, or zero. In making these amendments, Lender may take into consideration any then-prevailing market convention for selecting a substitute and margin for the specific Index that is unavailable or unreliable. Such an amendment to the terms of this Note will become effective and bind Borrower 10 business days after Lender gives written notice to Borrower without any action or consent of the Borrower.*

Here are the reasons this fallback language is considered *Robust*. First, it includes permanent cessation and pre-cessation triggers:

> *If Lender determines, in its sole discretion, that the Index has become unavailable or unreliable, either temporarily, indefinitely, or permanently, during the term of this Note…*

Second, it provides a clear path to selecting a new index and margin in that it gives the lender the authority to do this at its discretion:

> *Lender may amend this Note by designating a substantially similar substitute index. Lender may also amend and adjust the Margin to accompany the substitute index.*

8. Can FHLBank Chicago provide more details around the definition of *Legacy Unilateral* fallback language?

We consider fallback language to be *Legacy Unilateral* if it gives the lender the unilateral right to select a new index or index and margin in a permanent cessation scenario but does not include pre-cessation triggers around the index being unreliable or unrepresentative.

Below are examples of Legacy Unilateral fallback language that we have observed in residential and commercial loans. In both cases, the language includes a permanent cessation trigger (i.e. "the Index is no longer available") but does not contemplate any pre-cessation triggers around the index becoming unreliable or unrepresentative.

> <u>Commercial:</u> *If the Index is not available at the time of the Change Date, Lender will choose a new Index which is based on comparable information.*

> <u>Residential:</u> *If the Index is no longer available, the Note Holder will choose a new index which is based upon comparable information. The Note Holder will give me notice of this choice.*

9. Can FHLBank Chicago provide more details around the definition of *Other/None* fallback language?

Other/None includes loans lacking fallback language entirely as well as loans whose fallback language does not meet either the *Robust* or *Legacy Unilateral* definitions. Here is one example of *Other/None* language that we have observed.

> *If LIBOR is not available to the Bank, the applicable LIBOR for the relevant Interest Period shall instead be the rate determined by the Bank to be the rate at which Bank offers to place deposits in U.S. dollars with first-class banks in the London interbank market at approximately 11 a.m. (London time) two business days prior to the first day of such Interest Period, in the approximate amount of the principal amount outstanding on such date and having a maturity equal to such Interest Period.*

This fallback language does not even meet the *Legacy Unilateral* definition as it does not give the lender the right to select a new index in a permanent cessation scenario.

10. I'm still not sure how to classify my fallback language. What should I do?

If you are uncertain about whether fallback language you use would be considered *Robust, Legacy Unilateral,* or *Other/None*, please send a copy of the language in question to your Sales Director who will ensure you get a prompt response on how to classify it.

11. What if I can't provide any data or my data is incomplete?

If no data is provided, we will assume that LIBOR-linked loans contain *Other/None* fallback language which is considered inadequate and most at risk for haircut and valuation changes as the transition progresses. If your data is incomplete, please report what you have. Some data is better than none at all.

12. Why is FHLBank Chicago still asking for data on LIBOR-linked loans that mature after December 31, 2021, on the QCR form when the cessation date for the most used tenors was extended to June 30, 2023?

In response to recent regulatory guidance, we will continue requesting that you report the unpaid principal balance of LIBOR-linked loans in each asset class that mature after December 31, 2021.

13. My loans have adequate fallback language, but I'm not sure what replacement index to use. Are there any replacement indices that FHLBank Chicago will not accept?

At this time, we do not expect your choice of replacement index to affect loan eligibility. That said, we regularly monitor the state of the LIBOR-linked loan markets including the liquidity of loans with various types of fallback language and replacement indices. Should it become apparent that certain replacement rate choices are negatively impacting loan liquidity, haircut and/or valuation changes could become necessary. We will provide notice to you in advance of any changes. More broadly, we expect that most market participants will coalesce around a similar set of indices as doing otherwise could have a deleterious impact on customer relationships.