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Securitisation

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Trends and Developments

Contributed by Morgan, Lewis & Bockius LLP

Morgan Lewis's structured transactions practice serves the financing needs of the world's most sophisticated businesses. The team is a recognised global leader in the structured finance industry, domestically and internationally, working across offices in the USA, London, Asia and the Middle East. Its clients, both issuers and underwriters, are among the most highly respected global financial services institutions and the practice understands the evolution of structures because it was involved in many of the industry's significant firsts. In addition to a robust, dedicated structured transactions practice, it offers key practice area expertise to support transactions, including tax, the Employee Retirement Security Act (ERISA), litigation, broker-dealer, real estate and investment company practice lawyers. Morgan Lewis lawyers wrote the books that structured finance lawyers rely on: 'Offerings of Asset-Backed Securities' and 'The Federal Securities Law of Asset-Backed Securities'.

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Matthew P Joseph focuses primarily on structured finance transactions. He regularly represents issuers and underwriters in public offerings and private placements of ABS, and he is often involved in structuring innovative transactions with new asset types or unique tax and cash-flow structures, utilising various forms of credit enhancement and derivatives. He also represents large financial institutions in structured lending transactions both on balance sheet and in commercial paper conduit transactions as well as in acquisition financing transactions. Matthew's practice has focused most recently on the asset-backed space and specifically on transactions backed by marketplace loans, auto loans and leases, and student loans.

Steve Levitan has extensive experience in structuring highly complex securitisation transactions backed by collateral encompassing a broad range of asset types, including student loans, auto loans, marketplace (peer-to-peer) loans, Australian mortgage loans, commercial equipment receivables and leases, automobile receivables and leases, residential solar loans and leases, trade receivables, credit card account receivables, residential mortgage loans, home equity loans, financed insurance premiums, residual interests in pre-existing special-purpose entities and the resecuritisation of previously issued asset and mortgage-backed securities. Steve has represented sponsors/issuers and underwriters in public offerings, private placements, direct-lending/warehouse financings, offshore transactions and asset-backed commercial paper offerings. He has also represented clients in connection with acquisitions and sales of whole-loan assets and servicing operations. Steve's clients include the country's leading investment banks, commercial banks, Fortune 500 companies and boutique finance lenders.

Charles A Sweet serves as the practice development leader of the firm's structured transactions group. His securitisation experience encompasses a wide variety of asset classes, including automobile loans and leases, student loans, marketplace loans and residential mortgages. Charlie has worked on many innovative transactions and structures, with sponsors ranging from finance arms of Fortune 500 companies to technology-driven emerging growth companies. Charlie advises clients on the federal laws and regulations affecting ABS and other structured finance products, and is a co-chair of the Structured Finance Industry Group's Legal Counsel Committee. He is the co-author of the new fourth edition of the leading industry treatise, 'Offerings of Asset-Backed Securities', and was the original author of 'The Federal Securities Law of Asset-Backed Securities'.

During the recovery years after the financial crisis, market participants spent a large amount of time and energy responding to significant legislative and regulatory developments. These included significant revisions to Regulation AB (the regulatory framework for registered public offerings of asset-backed securities (ABS)),which is commonly known as Regulation AB II, and the rulemaking required under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), such as the US credit risk retention rules, the Volcker Rule (which generally prohibits certain banking entities from having ownership interests in covered funds and from engaging in proprietary trading), the so-called NRSRO due diligence rules (which impose pre-pricing filing requirements in respect of third-party due diligence reports received in connection with public and private deals rated by nationally recognised statistical rating organisations) and the repurchase demand reporting rules (which require ongoing filings describing pool asset repurchase demand activity for public and private deals).

When it adopted Regulation AB II in 2014, the US Securities and Exchange Commission (SEC) did not adopt every proposal it had made; some of the more important omitted proposals are discussed below. Until the 2016 presidential election, it appeared that the SEC was actively working on many of these omitted proposals and that some might result in new regulatory requirements. Following the 2016 election, the SEC's rulemaking momentum seemed to dissipate.

In 2017, the US Department of the Treasury (the Treasury Department) presented two separate reports to President Trump that included a number of liberalising recommendations regarding Regulation AB, the credit risk retention rules and other post-crisis securitisation rules. Also in 2017, the Structured Finance Industry Group (SFIG) issued a White Paper that advocated changes to some securitisation regulations. Many of the proposals made by the Treasury Department and SFIG are discussed below. It remains unclear whether any of these recommendations will eventually be implemented, but it seems likely that the current pause in new rule-making will extend at least until the next election in 2020.

New revisions to the EU risk-retention rules require compliance in a broader swathe of transactions. These changes are expected to heighten pressures on US transaction sponsors to create risk-retention structures that solve the disparities between the two regimes.

Calendar year 2019 also should see continued focus on planning for the conversion from the use of the London Interbank Offered Rate (LIBOR) index to another alternative interest rate reference index, ideally, one that is universally accepted.

Regulatory

Regulation AB II

One of the SEC's original Regulation AB II proposals that was not adopted would have broadened the disclosure requirements of Regulation AB to include not only registered public ABS offerings, but also most private placements of ABS and other "structured finance products." As proposed, "structured finance products" would have swept much more broadly than ABS to include, among other instruments, synthetic ABS, collateralised mortgage obligations, collateralised debt obligations (CDOs) and collateralised bond obligations. Over at least the past decade, the trend in many asset classes (other than, most notably, automobile loan and lease ABS) has been to issue more privately placed ABS that rely on exemptions from registration. The vast majority of private ABS offerings rely on the exemption from registration provided by Rule 144A under the Securities Act of 1933, as amended, which restricts sales (and resales) of the offered ABS to qualified institutional buyers.

Rule 144A private placements bring with them two primary benefits over registered public offerings: there is no need to undergo the lengthy and expensive process of filing a registration statement and having it reviewed by the SEC staff, and there are very few specific disclosure requirements for Rule 144A offerings. The adoption of the SEC's proposal to subject Rule 144A ABS offerings to the same disclosure standards as public deals would eliminate the latter advantage. While generally it is customary for privately placed ABS to be offered pursuant to a private placement memorandum that includes most of the information that would be required in a prospectus for a registered public offering, this is not required. Further, there are two notable exceptions to this general custom: static pool information regarding ABS previously issued by the sponsor and collateralised by similar assets, and the asset-level data for those asset classes mandated by Regulation AB II often are not included in the disclosures for privately placed ABS. The Treasury Department Capital Markets Report urged the SEC to signal that it will not extend Regulation AB-level disclosure requirements to Rule 144A ABS offerings.

As adopted, Regulation AB II requires disclosure of asset-level data for publicly offered ABS transactions backed by residential mortgage loans (RMBS), commercial mortgage loans (CMBS), automobile loans and leases, debt securities (ie, repacks) and other ABS (ie, resecuritisations). Due to privacy concerns, the required asset-level data points in some cases are less fulsome than those that are commonly disclosed in corresponding private offerings. For example, with respect to RMBS offerings, only a two-digit borrower zip code is required, while investors in private RMBS offerings often receive more granular identifying information (subject to confidentiality restrictions). This disparity may have the effect of further inhibiting future public RMBS issuance, which has been moribund since the financial crisis.

The SEC's original asset-level data proposals had addressed several other asset classes – including student loans, equipment loans and leases, and dealer floor-plan transactions – but because the final rules did not include these requirements, public ABS offerings in these asset classes currently do not have to provide this kind of disclosure. The SEC's proposals also included a number of general asset-data requirements that initially were proposed to apply to all asset types, but these line items were not adopted. Finally, the SEC recognised that certain types of ABS, such as credit (and charge) card receivables transactions, could be backed by many millions of accounts, which would make granular asset-level disclosures cost-prohibitive to sponsors and generally less useful to potential investors. The SEC proposed the concept of "grouped account data" for these asset classes, which would have combined accounts into statistically manageable groups with similar underlying characteristics, but did not include these asset classes in the enacted version of Regulation AB.

Of all the initial Regulation AB II proposals that were not enacted, the SEC appeared to have moved the furthest along on these new asset-level (and grouped account) data requirements. Prior to the change in administration, the SEC solicited detailed comments from SFIG regarding the applicable data points for pools of student loans, equipment loans and leases, dealer floor plans and credit/charge card receivables, in response to which SFIG submitted detailed consensus comments. Subsequently, the SFIG White Paper urged the SEC to announce its intentions publicly so the industry would know what it intended to do about these proposals. The Treasury Department Capital Markets Report also recommended that the SEC signal its intentions with regard to additional asset-level data disclosure requirements, urging the SEC to allow new classes to use the grouped account data method and to scale back the existing required data points for covered asset classes to a more manageable number. The Treasury Department also recommended that the SEC consider implementing a 'provide or explain' approach that would allow an issuer to omit certain fields if it could adequately explain the rationale for its omissions.

Regulation AB II imposed a new requirement to file a preliminary prospectus at least three business days before the first sale of ABS in a registered public offering (which generally occurs at the time of pricing). The purpose of this requirement was to give investors a minimum of three business days to consider their investment decisions, in an effort to permit them to form their own judgment independent of the credit ratings on the ABS. However, the Treasury Department Capital Markets Report noted that issuers face the possibility of price movement during this extended period and that, if the SEC adopted the Treasury Department's recommendations to streamline existing asset-level data requirements, potential investors should not need a full three business days to perform their analysis. The Treasury Department recommended reducing this waiting period to two business days or even one business day, depending on the characteristics of the particular asset class.

One of the more interesting Regulation AB II proposals would have required the creation and filing of a computer program reflecting the cash-flows from publicly offered ABS. This cash-flow waterfall computer program was supposed to provide investors with the ability to input their own assumptions regarding the performance of the asset and receive cash flow expectations regarding the related ABS. However, the SEC was not specific about whether it intended merely to require the program to describe how input monthly cash flows from the pool assets would be applied in the payment waterfall, or a more complete cash flow engine with the ability to generate detailed cash flow projections. Many sponsors feared that the cost of creating a program that was truly useful to prospective investors would be prohibitive and would expose them to an unwarranted risk of liability for unforeseen flaws. When the SEC re-proposed some elements of Regulation AB II in 2011, it indicated that it intended to revise and re-propose this requirement, but there has been no public follow-up.

Regulation AB requires that all material transaction agreements for a shelf take-down be filed as exhibits to the registration statement no later than the date that the final prospectus is required to be filed. Regulation AB II as proposed would have accelerated this timeframe to require that substantially final transaction documents be filed by the time the preliminary prospectus is required to be filed (ie, three business days before pricing). As a practical matter, transaction documents often are still being negotiated until pricing, so any requirement to file them substantially before then could have a significant impact on transaction timing. When the SEC adopted Regulation AB II, it stated that it would defer action on this proposal until it could incorporate its experience with all the other requirements imposed by Regulation AB II.

Credit-Risk Retention

The US credit risk-retention rules generally require the sponsor of an ABS transaction to retain (or cause a majority-owned affiliate to retain) at least 5% of the credit risk of any asset that is transferred, sold, or conveyed to any third party by means of the securitisation, through one of several specified mechanisms.

In mid-2017, the House of Representatives passed the Financial CHOICE Act of 2017 (CHOICE Act), which would have revised or repealed many provisions of the Dodd-Frank Act, including the elimination of the risk retention requirement for all ABS other than RMBS. The CHOICE Act was not passed by the Senate and given the shift in control of the House from Republican to Democratic in January 2019, is unlikely to be enacted into law in the near future. In con-

trast to the CHOICE Act, the Treasury Department Banking Report and the Treasury Department Capital Markets Report advocated the repeal or substantial revision of the risk-retention requirement for RMBS (although conversations with certain Treasury Department representatives suggested that the Treasury Department's recommendations were not limited to RMBS).

The US risk-retention rules designated the collateral manager of a collateralised loan obligation (CLO) as the sponsor responsible for retaining the required risk. In February 2018, in the case styled The Loan Syndications & Trading Ass'n v SEC and Board of Governors of the Federal Reserve System, the Court of Appeals for the DC Circuit held that managers of open-market CLOs are not subject to the credit risk-retention rules because they do not transfer the pool assets, directly or indirectly, to the issuing entity. The LSTA case may ultimately have implications beyond the CLO context, including the possibility that there are other securitisation structures where there is no sponsor that is required to comply with the US risk retention rules.

The SFIG White Paper made some recommendations to change the provisions of the risk-retention rules that provide an exclusion for securitisations backed by specified qualifying assets. Specifically, SFIG suggested that the down-payment requirement for qualifying automobile loans be removed to conform better to accepted automobile lending practices; that the five-year amortisation period for qualifying commercial loans be extended beyond five years, to conform with the longer expected life of most financed equipment and Generally Accepted Accounting Principles (US GAAP) for asset depreciation; and that securitisations of federally guaranteed student loans under the Federal Family Education Loan Program should not have risk-retention requirements that are in excess of the actual risk of principal loss to investors. The Treasury Capital Markets Report echoed some of these concerns and advocated the reconsideration of the qualified asset tests after further notice and comment rule-making.

The minimum mandatory holding period for risk retention in securitisations of most asset classes is two years, but the minimum mandatory holding period for RMBS risk retention and for third-party CMBS, third-party 'B-piece' buyers is five years. The Treasury Department Capital Markets Report urged shortening these five-year periods to a length more commensurate with the emergence period for underwriting losses.

The SFIG White Paper discussed several possible "technical corrections" to the risk-retention rules, including a simplified horizontal risk-retention option that does not require fair value calculations, participation interests and representative sample as permitted forms of risk retention, and a full exemption for transactions that comply with EU risk-retention requirements.

The agencies responsible for the credit risk retention rules had not responded to any of these suggested changes as of the date of this writing.

Volcker Rule

The Volcker Rule covered fund provisions generally prohibit any "banking entity" from acquiring or holding any "ownership interest" in a "covered fund." In order not to be a covered fund, a securitisation vehicle generally must rely on an exemption from registration under the Investment Company Act of 1940, other than Section 3(c)(1) (the 100 holder rule) or Section 3(c)(7) (the qualified purchaser rule). Other approaches involve structuring the ABS so as not to constitute ownership interests, or taking advantage of the loan securitisation exclusion provided by the rule, but these approaches are less common because they involve interpretive difficulties.

The SFIG White Paper advocated that the Volcker Rule be modified so that securitisation structures would be excluded from the definition of "covered fund." The Treasury Department Banking Report also contained a long list of proposed changes to the Volcker Act.

In response to these initiatives and others, in July 2018 the agencies that adopted the Volcker Rule regulations released a proposal to make numerous changes to the Volcker Rule, although for the most part they asked a series of questions and invited comments rather than making specific proposals. With regard to the scope of the "covered fund" definition, the agencies primarily focused on the adequacy of current exclusions, including whether to add an exclusion for entities that lack the common characteristics of a hedge fund or private equity fund. The agencies asked about possible changes to the definition of "ownership interest" that would make it easier to conclude that typical debt ABS interests are excluded. The agencies also asked whether changes should be made to the loan securitisation exclusion, such as permitting a small 'bond bucket' exception to the general prohibition on inclusion of securities as pool assets. The comment period for these proposals ended in October 2018.

Conflicts of Interest Rule

The securitisation conflicts of interest provisions in the Dodd-Frank Act were intended to prohibit a financial institution from shorting ABS interests issued in a transaction that it had assembled or underwritten and would prohibit "engaging in any transaction that would involve or result in any material conflict of interest with respect to any investor arising out of such activity" for a period of one year following the closing of the sale of securities from the offering. Unusually, the conflicts of interest implementing rules proposed by the SEC in 2011 were not highly technical; instead,

they would simply have restated the statutory prohibition, with minor tweaks. In order to apply the prohibition, market participants would have to rely on the interpretive guidance in the proposing release, which analysed in more detail the SEC's interpretation of the proposed rule. In short, a prohibited material conflict would be deemed to occur when a person involved in the structuring and implementation of the transaction is in a position to profit if the ABS perform poorly, or where such a party benefits by permitting a third party to structure the ABS transaction in such a way that the third party would benefit from a short-selling transaction. The SEC has taken no further action and whether the conflicts of interest rule will be implemented is uncertain.

EU Risk Retention

The US risk-retention rules apply to the sponsor of an ABS transaction that is subject to the jurisdiction of the US, subject to the application of a safe harbour for certain foreign transactions. Before 1 January 2019, the EU risk retention rules required any investor that was an EU-regulated bank, investment firm, consolidated entity, alternative investment fund (AIF) manager, or insurer to ensure that risk retention requirements were satisfied. New EU rules that came into effect on 1 January 2019 have several important impacts. Among other things, they directly oblige sponsors, originators and original lenders to comply with the risk-retention requirements, and apply to more types of institutional investors, including undertakings for the collective investments in transferable securities (UCITS) and non-EU AIFs. Thus, UCITS and non-EU AIFs may no longer invest in US securitisations unless they also comply with the EU risk-retention rules.

For this reason, the new EU rules are expected to increase the number of US securitisations that comply with both US and EU risk-retention requirements. However, because the specific requirements of the two sets of rules vary significantly, it can be difficult to structure a transaction where the same 5% interest satisfies both sets of requirements. For example, the US rules apply to offers and sales of "asset-backed securities" as defined in the Securities Exchange Act of 1934, as amended. While the line between a security and a loan under case law is somewhat vague, a credit agreement entered into by a bank or other traditional loan financing source is unlikely to be covered by the US rules. In contrast, the EU rules do not draw a distinction between a loan and a security, although they do specifically require a transaction to be tranched (a requirement that is not specified by the US rules).

The US rules generally require risk to be held by the sponsor, the entity that organises and initiates a securitisation by directly or indirectly transferring assets to the issuing entity. The EU rules also permit the required risk to be held by a sponsor, but define it more narrowly as an EU bank or investment firm that establishes and manages a securitisation scheme by purchasing exposures from third parties.

The US rules only permit the allocation of proportionate risk to an originator (the entity that created a financial asset) that contributed at least 20% of the pool assets. The EU rules define "original lender" similarly to a US originator, and define "originator" as an entity that was directly or indirectly involved in the creation of a securitised exposure or purchased third-party exposures for securitisation. Multiple originators or original lenders may hold proportionately and in some circumstances a single originator or original lender may hold the entire required risk.

The US rules generally permit the required risk to be retained by a sponsor's "majority-owned affiliate," defined as an entity that directly or indirectly majority controls, is majority controlled by, or is under common majority control with the sponsor. For these purposes, control is defined by reference to ownership of more than 50% of an entity's equity or any other "controlling financial interest" under US GAAP. Under the EU rules, the consolidated situation of a parent entity is taken into account only where, inter alia, it is a regulated EU parent credit institution, financial holding company or mixed financial holding company.

The US rules generally require risk to be held as an "eligible vertical interest" (ie, a vertical strip) of at least 5% of each class of ABS interests issued, or an "eligible horizontal residual interest" (ie, one or more ABS interests to which shortfalls must be allocated before impacting other ABS interests and having the most subordinated claim to principal and interest payments) with a US GAAP fair value of at least 5% of the fair value of all ABS interests issued. The EU rules permit risk to be held as 5% of the nominal value of each of the tranches sold or transferred to investors, or as a first loss tranche (including other pari passu or more senior tranches, if needed) representing at least 5% of the nominal value of the securitised exposures. The US vertical and horizontal options may be combined, but the EU nominal value and first loss tranche options may not. The EU first lost tranche option permits the use of over-collateralisation, or of a letter of credit, guarantee or similar credit support, none of which is permitted in the US.

The EU rules permit the retention of randomly selected exposures equivalent to at least 5% of the nominal value of the securitised exposures, or a first loss exposure of at least 5% of every securitised exposure. There is no similar "representative sample" or "participation interest" option under the US rules.

For securitisations of revolving exposures, the EU rules permit retention of an originator's interest of at least 5% of the nominal value of the securitised exposures, similar to the US 'seller's interest' option for revolving pool securitisations.

However, the EU does not offer risk-retention methods similar to the CMBS 'B-piece' option, the asset-backed commercial paper (ABCP) conduit 'originator-seller' option or the tender option bond option under the US rules.

The EU rules do not include the US exemptions for deals backed by qualified residential mortgages or other qualified assets, or by seasoned loans, or where the securities issued or the pool assets are backed by certain government guarantees. The EU exemptions are primarily limited to securitisations guaranteed by certain governmental institutions, institutions with a 50% risk weight or less and multilateral development banks.

The US rules do not permit risk retention to be satisfied on a synthetic or contingent basis, but the EU rules do (although if the retaining party is not an EU-regulated credit institution, it must be fully cash-collateralised).

Under the US rules, there are sunset dates after which all restrictions on transfer and hedging expire, but all requirements of the EU rules apply for the life of the transaction.

Alternatives to LIBOR

The interest rates on many ABS (and on many variable rate loans, credit card accounts, derivatives and other financial instruments) adjust in accordance with an index based on the average of the inter-bank offered rates for US deposits of certain durations in the London market based on quotations of major banks (ie, LIBOR). LIBOR is a global benchmark for consumer lending and often determines the interest rate that issuers and borrowers pay to borrow money. LIBOR is calculated and published for various currencies and periods by the benchmark's administrator, ICE Benchmark Administration Limited (IBA), which is regulated by the UK Financial Conduct Authority (FCA).

In November 2017, the FCA announced that the panel banks that submit information to IBA, as administrator of LIBOR, have undertaken to continue to do so only until the end of 2021 (LIBOR Phase-Out Date). It is not expected that a value for LIBOR (of any duration) will be calculated or published after the LIBOR Phase-Out Date.

The FCA's announcement followed a series of regulatory investigations dating back to 2012, in which certain financial institutions were accused of manipulating LIBOR and altering costs when reporting to regulators. In addition, lawsuits have been filed in the USA seeking damages for losses arising from alleged LIBOR manipulation. While some aspects of these lawsuits have been dismissed or settled, others continue to be litigated. These investigations and litigation may affect the use of LIBOR as a global benchmark even before the LIBOR Phase-Out Date.

The elimination or effective unavailability of LIBOR has implications not just for floating rate ABS but also for pool assets that have floating interest rates. This could lead to disconnected floating rates between the ABS and the related collateral if the reference rate is not addressed in both.

LIBOR is the subject of ongoing regulatory reform, including the EU Benchmarks Regulation (Regulation (EU) 2016/1011) (the Benchmarks Regulation). Under the Benchmarks Regulation, which became effective on 1 January 2018, new requirements will apply with respect to the provision of a wide range of benchmarks (including LIBOR), the contribution of input data to a benchmark and the use of a benchmark within the EU. The Benchmarks Regulation will, inter alia, require benchmark administrators to be authorised or registered and to comply with extensive requirements in relation to the administration of benchmarks, and prevent certain uses by EU-supervised entities of benchmarks of administrators that are not authorised or registered (with equivalent requirements for non-EU based administrators).

The Board of Governors of the US Federal Reserve System and Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (ARRC) in 2014 to identify possible alternative reference rates for US dollar LIBOR and to identify best practices for implementation of a new reference rate. In June 2017, the ARRC identified the Secured Overnight Financing Rate (SOFR), which is a secured rate derived from borrowing and lending activities on US treasuries, as its preferred alternative reference rate. Based on the work of the ARRC's Securitization Working Group (chaired by SFIG and the Commercial Real Estate Financial Council, or CREFC), in December 2018 the ARRC posted a consultative document that provides proposed fall-back language for contracts to address the possibility that LIBOR ceases to be available or is discontinued. Comments are due by 5 February 2019. Also in December 2018, SFIG released the first edition of a Green Paper setting forth recommended best practices for LIBOR benchmark transition. The consultative document and the Green Paper suggest the use of a 'waterfall' of fall-back language to deal with the potential discontinuance or effective unavailability of LIBOR. However, there are several key issues that are not fully addressed by the consultative document or the Green Paper and these will need to be dealt with for effective implementation.

Many existing ABS (and underlying pool assets) currently provide that if LIBOR is terminated or ceases to function, the applicable interest rates may become fixed based on the last LIBOR rate available. Many of these deals present no readily apparent amendment mechanism to incorporate the recommended fall-back provisions of the consultative document or the Green Paper. Also, there is likely to be basis risk between the cash flows on ABS and the underlying pool assets if floating interest rates on both do not adjust simultaneously and based on the sam reference rate. Going forward,

while new securitisation documents can provide for an effective alternative reference rate for the ABS, the interest rate provisions in the underlying pool assets will likely have been determined prior to the securitisation and may have been drafted by entities unaffiliated with the sponsor. Therefore, close co-ordination between securitisation sponsors and the originators of financial assets that are likely to be securitised is recommended.

SOFR differs from LIBOR in several key respects. First, SOFR is an overnight rate, while LIBOR is available in many different tenors (eg, one month, three month, etc) and is forward-looking. While the consultative document and the Green Paper suggest that the first alternative should be a forward-looking SOFR with a matching term to LIBOR, no such rates currently are available and some industry participants have expressed concern as to whether they will be by the LIBOR Phase-Out Date. Second, SOFR is a secured rate derived from borrowing and lending activities on US treasuries, while LIBOR is based on a survey of quotations from participating banks regarding what they believed the going-forward unsecured interest rate should be. Because SOFR is effectively a risk-free rate, it is likely to require a 'spread adjustment' to match LIBOR's unsecured and riskier calculation. While the waterfall provisions suggested by the consultative document and the Green Paper acknowledge that need, there is no current consensus as to what an appropriate spread adjustment should be or how it should be calculated. Finally, because SOFR is an overnight rate, the market must reach a consensus as to how to calculate properly a rate for use with consumer products and other contracts that provide for an interest rate to be set at the beginning of each interest accrual period. Because SOFR is an overnight rate only, calculating forward-looking rates based on spot rates or over a past period of time will be based on stale or backwards-looking information.

In combination, these factors – lack of multiple terms or tenors, the need for a spread adjustment and the lack of a forward-looking rate – may represent significant risk if not addressed in a neutral manner. The market will be watching closely to judge whether any new rate structures that are adopted have unintended consequences.

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