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Let's Talk LIBOR

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In This Issue ...

It's hard to believe that, after more than six years, we can actually see the LIBOR finish line.

My esteemed colleague, Lary Stromfeld, has been banging drums from the outset and has certainly earned his market-leading reputation with his critically important work guiding the Federal Reserve ARRC, his drafting of New York State and federal LIBOR legislation, his counsel to many of our leading financial services clients, his thought leadership and his management of our LIBOR Preparedness Team.

Lary has two items in today's *Cabinet News and Views* – an update on the ARRC's recent activities and an article on LIBOR he wrote for *IFLR*. Both are must reads as we get closer to the end of LIBOR as we know it.

Lots more to read about this week. And by way of coming attractions, we are taking an in-depth look at the FSOC proposals on an analytic framework for financial stability risks and nonbank financial company determinations, and will have that out for next week's edition. Also judging from the news out of Washington, it sounds as if we will be looking at the Federal Reserve's (and possibly the FDIC's) supervisory post-mortems on last month's bank failures, and will provide thoughts on those next week as well.

For now, please reach out here if there's anything you'd like to talk about.

Daniel Meade
Partner and Editor, *Cabinet News and Views*

ARRC Updates its Recommendations for Use of Term SOFR

By **Lary Stromfeld**
Partner | Financial Regulation

The Alternative Reference Rates Committee (ARRC) announced three updates to its recommendations for the use of Term SOFR.

First, the ARRC clarified the scope of "business loans" that may be hedged with Term SOFR swaps. Second, the revised recommendations recognize that end users may enter into Term SOFR basis swaps even when they do not have exposure on Term SOFR cash assets. Third, the ARRC clarified when the liabilities (*i.e.*, the securities) issued in a securitization could use Term SOFR.

The announcement first differentiated between "business loans" (for which Term SOFR may be appropriate) and intercompany loans (for which the recommendation remains 30- or 90-day SOFR in advance). A Term SOFR swap may be used to hedge a business loan that is primarily for a business or commercial purpose. The announcement gives several itemized examples, including a syndicated loan or trade finance transaction. The recommendation does not include business loans that are securities offered publicly or in 144A transactions or securities sold in private transactions unless, in the latter case, it is the "functional equivalent" of a loan that would otherwise be within scope of the recommendations. This last point tries to capture certain syndicated business loans irrespective of their treatment for certain regulatory purposes.

The announcement also expanded the market for Term SOFR derivatives by recognizing that dealers could enter into Term SOFR-SOFR basis swaps with end users who are not hedging their exposure on a Term SOFR cash product (which was the case in the ARRC's earlier recommendations). The ARRC was very clear that the broader recommendation did not cover either end users entering into Term SOFR derivatives that are not basis swaps or dealers entering into any Term SOFR derivatives with other dealers. Rather, this narrow expansion is intended to address "concerns that dealers may eventually build up positions that are so large as to render them unable to warehouse further additional Term SOFR exposures."

Finally, the ARRC recognized that Term SOFR could be used for the securities issued by a securitization that holds Term SOFR assets so that the cashflows would be better matched. However, "after these transition issues are past," the ARRC would not recommend the use of Term SOFR "in a situation in which a securitization's Term SOFR liabilities have been structured at issuance to materially exceed the anticipated cash flows from the portion of floating rate assets (which would be expected to be predominantly Term SOFR assets) in the securitization."

In a related development, the licensing agreement for use of CME Term SOFR is expected to be revised to be consistent with these updated ARRC recommendations, thus making such limitations a part of the contract under which market participants may use CME Term SOFR.

LIBOR Transition: The Final Leg of the Marathon

By **Lary Stromfeld**
Partner | Financial Regulation

Since Andrew Bailey, then CEO of the UK's Financial Conduct Authority, fired the starting gun in July 2017, regulators and market participants around the world have been planning for the end of LIBOR, which will now occur in less than 10 weeks. For many, this is the final leg of a marathon that has included many legal, economic and operational hurdles. For others, this will be an all-out sprint to the finish line. This article, originally published in *IFLR*, lays out some of the many considerations to meet the challenge of transitioning legacy contracts away from U.S. dollar LIBOR. Read it here.

OCC and FDIC Provide Supervisory Guidance on Certain Overdraft Practices

By **Daniel Meade**
Partner | Financial Regulation

By **Mercedes Kelley Tunstall**
Partner | Financial Regulation

The Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies") provided supervisory guidance this week on certain overdraft practices. Of particular focus are "Authorize Positive, Settle Negative" ("APSN") practices.

Prior to this guidance, banks were generally allowed to use their own judgment to ascertain when a particular overdraft charge would apply to transactions coming in, as long as they disclosed their methodology to consumers. However, many institutions have found – usually through customer complaints or lawsuits – that consumers are regularly confused by the methodology disclosures.

Accordingly, APSN transactions, as the name suggests, are transactions where a customer has sufficient account balances at the time the transaction is initiated (*e.g.*, a debit card transaction at a point of sale), but as other transactions are processed, the authorized transaction settles against a negative balance. The guidance highlights that some institutions will assess an overdraft fee on the APSN transaction *and* the intervening transactions that exceed the customer's account balance.

The agencies noted that they have "determined that certain overdraft practices related to APSN transactions were unfair" in their consumer compliance examinations. The Agencies went on to note that if a bank fails to take steps to avoid assessing overdraft fees for APSN transactions, then such failure "results in heightened risk of violations of the unfair, deceptive or abusive acts or practices ("UDAAP") provisions of the Dodd-Frank Act, and the unfair and deceptive acts and practices ("UDAP") provision of Section 5 of the Federal Trade Commission Act.

The Agencies encouraged institutions to review their overdraft practices for APSN charges. As this guidance indicates, many institutions have already made changes as a result of supervisory compliance examinations. In doing so, these institutions have had to employ a multi-pronged approach to identifying APSNs that includes human review, because it is not always obvious when they have occurred.

The Agencies also encouraged "review [of] disclosures and account agreements to ensure the financial institution's practices for charging any fees on deposit accounts are communicated accurately, clearly, and consistently." The Agencies concluded, however, that in their view, "disclosures generally do not fully address Dodd-Frank UDAAP and FTC UDAP risk associated with APSN transactions and related overdraft fees."

As we go to press, the Federal Reserve Board (“FRB”) did not issue similar guidance this week. The FRB may yet issue similar guidance, or may feel they have already addressed the issue. As FRB Governor Michelle Bowman noted in a speech last month, the FRB has focused on this issue since at least 2018.

The Consumer Financial Protection Bureau (“CFPB”) issued a circular last year indicating that they viewed APSN charges as likely to be an unfair act or practice for purposes of the Consumer Financial Protection Act. The circular provides an in-depth explanation of how overdraft fees tied to APSNs may end up being unfair to consumers.

The European Banking Authority Publishes Draft Guidelines on STS Criteria for On-Balance-Sheet Securitisations

By **Alix Prentice**
Partner | Financial Regulation

The European Banking Authority ("EBA") has published a Consultation Paper on draft Guidelines on the STS criteria for on-balance-sheet securitisations ("Draft Guidelines"), comments on which are due by 7 July. Developed in accordance with a mandate set out at Article 26 of the Securitisation Regulation (Regulation (EU) 2017/2402), the Draft Guidelines are intended to provide "a single point of consistent interpretation" of the criteria on simplicity, standardisation and transparency ("STS") as well as on the credit protection agreement, third-party verification agent and synthetic excess spread applicable to STS on-balance-sheet securitisation ("OBS"). Compliance with these criteria allows preferential risk-weighting under the amended Capital Requirements Regulation for originators retaining senior tranches in STS OBS.

The Draft Guidelines take into account guidance given in 2018 on the STS criteria for traditional non-ABCP securitisation, and aim to cover the STS criteria for OBS that require additional clarification. For a limited subset of requirements, experience of practical implementation of the guidelines in place for non-OBS securitisations has meant that this existing guidance requires updating, and those updates are included in this consultation.

At the conclusion of the consultation process, the EBA will issue three separate guidelines for OBS, non-ABCP and ABCP securitisation (both of the latter on a consolidated basis with previous iterations).

Draft Guidelines on OBS STS Criteria

Simplicity

Guidance proposed here covers a number of aspects, including:

- excluding arbitrage securitisations whereby protection buyers take positions outside their core activities for the sole purpose of writing tranched credit protection on them and arbitraging the yields from the STS label;
- clarifying credit risk mitigation requirements for significant risk transfer through synthetic securitisation;
- enhancing legal certainty around the ownership of legal title to the underlying exposures and enforceability under the credit protection agreement through guidance on specific representations and warranties from the protection buyer;
- ensuring clear and consistent selection of underlying exposures, prohibiting active portfolio management and ensuring that exposures added after closing are subject to no less strict eligibility criteria;

- requirements for homogeneity of underlying pools of exposures, along with contractually binding and enforceable obligations with full recourse, defined payment streams and excluding transferable securities (other than certain) corporate bonds;
- prohibiting resecuritisation being classified STS OBS;
- preventing cherry-picking and ensuring that exposures are not outside the ordinary business of the originator;
- ensuring underlying assets do not include exposures to credit-impaired debtors or guarantors with an adverse credit history;
- requiring at least one ordinary payment specified in the contract and related to the economic substance of the exposure to be made by each underlying borrower at the time the exposure is selected.

Standardisation

Guidance on standardisation includes:

- compliance with risk retention requirements;
- appropriate mitigation of interest rate and currency risks;
- excluding reference to atypical or complex rates or variables that investors use to model credit risk and cash flow;
- clarifications on enforceability for an investor when there is an enforcement event in respect of the originator;
- allocation of losses to investors and the application of different types of amortisation applied to tranches;
- safeguards for investors when there is a revolving period and the inclusion of early amortisation provisions when an SSPE is used;
- clarification on transaction documentation covering servicing standards and procedures and requirements for the third-party verification agent;
- identification of reference obligations on which protection is purchased via a reference register;
- facilitation of the timely resolution of conflicts between different classes of investors.

Transparency

Guidance on requirements relating to transparency covers:

- sufficiency of data on historical default and loss performance to allow appropriate due diligence;
- enabling investors to model cashflows;

- disclosure of the energy efficiency of assets when that information is available to the originator, sponsor or SSPE;
- compliance with investor disclosures required under Article 7 of the Securitisation Regulation.

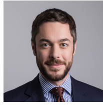
Requirements specific to OBS that have no equivalent in the requirements for non-ABCP securitisation

These guidelines have no existing equivalent and cover:

- which credit events should trigger payments under the credit protection agreement;
- ensuring that the credit protection agreement covers originators' losses in a timely manner, how to determine the losses and the amounts and timing for the interim and final credit protection payments;
- clarification on legal certainty for investors on the maximum extension period for debt workout and on contingent credit protection premiums;
- the requirement for the appointment of a third-party verification agent;
- the conditions under which the originator is able to exercise early termination rights;
- synthetic excess spreads committed by the originator as credit enhancement for investors;
- eligible forms of credit protection agreement;
- acceptable types of high-quality collateral that originators and investors should have recourse to.

While in the main the Draft Guidelines are a continuation of the status quo, they will form an important part of the EU securitisation framework in place since 2019.

FCA Delays Introduction of Sustainability Disclosure Requirements


By **Duncan Grieve**
Special Counsel | White Collar Defense and Investigations

By **Carl Hey**
Associate

The UK Financial Conduct Authority ("FCA") has announced that its widely-anticipated Policy Statement in response to the Sustainable Disclosure Requirements (SDRs) and investment labels consultation will now be published in Q3 2023 instead of H1 2023, and that the proposed effective dates will be adjusted accordingly. The consultation was motivated by a concern on the part of the FCA that "firms are making exaggerated or misleading sustainability-related claims about their investment products; claims that don't stand up to scrutiny (greenwashing)." The FCA's proposals subject to the consultation were intended "to build transparency and trust by introducing labels to help consumers navigate the market for sustainable investment products, and ensuring that sustainability-related terms in the naming and marketing products are proportionate to the sustainability profile of the product."

The delay, the FCA explained, will enable it to consider the significant response to its consultation on the new rules. The FCA reports that there is broad support for the proposed sustainable disclosure regime and broader policy outcomes that it is looking to achieve, while specifically pointing out the "rich, constructive feedback on some of the detail" of its proposal.

The FCA added that: "A strengthened regulatory framework for these products will increase opportunities and competition in the market and help foster growth and the demand and supply of products that better suit consumers' needs and preferences."

More specifically, the FCA has highlighted that it wants to take account of practical challenges faced by firms in implementing the SDRs as currently proposed. It highlights two areas of specific concern that it will review and consider further:

- refinement of specific criteria for the proposed labels; and
- how different products, asset classes and strategies can qualify for a UK sustainability label.

The FCA has also noted that its Policy Statement will clarify that for the SDR labels:

- it will not prescribe primary and secondary channels for achieving sustainability outcomes; and
- firms will not be required to obtain independent verification of product categorization to qualify for a label.

The delay to the publication of the Policy Statement is also likely to mean that the new anti-greenwashing rule (which was proposed to take effect from the publication of the Policy Statement) will be delayed. As noted above, the application of the regime will also be pushed back from the current provisional date of June 30, 2024 (12 months after publication of the Policy Statement), although the FCA is yet to confirm a new date for this.

Taking the Temperature: As we have commented on, the FCA has made it clear that it is focused on ESG-related disclosure, and just recently expressed concerns regarding the "overall quality" of ESG disclosures by benchmark administrators. However, the FCA's proposed rules for SDR and investment labels have been a source of debate, receiving praise and criticism from various groups. In January, the UK Sustainable Investment and Finance Association commended the rules for creating a "higher bar" for funds seeking to make sustainability claims. In contrast, in February, the Treasury Committee's Financial Service Regulation Sub-Committee urged the FCA to research the potential administrative and financial burdens of compliance with the proposed rule.

The delays will give in scope asset managers somewhat of a respite to prepare and consider the SDR's implications, including how it fits into other applicable regulatory regimes that asset managers may be subject to, such as the European Union's Taxonomy Regulation and Sustainable Finance Disclosure Regulation. We have reported on these issues on numerous occasions, such as here, here and here.

(This article originally appeared in Cadwalader Climate, a twice-weekly newsletter on the ESG market.)

Welcoming Smridhi Gulati to Our Expanding Leveraged Finance & Private Credit Team

We are pleased to announce that partner Smridhi Gulati has joined our Leveraged Finance & Private Credit team in London.

Smridhi joins Cadwalader from Dechert in the latest in a series of high-profile additions to the practice. London partners Matthew Smith and Bevis Metcalfe joined in 2022, and a four-partner, U.S.-based team – Ronald Lovelace, Patrick Yingling, Jared Zajac and Joseph Polonsky – joined in January. Also recently joining the group in London was ESG Finance and Investment partner Sukhvir Basran and special counsel Andrew Vickers.

Smridhi advises private credit funds, banks, private equity sponsors and corporate borrowers on domestic and international leveraged and acquisition finance transactions. She also has considerable experience in executing and restructuring complex private credit transactions at all levels of the capital structure.

"Private credit is nimble, flexible and innovative and has filled the gap in lending caused largely by regulatory constraints on traditional lenders," said London managing partner Greg Petrick. "In the wake of the pressure on banks given developments in March, we expect private credit to continue to garner significant market share in credit markets from corporates to real estate borrowers."

"I am thrilled to be joining the Cadwalader team in London," Smridhi added. "Cadwalader is committed to building out a dominant private credit practice, and to be able to join forces with Matt and lead that growth together couldn't be more compelling or exciting for me."

Read our full news release here.