ARRC Consultation on Adjustable Rate Mortgages (ARMs)

<u>*Section B: Triggers*</u>

Question 1. *Should fallback language for ARMs include either of the pre-cessation triggers (triggers 4(G)(ii) and 4(G)(iii))? If so, which ones?*

Answer:

- The Federal & State Law trigger would be unique to ARMs. It is not currently contemplated for inclusion in derivatives products, thereby potentially introducing basis risk between ARMs and their associated derivatives. We recognize that ARMs are a retail product and may be subject to federal and state regulations that may necessitate this trigger (e.g. consumer protection rules). Further, we would like to ensure that the Federal & State Law trigger applies consistently across all states, ensuring a uniform ARMs documentation.
- The Index is No Longer Reliable or Representative trigger is reasonable for ARMs, especially given the possibility of a Zombie LIBOR scenario. This trigger has also been recommended for inclusion in other cash products by the ARRC and is also under consideration for inclusion in ISDA derivatives (although preliminary results on a consultation on this trigger shows that the derivatives market is split on whether to include it).

Question 2. *Please indicate whether any concerns you have about these pre-cessation triggers relate to differences between these triggers and those for standard derivatives or relate specifically to the pre-cessation triggers themselves.*

Answer:

- Our concerns relate predominately to the differences between the proposed triggers and those for standard derivatives.
- If there is misalignment in the triggers of ARMs and their associated derivatives, there is a risk that one product will transition from LIBOR to the alternative rate and the other would not, thereby creating basis risk.
- In addition the instrument funding the mortgage may not have similar triggers

Question 3. *If pre-cessation triggers are not included, what options would be available to market participants to manage the potential risks involved in continuing to reference a Benchmark whose regulator has publicly determined that it is not representative of the underlying market?*

Answer:

- We encourage the ARRC to work with ISDA to determine whether the pre-cessation triggers could be included as possible fallback triggers for derivatives contracts. ISDA has recently done a consultation on whether to include the Index is No Longer Reliable or Representative trigger in OTC derivatives.
- We also encourage the ARRC to work with the major central counterparties (CCPs) to ensure that derivatives which include the pre-cessation triggers can be cleared.

- If Libor is still published and available, the contract likely wouldn't allow for Libor to be replaced. However, given that the rate is set for 1 year, there may be time in between the pre-cessation determination and the next rate reset date which would allow time for the client to refinance into a new mortgage with a more robust index. Industry groups may be able to explain the benefits for the clients to move away from Libor after the pre-cessation event

Question 4. *The ARM language proposed uses simplified language in an effort to be more comprehensible for the consumer market. Is the simplified language appropriate or are there concerns with the language not matching ISDA or other cash product language precisely?*

Answer:

- While we understand that the ARRC would want to simplify the fallback language in ARMs to make it easier for consumers to understand, this difference in language does risk misalignment with derivatives and other products indexed to Libor.
- This could potentially introduce basis risk as the ARMs or derivative, and/or funding instrument, is transitioned from LIBOR the alternative rate and the other would not.

<u>*Section C: Replacement Index and Margin*</u>

Question 5. *Is the replacement index determined by the Federal Reserve Board, the Federal Reserve Bank of New York, or a committee endorsed or convened by the Federal Reserve Board or the Federal Reserve Bank of New York the best choice as the first step of the waterfall? Why or why not?*

Answer:

- A common existing fallback in ARMs is for the Note Holder to select the replacement index. To consistent with current market practice, the Note Holder selection should be the first step in the waterfall.
- Even where the Note Holder selects the replacement rate, a benchmark determined by the Federal Reserve Board, the Federal Reserve Bank of New York, or a committee endorsed or convened by the Federal Reserve Board or the Federal Reserve Bank of New York would likely become the industry standard and adopted by many Note Holders.
- However, should the ARMs market determine a replacement rate for ARMs that is different than that chosen by the Federal Reserve Board, the Note Holders should have the flexibility to adopt that instead.

Question 6. *As noted in the narrative, the ARRC has committed to recommending spread adjustments for cash products that reflect the general difference between various tenors of LIBOR and SOFR. In addition, the ARRC has committed to seeing all-in, "spread-adjusted" rates published for use in cash products (e.g., a SOFR-based spread-adjusted replacement index for 1-year LIBOR). Should the ARRC recommend a spread adjustment for LIBOR ARMs and other consumer products, and should the corresponding spread-adjusted rate be the replacement index for the LIBOR ARMs?*

Answer:

- A common existing fallback in ARMs is for the Note Holder to select the spread adjustment to the replacement rate. To consistent with current market practice, the Note Holder selection should be the first step in the waterfall.
- Even where the Note Holder can select the applicable spread adjustment, a spread adjustment determined by the ARRC for LIBOR ARMs and consumer products would likely set the industry standard and adopted by many Note Holders; therefore the ARRC should recommend a spread adjustment .
- However, should the ARMs market determine a spread adjustment ARMs that is different than that chosen by the ARRC, Note Holders should have the flexibility to adopt that spread instead.

Question 7. *As noted in the narrative, in addition to recommending SOFR, the ARRC may recommend forward-looking term SOFR rates if it is satisfied that a robust, IOSCO-compliant term rate that meets its criteria can be produced. If the ARRC recommends forward-looking term rates (e.g., 1-month, 3-month, 6-month, etc.) and a corresponding spread adjustment, should a spread-adjusted term rate be the replacement index for LIBOR ARMs, or would a spread-adjusted average (simple or compounded) of SOFR be more appropriate? Please provide support for your answer.*

Answer:

- ARMs currently use forward looking term rates. While a spread-adjustment average determined in arrears could be better from a volatility perspective, more information is needed to determine if it is a desirable change from the forward looking term rates.
- Use of forward looking term SOFR would be different than the proposed SOFR ARM that would use compounded setting in advance. It may not be desirable to have different SOFR conventions

Question 8. *Should the Note Holder have the responsibility as the 2nd and last step of the waterfall? Why or why not?*

Answer:

- As per our answer in Question 5, Note Holder should be the first step of the waterfall.

Question 9. *Should the Note Holder have the ability to make adjustments (positive or negative) to the loan's margin to more closely approximate LIBOR at the time of replacement? Why or why not? If you do not believe the Note Holder should make adjustments to the loan's margin, and potential replacement indices diverge from the value of the current Index, what provision or step should be taken to preserve that consistency?*

Answer:

- Note Holders should be given the ability to make adjustments to the loan's margin to more closely approximate LIBOR at the time of replacement.
- This ability does risk disputes and litigation with clients, especially where the transition would negatively impact them. However, this litigation risk can be mitigated if the ARRC recommends

a loan margin adjustments that can be voluntarily adopted by Note Holders and the broader industry.

Question 10. *If the Note Holder is a trust (for example, as may occur in private label MBS), is there some entity other than the Note Holder that should be responsible for identifying the Replacement Index if Step 1 of the waterfall fails? Please provide sufficient rationale for your answer.*

Answer:

- This situation is not applicable to us.
- Theoretically, the servicer should be the entity (after the Note Holder) who should be responsible for identifying the Replacement Index.

Section E: Other Questions

Question 11. *Will this language have unintended consequences not considered by the ARRC working group, such as title insurance restrictions, state law endorsement or filing restrictions, etc.? If so, please explain and provide information about why this language would present challenges. If there are concerns with this proposed language, please be sure to specify if concerns relate to this proposed language, or index replacement language in general.*

Answer: N/A

Section F: General Feedback

Question 12. *Is there any provision in the proposal that would significantly impede ARM originations? If so, please provide a specific and detailed explanation.*

Answer: N/A

Question 13. *Please provide any additional feedback on any aspect of the proposal.*

Answer: N/A