HARVEST
Transparent Investment Valuations

September 24, 2019

To: ARRC Secretariat
Via email: arrc@ny.frb.org

Re: Consultation Response from Harvest Investments Ltd on Fallback Contract Language Consultation for New Closed-End, Residential Adjustable-Rate Mortgages

Dear ARRC Secretariat:

Thank you for extending the period for comment re: Fallback Contract Language Consultation for New Closed-End, Residential Adjustable-Rate Mortgages. As an independent securities valuation specialist with over twenty-five years' experience in financial reporting, securities valuation, and the use and application of fair value measurement, Harvest Investments, Ltd. is grateful for the ARRC's efforts to clarify fallback contract language for new adjustable rate mortgages (ARMs) when switching from LIBOR to another reference rate under a range of scenarios (i.e., triggers). We hope that the following responses to several of the questions posed in your call for comment will prove helpful in your deliberations.

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?

> We think that the language ARRC uses should match as closely as possible that used by ISDA. While we appreciate the ARRC's effort to provide a more consumer-friendly language, we think that a simplified language developed before ISDA has completed its deliberations on trigger scenarios and fallbacks could create unnecessary confusion and lack of clarity concerning the specific products being referenced across different contexts.[1]
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> We think it is important that a reconciliation process be set in place that would address divergences between the language recommended by ARRC and the language forthcoming from ISDA, something that we did not see mentioned in your call. We also think outside comments should be invited on the results of this process. Since valuation issues would clearly follow from

[1] As we are sure ARRC is aware, ISDA completed its consultations in August and has published preliminary statements about the results. To our knowledge, their deliberations are ongoing. ISDA's preliminary statement on triggers is here: https://www.isda.org/a/z4hME/Public-Statement-Preliminary-Summary-of-Feedback-to-Pre-Cessation-Consultation-Clean.pdf. Their preliminary statement on fallbacks is here: http://assets.isda.org/media/2d8f2c0d/92ec53e4-pdf/.

variances in language, we are concerned by the absence of a clear reconciliation process and strongly recommend that ARRC address this.

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?

The ARRC positions SOFR as the likely candidate to replace LIBOR. We have two principle concerns about this. First, trading in SOFR futures markets has so far been limited, although the CME reports growing contract volume.[2] This makes it difficult to assess the general impact of using SOFR as a replacement for LIBOR. From our perspective, the question of what institution or organization might occupy the requisite position to determine the first step in the waterfall is not as important as the question of whether the index chosen is sufficiently informationally reflective of market conditions, movements, and risks.

Second, and related, SOFR's backward- rather than forward-facing orientation has recently exposed it to "surge" episodes that can have a substantial (and distorting) effect on spreads and basis points.[3] If SOFR is chosen, these challenges will need to be taken into account and addressed directly. At present, and despite the anticipated end of LIBOR, new loans and bonds are still being issued with LIBOR. This means that all of these securities will be open to replacement event triggers. From a valuation perspective, this is concerning because of the potential dangers of valuation variance and distortion, which will need to be confronted directly.

More broadly, it is not obvious that ARRC can pose such a question before the work outlined by the ARRC in its July 2019 white paper "Options for Using SOFR in Adjustable Rate Mortgages" is completed.[4] The white paper suggests that ARRC envisions replacing 1-year LIBOR as an index rate with 6-month SOFR as an index rate. The ARRC also notes that they have not yet begun to publish the averages that will determine the SOFR index rate but anticipate doing so in the first quarter of 2020, at which point the rate and replacement of 1-year LIBOR as an index rate will be submitted for public comment.

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

[2] https://www.cmegroup.com/media-room/press-releases/2019/9/18/cme_group_announcessofrfuturestradingvolumeandopeninterestrecord.html
[3] https://www.shearman.com/perspectives/2019/09/sofr-surge-libor-stable-what-just-happened
[4] July, 2019 ARRC, "Options for Using SOFR in Adjustable Rate Mortgages" available here: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-SOFR-indexed-ARM-Whitepaper.pdf. Anticipated suggestion for replacing 1 year LIBOR appears throughout, but is summarized on p. 13. Regarding rates and the projection of early 2020 for their publication, see p. 6: "The Federal Reserve Bank of New York has indicated that it will solicit public feedback on its plans to begin publishing averages of SOFR by the first half of 2020, which may further help market participants understand and use averages of SOFR in ARM products."

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?

It is very difficult to translate from one rate to another, especially in a low rate environment. From a valuation perspective, we are specifically concerned that the shift will produce variances in reporting. We recommend that the ARRC directly address that likelihood in the interests of advancing clarity and accuracy in financial reporting.

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.

This question is difficult to address at present, because of current limited trading in SOFR futures markets (especially on the long end), despite reports of growing contract volume from the CME.[5] If robust criteria are produced, then we would be in a much better position to assess whether a spread adjusted term rate or a spread adjusted average is most appropriate.

Here we note the March letter from the Financial Stability Council to ISDA requesting that they undertake the canvassing of industry participants and deliberations about triggers and fallbacks. In that letter, FSC mentioned that there are multiple IBORs globally that could serve as an alternative to LIBOR, and seemed concerned that language detailing procedures for reference-rate switching be adequate for application across alternatives without proactively preferring a specific option. Here again the question arises about reconciliation between differences with ISDA, particularly given the remit FSC charged to them.[6]

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?

We think that the Note Holder should have this ability, and that it would provide an excellent mechanism for correlating with LIBOR at the time of replacement. Any spread differential will only be an estimate, however, and estimates may prove mistaken. For example, muni rates

[5] https://www.cmegroup.com/media-room/press-releases/2019/9/18/cme_group_announcessofrfuturestradingvolumeandopeninterestrecord.html
[6] 3/12/2019, letter from Financial Stability Council Official Sector Steering Group co-chairs to IDSA entitled "Derivative contract robustness to risks of interest rate benchmark discontinuation", available here: https://www.fsb.org/wp-content/uploads/P150319.pdf. See p. 2 in particular.

were expected to be 75% of taxable swap rates, and this did not prove to be the case. An adjustment ability would provide greater flexibility, transparency, and stability in such cases.

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.

Harvest thinks that both the issuing party and servicer should also be responsible, because they both play critical roles in the economics of the transition and in the achievement of appropriate transparency and credibility.

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Harvest thanks the Secretariat of the ARRC for its time and attention to our comments. If we can be of any further help in its deliberations, please feel free to contact Susan DuRoss at 312- 823-7051.

With best regards,

Harvest Investments Ltd.