Alternative Reference Rates Committee

Via email: arrc@ny.frb.org

5 February 2019

RE: Consultation regarding more robust LIBOR fallback contract language for new originations of LIBOR bilateral business loans

Our firm welcomes the opportunity to respond to the Alternative Reference Rates Committee (ARRC) consultation in relation to U.S. dollar (USD) LIBOR fallback contract language for new originations of LIBOR bilateral business loans. Our firm has set out the responses to the questions contained in the consultation paper released on 7 December 2018 below.

Our firm requests that its response please be posted anonymously.

Question 1: If the ARRC were to adopt one or more sets of bilateral business loan fallback language, which one or both of the recommended provisions (i.e., amendment approach and/or hardwired approach), in your view, is an appropriate policy? If you believe the amendment approach is more appropriate at present, what specific information (for instance, existence of term SOFR) would you need in order to get comfortable eventually adopting a hard-wired approach? Why?

Currently, our preference is to adopt an amendment approach given the number of variables that are presently unknown. Specific information that would allow us to be more comfortable adopting a hard-wired approach would include:

1. clarity on the triggers being adopted for the FRN market (and derivatives to a less extent).
2. existence of a term SOFR.
3. definition of the mechanism on the spread adjustment for each currency.

Item 1 is required to assist with managing the risk of the funding and asset markets adopting SOFR at different times. Items 2 and 3 would need to be endorsed by the Relevant Governmental Body or accepted as market convention (preferably both). This would be required for all currencies, or at the very least all major currencies, as loans may have limits denominated in one currency, however not be able to be drawn down in multiple currencies. It would be problematic if there were different levels of certainty across currencies.

Question 2: Beyond your response to Question 1, are there product or transaction types, or methods of documenting transactions, for which either of the fallback approaches would be problematic? If so, please explain. What other approach would you suggest?

None that our firm are currently aware of.

Question 3(a): Should fall-back language for bilateral business loans include any of the pre-cessation triggers (triggers 3, 4 or 5)? If so, which ones?

All triggers should be included.

Question 3(b) 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.

The concern on the pre-cessation triggers centres on the risk that the triggers will be different across the FRN market (primary concern) and derivative market (secondary concern) creating basis risk between loans and the underlying markets that fund / hedge them.

Question 3(c): 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 or a Benchmark permanently or indefinitely based on a number of submissions that the Benchmark’s administrator acknowledges to be insufficient to allow for production in a standard manner?
Bilateral negotiations would have to take place on a loan by loan basis, which would be problematic given volume as well as potential for lack of consistency (both timing and outcomes).

A market wide approach led by an industry association would be more practical approach, however this may not result in 100% consistency given it would be driven by convention rather than regulation.

**Question 4(a): Is an “opt-in” trigger appropriate to include? Why or why not?**

For bilateral facilities only, an opt-in trigger at lender discretion would be of use to include. The opt-in trigger will assist in managing and aligning the timing of bilateral loan reference rate transition with regards to both the syndicated loans as well as FRN markets. The key difference between an opt-in trigger for bilateral facilities vs syndicated is that:

- for bilateral loans, our firm would have full control over if and when the trigger is exercised.
- for syndicated loans, our firm would only have influence (which could vary between syndicates), not control over, if and when the trigger is exercised.

**Question 4(b): If you do believe an “opt-in” trigger should be included, do you prefer the approach in the hardwired proposal or the amendment proposal? Please explain.**

For bilateral facilities, the approach in the amendment proposal is our preference given the higher flexibility of the opt-in language in the amendment proposal.

**Question 5: Are there any other trigger events that you believe should be included for consideration? If yes, please explain.**

No.

**Question 6: If the ARRC has recommended a forward-looking term rate, should that rate be the primary fall-back for bilateral loans referencing LIBOR even though derivatives are expected to reference overnight versions of SOFR? Please explain.**

The fall-back rate should be aligned to the fall-back rate in the FRN market.

Assuming FRN markets also adopt this, forward looking term SOFR should be the primary fall-back as this gives certainty for the 3 month period. A potential consequence of the above is that either:

- a market mechanism will be developed to allow participants to swap overnight vs term SOFR; or
- clients looking to borrow at fixed interest rates will seek a fixed rate loan from the banks rather than taking a floating rate loan with a matching floating to fixed swap.

**Question 7: Should the Lender be able to eliminate certain interest period options if there are no equivalent SOFR terms available? If so, consider the following options: (i) the Lender may remove all interest periods for which there is not a published term rate or (ii) the Lender may remove only the interest periods for which there is not a published term rate and a term rate cannot be interpolated. Which of the options do you support? Why?**

Option (ii) would be the preference given it allows the greatest scope for replication of the existing borrower flexibility with regards to interest rate term periods.

**Question 8: Should “Compounded SOFR” be included as the second step in the waterfall? Why or why not? Would this preference be influenced by whether ISDA implements fall-backs referencing compounded SOFR or overnight SOFR?**

The fall-back rate should be aligned to the fall-back rate in the FRN market.

Assuming FRN markets also adopt this as second step, compounded SOFR should also be adopted as a second step. Whether ISDA implements fall-backs referencing compounded SOFR or overnight SOFR will be a consideration, however this will be secondary to fall-backs adopted by FRN markets.

**Question 9: If you believe that Compounded SOFR should be included, which compounding period is preferable (“in arrears” or “in advance”)? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR “in arrears” or “in advance”?**
Alignment with the FRN market would be the primary consideration and our firm would seek to align to the FRN Market to minimise basis risk. FRN markets appear to be adopting SOFR in arrears and our firm will seek to follow suit if that eventuates as FRN market convention / consensus.

**Question 10:** As noted, this consultation does not include Overnight SOFR as a final step in the waterfall. Do you believe that Overnight SOFR is an appropriate fallback reference rate for bilateral business loans or should the final step in the replacement rate waterfall be Compounded SOFR (after which the hardwired approach defaults to a streamlined amendment process)?

As above, alignment with the FRN market would be the primary consideration and our firm would seek to align to the FRN Market to minimise basis risk. To the extent FRN markets adopt Overnight SOFR as the final step in the waterfall, our firm will seek to follow suit.

**Question 11:** Is there any another replacement rate that should be added to the hardwired approach waterfall before parties move to the streamlined amendment process? If so, what is the appropriate rate or rates and at which stage in the waterfall should they be applied?

To ensure alignment with the FRN market and minimise basis risk, consideration should be given to incorporating Step 4 (Replacement rate recommended by Relevant Government Body + Spread) and Step 5 (Replacement rate in ISDA Definitions + Spread) from the FRN waterfall into the loan syndication waterfall.

**Question 12:** Do you believe that the ARRC should consider recommending a spread adjustment that could apply to cash products, including bilateral business loans?

Yes. The spread adjustment is a function of average bank credit risk. In the absence of a mandated/recommended spread adjustment on transition there is potential for disputes as clients seek to adopt a spread adjustment that benefits them the most. This risk is greater for bilateral loans than syndicated loans given transparency of single lender vs “average” bank spread. A client with a bilateral facility from a well-rated bank will logically seek a lower spread adjustment as that particular bank’s spread should be lower than average.

**Question 13:** Is a spread adjustment applicable to fall-backs for derivatives under the ISDA definitions appropriate as the second priority in the spread waterfall even if bilateral business loans may fall back at a different time or to a different rate from derivatives? Please explain.

Yes on the assumption that FRN markets adopt this as second priority as well (currently Step 2 in the spread waterfalls for both FRN and bilateral loans are both ISDA definition).

Notwithstanding the timing differences, adopting the same spread adjustment would align loan markets and derivatives going forward eliminating one potential source of basis risk / value transfer on an ongoing basis. The basis risk from potential differing reference rates is a separate matter and neither worsened or mitigated by this decision.

It should be noted that for FRN’s, it is footnoted that the ISDA spread only applies where the Unadjusted Replacement Benchmark is equivalent to the ISDA Fallback rate. There is no such modifier in the bilateral loan spread waterfall (although it could be interpreted as implicit). It would be preferable to explicitly adopt the same modifier in the bilateral loans language to eliminate a potential source of basis risk.

**Question 14:** Is there any another spread adjustment that should be added to the hardwired approach spread waterfall before parties move to the streamlined amendment process? If so, what is the appropriate spread and at which stage in the waterfall should it be applied?

No.

**Question 15:** For respondents that act as Lenders in the bilateral business loan market, would your institution be willing to (i) work with the Borrower to identify a new reference rate or spread adjustment, (ii) determine whether triggers have occurred, (iii) select screen rates where reference rates are to be found, (iv) interpolate LIBOR or term SOFR if there is a missing middle maturity, and (v) execute one-time or periodic technical or operational amendments to appropriately administer the replacement benchmark? Please respond to each and explain.

Our firm would be comfortable with (i), (ii), (iii) and (iv). It is unclear what may fall under (v), however our firm would be uncomfortable with undertaking any activity that introduces operational risk.

**Question 16:** In any of these situations, should the Lender have the right to take the relevant action, for example to designate loan terms unilaterally within the framework of either Appendix I or Appendix II, simply by notice to the Borrower? Alternatively, should the Lender have the right to take such action, subject only to the Borrower’s right to withhold consent? Please explain which approach, or what alternative approach, you think would be better.
From an operational perspective it would be preferable for the lender to be able to designate loan terms unilaterally however that may not be feasible as borrowers may not be comfortable with that approach. A more practical outcome would be a blended approach such that for some matters, the lender will be able to take unilateral action (e.g. (iii) and (iv)), however for other matters (e.g. (i) and (ii)), the lender will require borrower input via either explicit borrower agreement or borrower’s right to withhold consent (which should not be unreasonably withheld).

**Question 17:** Is it necessary that any replacement rate and/or applicable spread adjustment be published on a screen by a third party? Why or why not?

It would be necessary from a transparency and consistency perspective. Whilst the risk would be very low, if these rates were not published, there is a potential for dispute as to the correct rate to apply.

**Question 18:** Given that market practices and conventions may change over time, should the Lender’s limited ability to make conforming changes be available only at the point of transition or on a periodic, ongoing basis? Why or why not?

The ability of the agent to make conforming changes should be on an ongoing basis. Given the uncertainty of whether a term SOFR market will exist at transition or whether one may develop post transition, a certain amount of flexibility would be prudent. Given the high level of uncertainty, the language around this should be fairly open.

**Question 19:** Are there operational concerns about having the ability to convert many loans over a very short period of time? Please explain.

The multitude of variables that would require managing means that the inherent operational risk is very high. Examples of variables that need to be considered include (but not limited to):

- timing of definition of “standard” market fall back language and resultant amount of time remaining to amend agreements.
- amendments potentially being required to be in place at least 6 months before 1 January 2022 (e.g. what happens to a LIBOR 6 month drawdown made on a 15th July 2021?)
- complexity of facilities allowing draw-down in multiple currencies (especially non-major currencies).
- bottlenecks caused by shortages in key operational and legal resources (everyone in the market will be seeking the same key resources at the same time).
- delays caused by potential client disputes.
- delays caused by disagreements over the spread adjustment (this risk is greater for bilateral loans than syndicated loans given transparency of single lender vs “average” bank spread).

**Question 20:** Do you see other operational challenges that fall-back language should acknowledge or of which the ARRC should be aware? Please explain.

As above. The key operational consideration is that there are many unknowns and variables which means that, by default, any fall-back language written now has to be generic to cater for those unknowns. As the transition date approaches and key decisions are made, there will be greater certainty allowing for more precise (and better) fall-back language, however less time to operationally implement that language.

Additional considerations for bilateral loans are:

- some borrowers may not be as large or as sophisticated as syndicated loan borrowers, requiring a greater focus on client education and communication during transition.
- bilateral loans have the potential to be lower value / higher volume than syndicated loans and it is the volume of loan agreements that will be one of the primary drivers of effort.

**Question 21:** If bilateral business loans fall back to a different rate from derivatives, how do market participants expect to handle the interplay of loans and their hedges? Would market participants expect that current swaps would be terminated and a new swaps entered into once the loan has transitioned?

As a lender, our firm would prefer that the fall back approach works for our customers (i.e. the borrowers) too and does not result in any material negative outcomes for them.
From a borrower’s perspective, where there is a different rate between the hedge and the underlying loan (or if they transition at different times), this creates basis risk.

If a borrower has applied hedge accounting, this has the potential to result in hedge ineffectiveness and P&L volatility. It is not possible to predict the likelihood or quantum of this as it will depend on whether the loan or derivative moves first, rate relativities between the two and as well as how each borrower has implemented their hedge accounting.

The options are to either:
1. accept this basis risk; or
2. eliminate the basis risk by restructuring the transaction.

In event of option 2, this could be done by either executing an additional derivative or terminating the existing derivative and entering a new derivative.

Considerations for the borrower in their decision-making will include:

- accounting treatment of the derivative and underlying loan.
- potential value transfer in any restructuring.

**Question 22:** Would market participants that execute interest rate hedges prefer to fall back to the same rate and spread that becomes operative under the ISDA Definitions even if a term SOFR is available? If so, please provide comments on the proposal for hedged loans set forth in Appendix VI, including a discussion of any operational concerns. Please provide comments on any other approaches you think could be useful in addressing fallbacks in loans and related hedges.

As a lender, our firm only wants to fall back to the same rate and spread that becomes operative under the ISDA definitions to the extent that FRN markets have also aligned to ISDA. Alignment with the FRN markets (that provide the underlying funding for our loans) and minimisation of basis risk across lending and FRN markets would be our primary consideration.

This would apply even in the case where our firm was the provider of both the swap and the underlying loan to the borrower.

The risks attached to the loan, funding and derivative books are managed by various teams at both a discrete and portfolio level. Aligning the loan or associated swap for hedged loans may result in parts of each of the loan and derivative portfolios falling back at different times or rates to the rest of the loan and derivative portfolios. This will have flow on implications and may introduce complexity into how our firm seeks to manage the overall loan and derivative portfolios. Hence the optimal approach for our organisation may not necessarily be to align the loan to the swap, although it certainly is not ruled out.

**Question 23:** When a loan is only partially hedged, either by a swap that is not coterminous with the loan’s maturity or a swap the notional amount of which is less than the loan amount (or the portion of the loan accruing interest based on LIBOR), should a trigger event result in the entire loan balance converting to the fallback benchmark? Would it be operationally practical to align only the hedged portion’s terms with the terms of the swap? What other concerns would market participants anticipate in operationalizing dynamic tranching of a partially hedged loan?

Yes a trigger event even should apply to the entire loan. As a lender, whether the borrower has an associated derivative (whether partially or fully covered) is an ancillary consideration. Alignment with the FRN markets (that provide the underlying funding for our loans) and minimisation of basis risk across lending and FRN markets would be our primary consideration.

It would be operationally complex to have one existing partially hedged loan convert into two separate tranches with potentially different fallbacks (triggers, reference rates, spread adjustments). The operational complexity would encompass:

- initial operational effort to set up two tranches.
- ongoing operational effort to maintain two tranches.
- flow on impacts on system requirements.
- additionally complexity where there are draw-down / amortisation profiles.

The outcome would be incremental operational risk for minimal benefit (in fact may increase basis risk with FRN markets) from a lender’s perspective.

Accordingly, our firm would consider it impractical to dynamically tranche a partially hedged loan.

**Question 24:** Are there any provisions in the fallback language proposals that would significantly impede bilateral business loan originations? If so, please provide a specific and detailed explanation.
None outside of what has been previously outlined.

**Question 25: Please provide any additional feedback on any aspect of the proposals.**

A transition off LIBOR to an alternative reference rate will happen, however there are many variables and uncertainties. The “market” will work things out, however at the current level of uncertainty, the risk of market disruption during transition is not low and it may differ across the loan, FRN and derivatives markets (and may actually arise from differences across these markets).

The opportunity to manage the risk of market disruption lies in:

1. maximising alignment across all 3 markets wherever possible (with alignment of loan syndication to FRN a priority from our perspective)
2. providing as much certainty on as many key variables as possible

With regard to 1, our firm strongly recommends that ARRC and ISDA work together to harmonise the proposals across the loan syndication, FRN and derivative markets. Consideration and development of proposals individually across what are essentially interconnected markets runs the risk of unintended consequences which a more holistic approach may help mitigate.

With regard to 2, our firm recommends that the relevant government authorities give consideration to mandating a transition date/event (certainty of trigger event) or a spread adjustment calculation mechanism or methodology at transition that could be incorporated into fall-back language across all 3 markets.