Alternative Reference Rates Committee
Federal Reserve Bank of New York
New York
United States of America

Email: arrc@ny.frb.org

February 5, 2019

Re: <u>ARRC Consultation regarding more robust LIBOR fallback contract language for new issuances of US$ LIBOR Bilateral Business Loans</u>

Dear Committee Members,

We applaud the efforts of the Alternative Reference Rates Committee (the "ARRC") to develop recommended contract language to address the transition from US$ LIBOR to SOFR for bilateral business loans. We think that the Consultation Paper is constructive and provides welcome visibility. We have the following thoughts on the proposals and certain questions posed in the Consultation Paper.

Amendment vs. Hardwired Approach

Currently, we support the adoption of the "amendment approach" as the more appropriate policy. The "hardwired approach" would be appropriate once (i) a robust, liquid, forward looking SOFR term rate is published and available, (ii) market participants have built out appropriate operational infrastructure to support overnight rates and/or compounded SOFR rates and (iii) it becomes apparent that term SOFR will be the prevailing alternative benchmark rate adopted by the loan market. The amendment approach, together with current market disruption clauses, should continue to be used to avoid operational risk associated with lenders not being able to support the rates proposed under the hardwired approach. The amendment approach also provides the parties with flexibility to consider the appropriate changes to the loan documentation to implement the prevailing alternative benchmark rate being utilized at the time trigger events occur, whereas adopting the hardwired approach now may lead to redundant or outmoded clauses which may then need to be further amended. Once there is greater certainty around the publication of a robust, liquid, forward looking SOFR term rate, we would be more comfortable adopting a hardwired approach.

Triggers

We support the inclusion of all three pre-cessation triggers, (i.e., "an unannounced stop to LIBOR (trigger 3), a material change in LIBOR (trigger 4), or a shift in the regulatory judgment of the quality of LIBOR that would likely have a significant negative impact on its liquidity and usefulness to market participants (trigger 5)"). While we would prefer to have consistency in the triggers with over-the-counter ("OTC") derivatives, we think that the benefits of including these triggers outweigh the benefits of broad-based consistency, particularly since OTC derivative terms will be able to be amended to address the LIBOR transition through a standardized protocol. We note ISDA's recent efforts to alleviate the misalignment between OTC derivatives and cash products by providing market participants with draft templates for OTC derivative transactions that include the pre-cessation triggers and allow for applicable derivatives to convert to the fallback rate of the related/hedged cash product. Including the pre-cessation triggers as well as the opt-in triggers will provide market participants with greater flexibility to transition their portfolios of bilateral business loans in a more orderly fashion.

Primary Fallback Rate

To the extent the hardwired approach is adopted, we support the use of a forward looking term SOFR rate as the primary fallback rate. We believe this would reassure market participants as it (i) reflects current practice with regard to LIBOR, (ii) benefits both borrowers and lenders who require knowing the interest rate in effect before the commencement of the interest period and (iii) is simpler to implement operationally. Again, to the extent possible, it would be preferable to have consistency with OTC derivatives. In addition, we support permitting Lenders to remove any interest rate periods for which a term SOFR rate is not quoted, in order to better match current practice with regard to LIBOR interest periods.

We would encourage the ARRC to move quickly towards the publication of a robust, liquid forward looking term SOFR rate in order to aid the transition from LIBOR. We note the Financial Stability Board acknowledged in its July 2018 white paper that use of term rates for certain segments of the cash markets would be compatible with financial stability.

Secondary Fallback Rate

We believe Compounded SOFR should be the second step in the waterfall and suggest that it would be preferable to have it calculated in arrears in order to better align with OTC derivatives.

Final Fallback Rate

We do not believe that Overnight SOFR is an appropriate fallback rate for bilateral business loans (especially for longer interest periods) and agree that it should not be included as a final step in the waterfall. At this point in time, we would not recommend that any other replacement rate be added to the hardwired approach before moving to the streamlined amendment process.

Spread Adjustment

We strongly encourage the ARRC to consider recommending a spread adjustment to apply to cash products (including bilateral and syndicated business loans and FRNs), and we support the proposed spread adjustment waterfall. We believe an ARRC published spread adjustment would promote transparency and credibility and encourage transition for cash market participants, especially given the varying degrees of sophistication in certain segments of the loan market. We would encourage the ARRC to consider the proposal by the Sterling Overnight Indexed Average (SONIA) Loan Working Group for the creation of a joint SONIA, ARRC and ECB consultation to determine the spread adjustment for cash markets, which we believe would be valuable.

Role of the Lender

Discretion can be a sensitive topic with market participants, and we therefore believe any such use should be transparent and well-governed to promote credibility. We note that both the amendment and the hardwired approaches are only feasible to the extent that the Lender is willing to exercise certain levels of discretion in order to transition to the new rates; however, such discretion should be minimized. In particular, (i) replacement rates and spread adjustments should be publicly quoted and available in order to provide market participants with transparency and objectivity, and the ARRC should work to achieve this result, and (ii) to the extent term SOFR is being quoted, we would expect that rates would be quoted for interest periods equivalent to the most commonly used LIBOR interest periods currently (e.g., 1M and 3M LIBOR). In addition, we support including the ability for Borrowers to object in all cases where this is included in the proposed language. We also believe that given that market practices and conventions may change over time, the Lender's limited ability to make conforming changes should be available on a periodic, ongoing basis, in order to ensure that the loan documentation remains consistent with market practice and supportable from an operational perspective.

Operational Considerations

There are significant operational challenges to implementing any of the currently proposed alternative reference rates, as loan operations systems are currently unable to accommodate them. Another reason to adopt a forward looking term SOFR rate, however, is that it will be much simpler and quicker to accommodate operationally.

Hedged Loans

With respect to bilateral business loans hedged by interest rate swaps entered into with the lender, we expect that market participants would prefer the loans to fall back to a forward looking term SOFR rate if available. As a result, we would expect that the corresponding interest rate swaps would be modified or terminated and replaced with term SOFR-based swaps at the time of transition. Although there are benefits to aligning the fallback provisions between the loan and corresponding derivative, as noted earlier, current loan operations systems would need to be updated in order to accommodate compounded SOFR in arrears as a fallback rate. Such updates will take significant time to develop and for market participants to adopt. To the extent that the fallback provisions are aligned and the loan is only partially hedged, we would expect the entire loan to fall back to the same rate as it would be administratively difficult to have portions of the loan fall back to different rates.

General Feedback

We encourage the ARRC to coordinate its efforts and final recommendations regarding contract fallback language with relevant governmental authorities and/or industry bodies in other jurisdictions in order to promote a consistent transition approach even though international convergence may not be possible.