CONSULATION RESPONSE – BI-LATERAL BUSINESS LOANS

SUBMITTED WITH A REQUEST FOR ANONYMITY

Question 1

As a policy matter, we believe the Amendment Approach is appropriate. Given the uncertainty regarding SOFR term rate conventions, behavior and pricing and the uncertainty regarding corollary interest rate hedging, we believe it is premature to adopt the Hardwired Approach. Once those attributes of SOFR term rate and interest rate hedging firm up, we believe adopting some version of the Hardwired Approach will be appropriate. Adopting the Hardwired Approach before SOFR term rate attributes are fixed or nearly fixed would lock hardwired contracts into an inflexible model that includes some challenging fallback approaches. Those fallback approaches may or may not be the most desirable approach at the time a trigger occurs.

The unknowns with respect to the SOFR term rate conventions include a) whether and when term SOFR will be developed, b) how term SOFR will behave, c) whether there will be SOFR term fixings available for all current LIBOR interest periods, d) how Compounded SOFR will be calculated and behave, e) whether Overnight SOFR could be effectively implemented and how the Replacement Benchmark Spread function for Overnight SOFR will be applied to various term periods, and f) how the Replacement Benchmark Spread will be calculated, whether it will be published, and in the absence of an ARRC-endorsed Replacement Benchmark Spread, whether ISDA methodology will be suitable.

Also, FASB's adoption of SOFR as a permissible benchmark for hedging could conceivably lag behind a LIBOR cessation trigger. In addition, even if term SOFR exists when a LIBOR cessation trigger has been tripped, term SOFR might be so immature that appropriate hedging markets lack depth and availability for normal hedging strategies.

Locking into a methodology that relies on so many unknown attributes could have significant unanticipated consequences and significant economic impacts for both lenders and borrowers.

Question 2

No response.

Question 3

a) We believe all suggested pre-cessation triggers are appropriate. Each pre-cessation trigger indicates either a significant deficiency in LIBOR (not published or insufficient submissions) or a critical impediment to LIBOR usage (lender's regulator indicating LIBOR is not representative or may not be used). In all of these pre-cessation circumstances, it would be very challenging to continue to use LIBOR.
b) Pre-cessation triggers that are not replicated in corresponding interest rate hedges are challenging. Consideration should be given to harmonizing triggers between loans and derivatives. Failing that, consideration should be given to using correlated triggers for hedged loans and for loans that are not hedged to use the more robust set of pre-cessation triggers. In any case, pre-cessation trigger "5" that occurs when a lender's regulator in essence limits the use of LIBOR by the lender will be necessary in the loan space – so if not adopted in the derivatives space, some asymmetry between triggers may be unavoidable.
c) See above.

Question 4

a) Opt-in trigger is appropriate policy. Depending on timing of LIBOR cessation, lenders may have significant inventory of LIBOR contracts and conversions to work through. Having contractual flexibility to do so is highly desirable. Similarly, many borrowers may desire to convert prior to cessation and contemplating that possibility within the contract will facilitate execution.
b) We prefer the Amendment Approach opt-in text to the opt-in text suggested in the Hardwired Approach. The Amendment Approach is less rigid and mechanical. We believe that it is highly likely that if opt-in conversions to a new reference rate occur, they will occur as part of a market movement in a particular direction and that instances of one-off conversions not consistent with market sentiment will be low. Because of this, we do not believe rigid, objective pre-conditions to opt-in conversions are necessary. Note that while we prefer the Amendment Approach's opt-in text, if the Hardwired Approach is recommended, we believe it should be recommended with an opt-in feature, whether or not that feature reflects the current hardwired or amendment draft.

Question 5

No.

Question 6

Yes. Forward-looking term rates should be the primary fallback for bi-lateral loans referencing LIBOR. Ideally, derivative conventions and cash product conventions will be harmonized. With market demand that may come to be. We do not believe ISDA's intention to develop conventions based on overnight rates should drive the cash market to corresponding conventions, given borrower and lender commercial expectations for term rates. However, we also believe that some borrowers will require the ability to perfectly hedge their loan exposure, so that if methods for perfectly hedging term SOFR are not available and hedging is only provided for "in arrears" calculated compounding SOFR, then in arrears compounding SOFR loans will also be offered.

Question 7

Given the possible absence of certain SOFR term periods, the lender ought to be able to reasonably eliminate the option to convert to SOFR term periods that are not published and cannot be interpolated.

Question 8

While we prefer the Amendment Approach, if the Hardwired Approach is adopted, Compounded SOFR is a credible fallback. With respect to the Hardwired Approach to the extent Term SOFR is not available, secondary steps in the waterfall should take into account ISDA conventions.

Question 9

Compounded SOFR calculated in arrears is likely to be unacceptable to certain types of borrowers and so if Compounded SOFR were to be used we would prefer calculation in advance. For instance, a significant segment of borrowers is likely to desire certainty on their borrowing costs prior to incurring debt and not to be subject to market swings after a borrowing is made. In addition, borrowers with access to several different pools of capital who borrow under a working capital revolving line of credit will likely want to know the rate charged for a loan prior to borrowing so that they can evaluate the relative cost of capital among various sources. We believe a significant segment of borrowers will have legitimate commercial expectations to know what rate they are accruing in advance of borrowing. If "in arrears" calculated Compounded SOFR were hardwired into the fall back waterfall, those borrowers with legitimate need for borrowing cost certainty would be locked into a borrowing structure that may be commercially unreasonable for them.

In addition, operationalizing an in arrears approach may be challenging. If Compounded SOFR is the selected rate under the waterfall, there is some likelihood that LIBOR cessation is occurring on the early side of the possible timeline of cessation because Term SOFR will, by definition, not be viable. In connection with an early LIBOR cessation, many market participants may not be ready to operationalize an in arrears rate.

Question 10

Using an overnight rate for various term periods, including extended periods, e.g., six months, one year, is very challenging. Overnight rates can be erratic. Also, no viable mechanism for consistent spread adjustment for operationalizing an overnight rate for a term period is proposed. Accordingly, omitting an Overnight SOFR rate in the hardwired waterfall is appropriate.

Question 11

We prefer the Amendment Approach and do not recommend the inclusion of other rates in the Hardwired Approach waterfall.

Question 12

We believe an ARRC-endorsed spread adjustment methodology is appropriate if the methodology is developed by the market with support across market participants of various sizes and complexities.

Question 13

Because the derivatives market may fall back to SOFR-based rates using different methodology than the cash markets, and because derivatives may not be falling back at the same time as business loans, using derivatives market spread adjustment methodology for the cash market is challenging and is another strong reason why adopting the Hardwired Approach at this time is premature.

Question 14

No.

Question 15

As a Lender, we would be prepared to perform all of the enumerated tasks (identifying replacement rates, determining whether triggers have occurred, selecting new screen rates, interpolating SOFR term rates for "missing" terms, and adopting technical amendments to implement new reference rates).

Question 16

The ARRC should recommend opt-in text that includes a negative consent approach, i.e., pursuant to which the lender may provide notice to the borrower of opt-in to a new reference rate and, if the borrower does not object within a specified period of time, the opt-in becomes effective. This negative consent approach should be available for either the Amendment or Hardwired Approach. The ability of the borrower to negate the opt-in protects the borrower. The ability to execute opt-in without affirmatively obtaining consent will facilitate LIBOR "inventory" conversion. This is a positive outcome from a policy perspective and balances various stakeholder interests.

Similarly, the ARRC should recommend Amendment Approach text that permits either lender unilateral or negative consent conversion from LIBOR to a new replacement rate and spread. In the case of lender unilateral conversion, the borrower will very likely be the beneficiary of a rate that is better than the ultimate fallback rate which will likely be based on a Fed Funds rate. In the case of negative consent conversion, the borrower has the ability to negate the conversion (and likely cause a fallback to higher ultimate fallback rate like Fed Funds plus a spread). In both cases, the interests of both lenders and borrowers are taken into account and the policy objective of smooth conversion is protected.

Question 17

It is highly preferable for the replacement rate and spread adjustment to be published. Publication will add credibility and transparency and facilitate operational implementation. To the extent that the market has, for some limited period of time, not identified and adopted a published rate, publication may not be necessary so long as the rate implemented is more favorable to the borrower than the ultimate fallback of Base Rate.

Question 18

The Lender's ability to make conforming changes should not be limited to a one-time only event given the possibility that conversion to a replacement rate could occur on a rushed basis with unexpected timing and before replacement rate conventions are fully regularized. As market conventions develop, it may be desirable and appropriate to limit the amount and timing of conforming changes, but at this point, with so many unknowns, it would increase market challenges to limit the Lender's qualified discretion on these matters.

Question 19

Any system conversion introduces the possibility of operational risk. Converting from LIBOR to a new reference rate may introduce unique challenges. Unlike conversion to the Euro currency and Y2K operational readiness, the timing of conversion may not be known well in advance. Accordingly, depending on the timing of conversion from LIBOR to a new reference rate and whether that conversion is scheduled well in advance of its occurrence, the conversion off of LIBOR over a short time frame could introduce the likelihood of operational errors.

Question 20

Operational challenges associated with providing notices and implementing conversion may be challenging on a portfolio basis especially over a short period of time. That is why opt-in text is important because it will provide the market time to migrate portfolios over time versus during a very short LIBOR cessation trigger window.

Question 21

Absent a change in derivative documentation norms, we would expect that if a borrower were to hedge its LIBOR interest rate exposure under a loan and that loan fell back to a new interest rate, that the borrower would seek to terminate the hedge and assuming the borrower's continued desire to hedge its interest rate exposure, or the lender's continued requirement that the borrower hedge its exposure, the borrower would enter into a new swap that hedged its interest rate exposure under the loan with the new reference rate.

Question 22

We believe that market participants may want a product pursuant to which a hedged LIBOR based loan automatically fell back to the same reference rate referenced in the hedge. We believe the ARRC consultation narrative associated with this proposal adequately describes the challenges associated with that product, including a possible mismatch between fallback triggers (loans are likely to have more triggers than derivatives), issues associated with partial hedging of a loan (either temporally or notionally), and operational issues associated with implementing the derivatives fallback conventions on the cash loan systems.

Question 23

We believe that to the extent there is market demand for a product that provides for symmetrical reference rate provisions between a cash loan and a corresponding interest rate hedge, market participants should independently develop whether or not a LIBOR cessation trigger under one product (i.e., the loan or the hedge) triggered reference rate conversion on just the hedged portion of the loan or the entire loan. Given the immaturity of SOFR, if the product were to be offered today, we believe that the product should provide for maximum flexibility around mechanics such as this in order to avoid locking into conversion mechanics that are either unreasonably challenging to implement or which may turn out to be inconsistent with market norms once those norms develop around a more mature SOFR.

Question 24

We believe that offering clients an "in advance" calculated rate will be necessary in the bi-lateral space and accordingly if the ARRC were only to recommend an in arrears rate, that would impede origination.

Question 25

We believe that in the bi-lateral space there will be more originator-to-originator experimentation on how to address LIBOR cessation since the primary commercial drivers of these terms will be the loan originator's commercial and operational needs and the corresponding needs of its customer. As LIBOR cessation continues to come into sharper focus for the borrower community, borrowers will increasingly negotiate acceptable provisions and/or shop among loan originators for optimal provisions. We believe market homogeneity in this space is much less important than in the syndicated space.