ARRC Consultation on Bilateral Business Loans

Section A: General Approach of the Two Fallback Proposals

**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?

Answer:

- We believe that the best option is to adopt the amendment approach and then to shift to a hardwired approach when a term SOFR rate or another market-agreed benchmark develops.
- However, the concern with the amendment approach is that there could be a rush to amend a large volume of loan documentation as the date of LIBOR’s discontinuation approaches.

**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?

Answer:

- In contrast to syndicated loans, there is only one lender for bilateral loans. Many of the terms of the transition will be settled through negotiation between the borrower and lender.
- Further, as bilateral loans are typically used by smaller entities, volume could be an issue, thereby necessitating the implementation of the hardwired approach earlier rather than later.

Section B: Triggers

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

Answer:

- Yes, we support triggers 3, 4 and 5.
- We also support an additional “catchall” trigger that would transition the loans to a replacement reference rate in other relevant events, as appropriate.
- It should also be noted that the additional “opt-in” triggers will be easier to incorporate into bilateral loans than syndicated loans as there is only one lender.

**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.

Answer:
- From solely a bilateral loans perspective, triggers 3, 4 and 5 are suitable. Our concerns with these pre-cessation triggers are centered on their deviation from the derivatives market.
- Another concern is whether derivatives that include the additional pre-cessation triggers could be cleared. Lenders who seek alignment between the loan and the derivative could include the pre-cessation triggers in the derivative. However, in order to clear the derivative, those pre-cessation triggers must meet the requirements outlined by the central counterparty (CCP).

(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?

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 (either as a mandatory or opt-in trigger).
- We also encourage the ARRC to work with the major CCPs to ensure that derivatives which include the pre-cessation triggers can be cleared.
- The risk in this situation is more so with the borrowers as their side has the exposure to a rate that is no longer valid.
- For bilateral loans, the lender may have the discretion to select the successor rate. The lender can send a notice that the reference rate is no longer valid. The borrower can work the lender to transition off of the stale rate.
- The loan provisions can also give the borrower the ability to select from a number of possible successor rates (for example, for USD LIBOR the successor rate is often the US base rate).

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

Answer:

- An opt-in trigger is appropriate to include for bilateral loans, in fact they may be more relevant for these products than for syndicated loans.
- The lender in a bilateral loan would have more control over when the loan would move over to the fallback rate than a lender in a syndicated loan.

(b) Do you believe an “opt-in” trigger should be included in both the hardwired and amendment proposals or only in one (please specify which and explain)?

Answer:

- Opt-in triggers should be included in both the hardwired and amendment proposals.
- The opt-in triggers will provide the flexibility on deciding when to move legacy loan book from LIBOR to SOFR or another market-agreed benchmark. This would help the market handle transition large volumes of smaller contracts.

- The lender could also have the power to initiate the opt-in for the hardwire approach. This could give the lender time to address the transition ahead of LIBOR’s discontinuation.

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

Answer:

- We support an additional “catchall” trigger that would transition the loans to the replacement reference rate in other relevant events, as appropriate.

**Section C: The Replacement Benchmark**

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

Answer:

- Yes, the ARRC recommended forward-looking term rate should be the primary fallback for bilateral loans referencing LIBOR. Ideally all product classes would move towards this forward-looking term rate, whether it is term SOFR or another market-agreed benchmark rate.

- Sophisticated firms (such as banks and other large financial institutions) may manage their exposures to term SOFR and compounded SOFR separately. These firms may have to put capital against, and incur basis risk for, any mismatch between their loans and the related hedges; whereas corporations may have more flexibility. However, a bifurcation in the market between lenders that use swaps and those which do not is likely not to be sustainable or desirable.

**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?

Answer:

- Either approach is fine; however, it would depend on the ability of the lender to implement such an approach. Client demand would determine which approach that is more broadly adopted in the market.

- For (i), lenders should have the ability to eliminate certain interest period options if there are no equivalent term SOFR rates or other market-agreed benchmark rates available. The limitations would vary by documentation as there are not provisions that are universal across the board.
- For (ii), the Lenders could allow for this as long as they have the capacity to price it.

**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 fallbacks referencing compounded SOFR or overnight SOFR?

Answer:

- Yes. Alignment with the derivatives market (which is expected to select compounded SOFR) is key. It is important to align the loan and derivatives documentation as much as possible.

**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”?

Answer:

- While the preference for the loan market is a forward-looking rate, the stronger preference is to have the loan and derivatives documentation align.
- As per the results of the recent ISDA consultation on the fallback provisions for derivatives, the loan market should use a compounded in arrears methodology to align with the direction of the derivatives market. We note that this methodology is already in place for several existing replacement reference rate products (floating rate notes (FRNs), bonds, etc.).

**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)?

Answer:

- Overnight SOFR is not an appropriate fallback reference rate for bilateral loans. The final step in the waterfall should be compounded SOFR. Further, if overnight SOFR is available, a compounded SOFR could be derived from that rate.
- Overnight SOFR was widely rejected in the ISDA consultation on fallback provisions for derivatives products.
- Overnight SOFR has high daily volatility, with spikes around month and quarter ends. To illustrate, SOFR ranged greatly from the end of 2018 to the beginning of 2019:
  - December 28, 2018 – 2.46%
  - January 2, 2019 – 3.15%
  - January 4, 2019 – 2.45%
  - January 30, 2019 – 2.39%
  - January 31, 2019 – 2.58%
  - February 1, 2019 – 2.47%
**Question 11.** Is there any other 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? Please explain.

Answer:

- No, the waterfall in the hardwired approach is comprehensive.

**Section D: The Spread Adjustments**

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

Answer:

- Yes, the ARRC should consider recommending a spread adjustment for cash products. The regulators have the authority and clout to recommend a spread adjustment that could be adopted broadly in the market. This would be particularly needed if there is a material impact resulting from the transition to a new replacement reference rate.
- Alternatively, the ARRC could recommend a methodology for the spread adjustment which allows for a more dynamic spread.
- While some vendors are trying to occupy this space, it is unclear if they would have the authority or influence to recommend a spread adjustment that would be widely accepted.

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

Answer:

- Yes. Alignment between loans and derivatives contracts is paramount; the aim should be to maintain this consistency. Some lenders may even prioritize alignment over a forward-looking term rate as this would get rid of basis risk between the loan and the derivative.
- However, if there different fallback rates used (e.g. term vs compounded SOFR), the spreads adjustments applied should be compatible and right-sized for the fallback rate.

**Question 14.** Is there any other 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?

Answer:

- It is hard to answer this question, as there is not yet a developed term SOFR or another market-agreed benchmark rate. As a result, we don’t currently recommend the hardwired approach.
- With the development of the term SOFR rate or another market-agreed benchmark, a hardwired approach could be transitioned to over time.

Section E: The role of the Lender

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.

Answer:
- (i) Yes, as the lender we would be open to working with the borrower, but our preference is that the successor rate and spread adjustment be published by a third party.
- (ii) Yes, as the lender we would be willing to determine if a trigger has occurred.
- (iii) Yes, as the lender we would select screen rates based off the predominant market convention of the time.
- (iv) Yes, we would work with the client on finding a solution in line with market practice to find a missing maturity. This could involve interpolating LIBOR, term SOFR or another market-agreed benchmark.
- (v) Yes, we would be willing to make such amendments, if they meet client needs, and are in line with industry practice.

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.

Answer:
- If allowed under the loan agreement, the lender should have the ability to do this.
- This is a right the lender would like to have; however, borrowers would be reluctant to give up unilateral rights. There may be borrower pushback, but this should not be significant as long as the all-in yield (RFR + spreads and adjustments) are the same. Borrowers may want protection to ensure the all-in yield is equivalent.
- Lenders should have the flexibility to make decisions either through notice or by negative consent.

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?

Answer:
- It would be desirable for an independent third party to publish the replacement rate and spread adjustment. Ideally, the regulator or governmental authority responsible for the rate should recommend this rate and spread adjustment.

**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?

Answer:

- For what is not specified in the loan agreement, the lender should be able to make changes that conform to the market conventions that emerge over time.

**Section F: Operational Considerations**

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

Answer:

- We believe that the smoothest way to convert a loan is to do so on the last day of its interest period to avoid breakage cost. The sheer volume of loans to be transitioned is also a significant concern.
- There are operational concerns with transitioning a large volume of loans over a short period of time through the amendment approach. A shift to the hardwired approach once term SOFR rate or another market-agreed benchmark has developed would mitigate these concerns.

**Question 20.** Do you see other operational challenges that fallback language should acknowledge or of which the ARRC should be aware? For example, both approaches to fallback language involve various notices from the Lender—do these requirements and the resulting communications between parties impose undue operational burdens? Please explain.

Answer:

- Such notification requirements would not be operationally burdensome.

**Section G: Hedged Loans**

**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?

Answer:
- If once a loan has transitioned, the associated derivatives are terminated and new derivatives are entered into, this could solve the issue of the loan and hedges having different triggers and the products referencing different rates.

- Typically if a credit agreement terminates, the derivative would terminate as well. However, if the loan agreement is amended, the derivative would not necessarily terminate.

- Currently, many clients are expecting that the loan and derivatives would transition from LIBOR to SOFR or another market-agreed benchmark at the same time. Market participants would expect the spread adjustment to occur on their existing derivatives once loans make the full transition to SOFR. It is key for ISDA and ARRC to work together to facilitate a seamless transition.

- Client dialogue has been fairly limited on this front as many are waiting for ISDA to finalize its future approach. There needs to be client engagement to clarify what happens in the event the loan is transitioned (especially with regards to the associated hedges) and to set the client expectations. The ARRC could assist with market education.

**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.

**Answer:**

- Client would like to have the successor rates for the loans and hedges aligned. The ISDA definition is already included as the second step in the waterfall in recognition of this.

- Market participants will vary in their preference. Some will prefer having a forward-looking term rate for the loan and the hedge referencing a compounded rate; while others may prioritize alignment have both products reference the compounded rate. This would depend on the needs of the organization (i.e. needing to know interest rates and payments in advance) and the infrastructure they have in place (i.e. can their systems handle a backwards looking rate or manage exposures to different rates).

- It is unclear why the ISDA definition in placed in a separate Appendix, as compounded SOFR is already in the waterfall.

**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?

**Answer:**
- While splitting the loan for the transition may be possible, it would be operationally challenging. Only sophisticated, large firms may be able to do this.
- If the trigger 1 or 2 transitions the hedge, the loan should be transitioned as well. However, if a pre-cessation trigger occurs, then the non-hedged portion of the loan would move over, but not necessarily the hedged portion. This bifurcation of the loan is operationally challenging.
- Borrowers may be given the ability to select the fallback rate and they may choose to delay the transition to ensure alignment with the associated hedges and avoid basis risk.

**Section H: General Feedback**

**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.

**Answer:**

- To minimize disruption and ease the transition of cash products, the markets should take aligned approach across asset classes.
- To help facilitate the transition, there should be alignment between the loans and derivatives products.
- Also, there should be alignment with the syndicated loans market. Market conventions that are developed in the bilateral loans space can be adopted by the syndicated loans market, and vice-versa.

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

**Answer:**

- Ideally, the fallback would be a forward-looking term rate, if one develops, to be consistent with cash products currently.
- We do have concerns regarding the development of a term SOFR rate, which under the current ARRC paced transition plan is set for the end of 2021. This will not give the market sufficient time to transition over before the discontinuation of LIBOR, which is also expected at the end of 2021.
- A key goal is alignment between the derivatives and cash products.
- Firms wish to avoid mismatches between the rates at which they access funding and the rates which are charged to clients on bilateral loans.
- The transition from LIBOR to SOFR or another market-agreed rate will pose significant operational challenges on market participants. These issues include: product valuation and risk management, updating internal systems/models, cross-currency market (the characteristics of the alternatives rates differ between jurisdictions), harmonization of the transition across products/jurisdictions, and tax/accounting.
- Also, as a general point, there should be alignment in the approaches taken with the bilateral and syndicated loan markets. Further, there should be general alignment across cash products (including FRNs and securitizations).