Date: February 5, 2019

Submitted Electronically to: arrc@ny.frb.org

Alternate Reference Rates Committee
Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045

Re: Consultation Response -- Bilateral Business Loans

Below please find responses regarding the Alternate Reference Rate Committee’s (“ARRC”) Consultation Regarding More Robust Fallback Contract Language for New Originations of Libor Bilateral Business Loans, published on December 7, 2018 (the “ARRC Consultation”). Capitalized terms used and not defined herein shall have the meanings set forth in the ARRC Consultation.

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?

We prefer the amendment approach at this point. Once publication of an acceptable forward-looking term SOFR rate and a spread adjustment begins, then the hardwired approach will be preferable with respect to certain bilateral loan products or transactions. We believe we have time before LIBOR ceases for those key data points to become available on a screen for us to use. However, we recommend that the ARRC endorse both the amendment approach and the hardwired approach, as the loan market seems split on which one is currently the preferred approach. We also think that it is beneficial to have the fallback language for the hardwired approach available to the market so that as soon as an appropriate forward-looking term SOFR rate and spread adjustment are published, the market participants may voluntary choose to use the hardwired fallback language depending on the types of bilateral loan products or transactions.

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?

The terms and structures of bilateral loans are more customized than those of broadly syndicated loans. The bilateral loan documents may vary greatly due to product or transaction types, diversity of borrower profiles and the unique characteristics of underlying collateral package if the loan is secured. As a result, the borrowers in this market are likely to demand a more customized approach when selecting a new reference rate and making other related changes such as the spread adjustments. Further, the bilateral loan documents are relatively easier to
We prefer the hardwired approach compared to syndicated loan documents. There is also a much wider range of borrowers in this market which do not participate in or have no access to the syndicated loan market at all. Those borrowers may not feel comfortable following the syndicated loan market practice and especially desire flexibility to select a new reference rate and spread adjustments that fit specific transaction types and their operational capacities. We believe that the amendment approach allows the bilateral loan parties the flexibility they need to adjust the loan terms holistically when the reference rate transition begins.

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?

All three of these triggers should be included. We understand that these triggers differ from ISDA’s current triggers and may result in different benchmark replacement dates in a bilateral loan for which the borrower utilizes interest rate swaps to hedge its floating rate exposure. However, we believe that a newly executed swap contract can incorporate (or an existing swap contract can be amended to include) the same triggers as those in the bilateral loan documents so that the swap and the hedged loan will have a matching benchmark replacement date to the extent the same entity provides the swap and the hedged loan. The inclusion of matching triggers could be negotiated on a deal-by-deal basis.

(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.

See answer to (a) above.

(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?

This is the exact reason why we feel that it is important to include pre-cessation triggers. If the pre-cessation triggers are not included, the market participants will have to negotiate the pre-cessation triggers on a deal-by-deal basis to manage the potential risks that a benchmark is no longer representative or reflective of the prevailing rates for the relevant transactions. We also believe that there should be a fallback mechanism vetted and accepted by the loan market that would be used in the event that a benchmark is unavailable, regardless whether pre-cessation triggers are included in transaction documentation.

Question 4.

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

Yes, it would be appropriate to include an “opt-in” trigger. Increased flexibility is desirable especially for the transaction parties of a bilateral loan. An “opt-in” trigger initiated by a lender may also alleviate issues associated with potentially high volumes of amendments.

(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).

We prefer the “opt-in” trigger in the amendment proposal because it is based on “bilateral business loans being executed” at the time a lender determines whether an “opt-in” trigger should be initiated. The “opt-in” trigger in the hardwired approach refer to “[two] currently outstanding syndicated loans” which fails to recognize the
diversity of the borrowers and transaction types in the bilateral loan market regardless of the number of syndicated loans specified in the trigger.

**Question 5.**

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

None.

**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.

Yes. A forward-looking term SOFR rate that is publicly available to borrowers and lenders is the closest replacement for LIBOR (as it will be a rate known at the time the loan is made and it will have a term relatively consistent with current LIBOR tenors) and thus easiest for the loan market to understand and adopt from both the lender and borrower perspectives. While in theory it may be possible for the loan market to evolve in a way that would allow market participants to use a daily compounded SOFR rate at some point in the future, such a change would require significant systems and accounting changes that we feel would be difficult for the market to absorb on top of the other changes related to the cessation of Libor.

The fact that the derivatives market is using overnight versions of SOFR as its replacement Benchmark is unfortunate, but the derivatives market (i) will need to create new hedging products to hedge forward looking term SOFR rate loans or (ii) the embedded hedge transaction could, theoretically, be conformed to the underlying loan agreement rate structure (i.e. forward-looking term SOFR), on a deal-by-deal basis. It also is important to note that these hedges must continue to qualify for favorable accounting treatment.

**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?

As a lender, we would prefer not to calculate an interpolated rate and would prefer to use whatever screen rate is available. This approach provides certainty to the borrower and the lender and avoids potential disputes over interpolation calculation mechanics. Further, interpolation cannot be properly evaluated without understanding the nature and composition of the term SOFR. If there is no screen rate available for an interest period, then that interest period should not be available to the borrower.

**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?

We are comfortable including compounded SOFR as the second step in the waterfall for some types of bilateral loan. With respect to certain bilateral loan products we may feel more comfortable terminating the contracts if a forward-looking term SOFR is not published. However, we want to emphasize that we feel it is very important to
have a published forward-looking term SOFR rate so that it would not be necessary to use compounded SOFR, except in extraordinary circumstances.

**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”?

As mentioned above, it is our hope that we will never need to use this option. With that being said, compounded SOFR in advance has the advantage that the rate is known by the lender and the borrower at the beginning of the interest period, as is the case with LIBOR today. Further, many borrowers in the bilateral loan market are not publicly-traded companies and may be reluctant to remodel their treasury management and operational systems to accommodate compounded SOFR in arrears. While we recognize that compounded SOFR in arrears is fairer to the lender and the borrower because it reflects the actual rates that were in effect during the interest period, we believe that the bilateral loan market participants need to consider the potential outcome that the “in arrears” and “in advance” compounding periods are both used and the market participants would have to be prepared to update their operational systems accordingly to minimize potential disputes with respect to rate determination, interest calculation, billing, account reconciliation and other operational matters.

**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)?

We do not believe that Overnight SOFR is an appropriate fallback for bilateral loans. The final step in the replacement rate waterfall should be Compounded SOFR. Using day one's rate for the entire interest period may be unfair to the lender or the borrower, depending on what happens to rates over the life of the interest period. This problem is exacerbated for longer interest periods (such as 6 or 12 months). We also note that that Overnight SOFR increases on certain days of the month/quarter. For example, the rates on overnight Treasury repurchase agreements pushed Overnight SOFR higher by approximately 70 basis points over a two-day period to 3.15% on January 2, 2019. It later retreated to 2.45% on January 4, 2019 and has since been relatively stable. Considering that both the repurchase market and consequently Overnight SOFR are sensitive to the short-term fluctuations in Treasury bill supply, it is not appropriate to use Overnight SOFR as a hardwired fallback rate.

**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?

No. As discussed above, we believe that the Compounded SOFR should be the last step in the hardwired approach waterfall. If Compounded SOFR is not available, the lender and the borrower should move to the streamlined amendment process. During the amendment process, the lender and the borrower may at their option restructure the loan pricing from a term rate to use Overnight SOFR or another publicly available rate.

**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. Development of a robust ARRC recommended and published credit spread adjustment is very important to the loan markets. It is our view that the published spread adjustment for the first 5 years after conversion should be based upon SOFR futures trading on the CME or other futures market, and how these transactions compare to the forward LIBOR curve. For longer-term purposes (6+ year terms) it may make more sense to look beyond the CME futures markets and base the spread on the swap market generally and the basis between SOFR/LIBOR and SOFR/Fed Funds.

**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.

As discussed above, it is very important to the bilateral loan market that ARRC will recommend and publish a spread adjustment taking into account a forward-looking term SOFR rate structure. If that option is not available, it makes sense that the second priority in the hardwired approach spread waterfall be the ISDA spread adjustment if the bilateral business loans fall back to ISDA’s new reference rate (i.e. Compounded SOFR in arrears) and if the ISDA spread adjustment is published by a third party vendor. However, it is important to note that the appropriateness of spread adjustments is dependent on the underlying rate. If the bilateral business loans fallback to a forward-looking term SOFR, the ISDA spread adjustment may not result in adequate spread adjustment since it is developed for Compounded SOFR in arrears.

**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.

As a lender, we would be willing to perform all of the activities set out in the question other than interpolation. We believe that borrowers should only be offered interest periods that coincide with published term SOFR periods to minimize the risk of disputes over whether interpolation methodologies are appropriate.

**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.

In regards to bilateral loans with a more complex structure and bespoke terms, an amendment subject to the borrower’s affirmative or negative consent is more appropriate than a simple notice. With respect to standardized bilateral loan products for which the consistency of the loan documents are evident, a simple notice to the borrower may be appropriate depending on whether the borrower affirmatively acknowledges its consent to a simple notice approach at the origination of the loan.

**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?
Yes. It is extremely important from an operational and transparency perspective to have a replacement rate and applicable spread adjustment published on a screen by a third party. Publication of the replacement benchmark rate and the applicable spread adjustment will significantly reduce the risk of disputes among the parties over the appropriateness of the replacement rate or spread adjustment methodology.

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 Lender’s limited ability to make conforming changes should be available on an ongoing basis, however, this right should be limited in scope to only those changes that are necessary in the lender’s commercially reasonable business judgment and from an administrative perspective to give effect to the replacement rate such as changes to the determination time of the replacement rate or changes to the publisher of the replacement rate.

Question 19.

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

Yes. Incorporating a replacement rate and the applicable spread adjustment will require significant resources to identify the affected loans and update the loan operation systems to reflect the new benchmark and spread. This is why we believe that the “opt-in” option is an important option for the loan market. With the “opt-in” option, we can try to coordinate an orderly conversion over time as soon as an acceptable term SOFR rate and the corresponding spread adjustment become publically available.

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.

Yes. In addition to committing to significant resources to inventory the affected loans and update the loan operation systems, a lender has to establish processes and procedures to comply with the various notice requirements under the fallback language and appropriately respond to borrowers’ inquiries with respect to rate determination, interest calculation and other invoicing related matters. The complexity of loan administration and operation will be further increased if a forward-looking term SOFR rate is not available and the bilateral loans falls back to Compounded SOFR in arrears.

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?

With respect to bilateral floating rate loans that require borrowers to maintain an interest rate swap, our expectation is that the borrowers will continue to keep the swap in order to maintain covenant compliance, whether the loan falls back to a different rate from derivatives or not. For the purpose of mitigating basis risk in this segment of the loan market, we really hope that ISDA can take into account of the loan market’s strong preference for a forward-looking term SOFR and work with derivatives market’s regulators to develop a contract mechanism to match the fallback rate under the swap to the
fallback rate under the loan. With respect to other bilateral loans where an interest rate swap is not required by the loan documents, the borrower may negotiate with its swap counterparty to have a termination option if the loan falls back to a different rate.

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.

Currently, ISDA has chosen compounded SOFR in arrears rate as the fallback rate which was developed for derivatives and generally does not fit with the expectations of the loan market participants. As a lender, we do not want to limit ourselves to the fallback rate and the spread adjustment selected by ISDA whether the loan is subject to an interest rate swap or not. If a forward-looking term SOFR becomes available, we want to have the flexibility to fall back our bilateral loans to forward-looking term SOFR. We hope ISDA recognizes the divergence of the fallback methodology between the derivatives market and the loan market and works with LSTA, FASB and other relevant industry groups to develop a new hedging product for forward-looking term SOFR. This is extremely important not only to mitigate basis risk but also the complications in hedge accounting and tax treatment, especially for publicly-traded borrowers which in our experience are highly sensitive to the possible loss of hedge accounting treatment for the swaps they enter into for longer term loans, whether syndicated or bilateral.

Question 23.

When a loan is only partially hedged, either by a swap that is not coterminal 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?

As a lender, we do not want to create a contractual obligation under the loan documents to fall back to the ISDA rate and spread. This view does not change whether a loan is fully hedged, partially hedged or not hedged at all. Our current documentation standard is not to include any language in the loan documents to require us to fall back to the ISDA rate and spread as well as any language relating to dynamic tranching or full conversion for partially hedged loans.

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.

No.

Question 25.

Please provide any additional feedback on any aspect of the proposals.

We have no additional feedback on the proposals.