BMO Capital Markets

February 5, 2019

Alternative Reference Rates Committee ("**ARRC**")

Via email submission to: arrc@ny.frb.org

Re: Consultation Response – Regarding More Robust LIBOR Fallback Contract Language for New Originations of LIBOR Bilateral Business Loans

BMO Capital Markets ("BMO CM") welcomes the opportunity to respond to the ARRC Consultation regarding more robust LIBOR fallback contract language for new originations of LIBOR bilateral business loans. BMO CM recognizes the need for establishing industry standards and best practices in transitioning bilateral loans referencing LIBOR to reference a replacement benchmark as a means to prevent market disruption in the event of LIBOR cessation beyond 2021. Our responses are as follows:

<u>General Approach of the Two Fallback Proposals</u>

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?

<u>Response:</u> BMO CM prefers both methods to allow flexibility depending on client preference.

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?

<u>Response:</u> BMO CM is of the view that there will be more client feedback in the bilateral space compared to the syndicated loan market where clients have a preference of one approach or the other. The bilateral loans market has a greater range of client types, views, and sophistication. Therefore it is important to have the flexibility to have either the amendment or hardwired approach.

In addition, BMO CM notes that some of our smaller loans are completed using laser pro documents, which is vendor supported and used by other firms in the industry. Laser pro documents are an automated set of documents generated without external counsel intervention. Whichever approach is used will need to be incorporated into this these vendor supported documents.

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?

<u>Response:</u> BMO CM is of the view that all pre-cessation 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.

<u>Response:</u> BMO CM does not have any concerns about these pre-cessation triggers.

<u>Pre-cessation Triggers</u>

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?

<u>Response:</u> BMO CM notes one option would be to ensure that all agreements have the base rate as a fallback option. If the base rate is not an option the borrower should be approached for an amendment.

<u>Early "Opt-in" Triggers</u>

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

<u>Response:</u> BMO CM is of the view that an "opt-in" trigger is appropriate to include as it would provide flexibility and enhance stability.

Question 4(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).

<u>Response:</u> BMO CM is of the view that the "opt-in" trigger should be included in both the hardwired and amendment proposals.

<u>Other Triggers</u>

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

<u>Response:</u> BMO CM does not believe any additional trigger events are necessary.

<u>Forward-Looking Term SOFR</u>

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.

Response: BMO CM prefers a forward-looking term rate. Some fixed principal and interest have amortization schedules that will require a resynchronization and a daily changing rate will cause significant operational and financial challenges.

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?

Response: Yes, BMO CM is of the view that the Lender should be able to eliminate certain interest period options if there are no equivalent SOFR terms available. BMO CM prefers option (i) "the Lender may remove all interest periods for which there is not a published term rate." An interpolated rate can be inaccurate if interpolation is done over terms that are far apart (e.g. interpolating 3M SOFR from 1M and 6M rates).

Compounded SOFR

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?

Response: BMO CM maintains that whether or not Compounded SOFR should be included as the second step in the waterfall depends on the approach taken. BMO CM's loans systems are simple and do not compound daily. If compounding is included in the rate quote itself and it's a daily changing rate BMO CM is of the view that it is fine to include compounded SOFR as the second step in the waterfall. If, however, compounding also includes interest on the interest this will create system and operational issues as BMO CM's systems only calculate simple interest and not daily compounding.

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"?

Response: BMO CM is of the view that should compounded SOFR be included, the preference would be to include it "in advance."

Compounded SOFR "in arrears" has a locked component in place (daily rate does not change during a period of time before the end of the period), but if you are compounding all the way to the end of the cycle you might not have an accurate rate or accrual until after the payment due date. This causes an issue as most customers in the bilateral market want their bills up to 15 days ahead of time or have fixed Principal + Interest Amortization Loan Repayment Schedules.

In the compounded SOFR "in advance" approach, however, compounding is done upfront (in advance), removing the daily factor.

<u>Other Fallback Rates</u>

***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)?*

<u>Response:</u> BMO CM is of the view that overnight SOFR is an appropriate fallback reference rate for bilateral business loans as it would be easier.

***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.*

<u>Response:</u> BMO CM does not believe any other replacement rates should be added to the hardwired approach waterfall before parties move to the streamlined amendment process.

<u>Spread Adjustments – ARRC Spread Adjustment</u>

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

<u>Response:</u> BMO CM is of the view that while it is not absolutely necessary for the ARRC to consider recommending a spread adjustment that could apply to cash products, including bilateral business loans, it may be beneficial in certain situations. Specifically, if the consensus is to use a fallback rate that is different from the one recommended by ISDA there could be some benefit in a spread adjustment that applies to cash products.

<u>Spread Adjustments – ISDA Spread Adjustment</u>

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.

<u>Response:</u> BMO CM is of the view that the ISDA spread adjustment is appropriate if the choice of fallback rate is the same as the one recommended by ISDA. If the choice of fallback rate is not the same, it would not be appropriate.

Spread Adjustments – Other Spread Adjustments

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?

Response: BMO CM is of the view that the spread adjustments in the waterfall structure should be sufficient and no other adjustments are needed.

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.

Response: BMO CM would prefer not to complete the above tasks, however we understand that these responsibilities may fall on the admin agent and would be willing to complete them as needed.

BMO CM is most concerned about (iv) interpolate term SOFR if there is a missing middle maturity. This particular activity is unlike any BMO CM currently performs as an admin agent. In addition, it appears to be the most prone to allegations of error or wrongdoing.

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.

Response: BMO CM is of the view that the Lender should have the right to take the relevant action depending on the market segment:

A) On some segments the loan agreements are not specifically negotiated and there are no lawyers involved, as it is a smaller part of the market. For these types of loans the lender should have the ability to decide what the terms are and provide notification of those terms to the borrower(s).
B) For the larger part of the market, where documents are negotiated, the borrower will want more input and this should be allowed.

In summary: BMO CM would expect more ability to unilaterally decide on smaller and more automated parts of the market.

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?

Response: BMO CM believes that it would be helpful for any replacement rate and/or applicable spread adjustment to be published on a screen by a third party. This would ensure consistency and transparency and allow systemic rate interfaces, rather than relying upon Agent advisement.

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?**

Response: BMO CM is of the view that the Lender should have the ability to make conforming changes on a periodic, ongoing basis. Flexibility is desirable, and this would simplify the process of making conforming changes.

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.

Response: BMO CM believes there are concerns from both a documentation perspective and back office perspective. Significant resources would be required on both perspectives to complete the amendment process at the time of a LIBOR cessation. BMO CM notes that system challenges are also a concern, as this will substantially change the rate structure impacting customers' payment and billing terms. For example, a customer may be billed at the end of the month rather than the typical 15 day timeframe which may cause bills to be inaccurate. Payments may be received after ME periods as rates aren't defined until next day on daily rate options, creating technical payment defaults. Customers will be unable to predict final cash flow or payment amounts, requiring post period notifications.

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 Lender14 – do these requirements and the resulting communications between parties impose undue operational burdens? Please explain.

Response: BMO CM sees the following as potential operational challenges:

A) Notification requirements for bankers;

B) Breakage costs (tranche-based LIBOR, 30/60/90 days). If transitioning a client from LIBOR to SOFR and a breakage costs exists, we would need to either consume that cost or phase in that cost to line up the client's next interest period.

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 swap entered into once the loan has transitioned?

Response: BMO CM is of the expectation that when a loan is hedged, the loan agreement would act as the driver. When a loan transitions to SOFR there would be a mismatch between the loan and the hedge. BMO CM is of the view that the way to handle this is to amend the swap so that it becomes consistent with the credit agreement to avoid becoming constrained in what we do on the lending side.

Interest rate swaps used by a bank's treasury/ALM department for hedging would be centrally cleared for the most part. The industry is still working on the appropriate ISDA fallback provisions for derivatives. To the extent treasury/ALM department are using interest rate swaps to hedge portfolios of LIBOR loans in its overall ALM mandate, the potential for basis risk will arise as/when the loan portfolio transitions to SOFR vis-à-vis the swap industry's transition under a different pace. That is why an enterprise view of IBOR management with the lines and treasury collaboratively sharing information is critical. From my observation, I think BMO is taking these steps at a senior level from what I have read from the recent newsletter by the IBOR transition team.

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.

Response: BMO CM is of the view that the proposed language for swaps is a lot longer than would normally be incorporated in a swap (e.g. ISDA documents are much shorter and simpler in some ways than credit agreements). If the swap language being proposed by the LSTA is accepted, reactions may differ. BMO CM feels the language is fine but raises concerns that it is more than what a lot of clients expect to see in swap type documentation.

One alternative to the proposed language would be to not have fallback language in the swap and simply agree on a swap related amendment at the time a change to the interest rate swap is needed.

BMO CM has not additional comments on the language except that we anticipate some clients will feel like it is too long and complicated. BMO CM suggests considering the alternative of not including fallback language in the swap and agreeing on an amendment with the borrower at the time the agreement is amended.

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?

Response: Yes, BMO CM is of the view that 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), a trigger event should result in the entire loan balance converting to the fallback benchmark.

No, BMO CM does not believe it would be operationally practical to align only the hedged portion's terms with the terms of the swap. It is not operationally feasible to split a loan into different tranches, as transaction costs to that would not be feasible. If this was required there would be a huge operational change.

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.

Response: BMO CM has not identified any provisions that would significantly impede bilateral business loan originations.

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

Response: BMO CM does not have any additional comments at this time.