ARRC CONSULTATION REGARDING MORE ROBUST LIBORFallback CONTRACT LANGUAGE FOR NEW ORIGINATIONS OF LIBOR BILATERAL BUSINESS LOANS

The Bank of Nova Scotia -- Response

**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 hardwired approach? Why?

**Answer to Question 1.** In theory, a “hard-wired” approach is preferable as it would provide greater clarity to all parties, lessen administrative burden, and reduce operational risk and market risk. However, before adopting a hard-wired approach, and thereby including specific language into our documentation, we need a more developed market understanding of the proposed fall back rates and the spread adjustment. This is critical if we are asking borrowers to accept hard-wired terms. For example, ARRC has proposed that forward-looking term SOFR be the primary fallback in the waterfall of replacement benchmarks, although this benchmark has not yet been developed.

Borrowers with LIBOR-based term loans may have related interest rate hedges. Ideally, there is consistency between the loan and derivatives market with respect to triggers and fallback rates. The derivatives market has, however, selected a fallback rate based on compounding in arrears, which differs from the rate currently proposed by the ARRC as the primary fallback rate for the loan market (forward looking term SOFR). This creates a misalignment between the loan and the corresponding hedge and makes it more difficult to the loan market to back an industry solution based on hard-wiring of terms that will result in possible misalignment.

**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 to Question 2.** As noted in our answer to Question 1, LIBOR-based loan agreements and corresponding hedges will likely be subject to differing fallback rates and therefore be subject to misalignment once LIBOR is permanently discontinued.

**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 to Question 3 (a).** Our view is that the language used to describe the fallback triggers should be identical as between loans and derivatives to ensure the lending and derivatives markets don’t move asymmetrically. In addition, our view is that the triggers should be based on events that are objectively verifiable so as to avoid potential disputes when the language is invoked.
**Question 3 (b).** Please indicate whether any concerns you have about these precessation triggers relate to differences between these triggers and those for standard derivatives or relate specifically to the pre-cessation triggers themselves.

**Answer to Question 3 (b).** As stated in response to 3(a), our concerns relating to pre-cessation triggers pertain primarily to the possible misalignment between the terms of the loan agreements and related hedge documents.

**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?

**Answer to Question 3 (c).** Most standard loan agreements include clauses that address market disruption respecting LIBOR loans, which could be used in situations where there are no adequate and fair means to ascertain LIBOR for a given interest period.

If, however, the market view is that these “market disruption” clauses are not adequate to address scenarios such as the permanent discontinuance of LIBOR, it is preferable to rely on pre-cessation triggers, provided there are published replacement rates, and triggers (and the language describing those triggers) are aligned with those in standard derivatives documentation (as mentioned in our answer to Question 3(a)).

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

**Answers to Questions 4 (a) and (b).** We acknowledge there will be some period of time prior to the permanent discontinuation of LIBOR, or a formal notice from the regulator of a cessation date, when both LIBOR and SOFR based loans will be offered. While an “opt-in” trigger would allow for a more gradual or earlier transition to a new benchmark, than if only objective and external triggers are available, we have some concerns about its inclusion.

In the context of the syndicated loan consultation, we noted the risk that not all banks in a syndicate may be operationally ready to accommodate the new rate(s) at the same time. An “opt-in” trigger may prompt a request for a move to a new rate before all lenders are ready.

In the context of a bilateral loan, this issue does not arise. If both lender and borrower are operationally ready, there would be greater flexibility for the parties to negotiate an earlier move to a fallback rate. However, given financial institutions will have numerous bilateral loans, it may not be feasible to work with each client independently, and financial institutions may seek to discourage the negotiation of individual triggers on a case by case basis.
Question 5. Are there any other trigger events that you believe should be included for consideration? If yes, please explain.

Answer to Question 5. No, not at this time.

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 to Question 6. Because a Term SOFR is akin to LIBOR, it would be more familiar to borrowers and may be simpler to operationalize. However, we urge the ARRC to consider the potential impact of misalignment between the fallback rates in the interest rate swap and loan where the loan is hedged. If the accounting firms conclude that borrowers are not eligible for hedge accounting due to this misalignment, the loan market will have to accommodate a fallback rate based on compounded in arrears. If, however, it is expected there will be an active swap market for Term SOFR, ISDA should take steps to accommodate borrowers with interest rate hedges.

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 to Question 7. If Term SOFR is the primary fallback in the waterfall, only publicly quoted tenors should be available to borrowers. Lenders should be able to amend the agreement to remove tenors for which there is no published term rate. Since Term SOFR is still not available, the language should allow for the possibility that new terms emerge after a Benchmark Discontinuation Event.

We would consider the feasibility of using interpolated rates, should a use case be provided and the market agrees to a standard mechanism (with an assumption that SOFR moves in a linear fashion between quoted tenors).

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 to Question 8: For reasons noted above, the order of the waterfall relates to whether a loan is hedged to an interest rate swap. If the loan is hedged, alignment with the fallbacks in the derivatives market will be desirable (if Compounded SOFR is the fallback rate for swaps, the loan market will have to adapt to it). If the loan is not hedged, alignment with the derivatives market methodology is less relevant, and the loan could fallback to a Term SOFR rate.

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 to Question 9.** If Compounded SOFR is included in the waterfall, our preference is for Compounded SOFR in arrears. However, we also request that the ARRC publish a use case which would clearly show how interest would be calculated in a lending scenario; that is, how daily interest accruals would be generated. It is critical that all market participants adopt the same methodology for Compounded SOFR and the calculation is clear and transparent to borrowers.

**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 to Question 10.** For the reasons stated above, our response to this question depends on the approach ultimately adopted by ISDA, as well as an assessment of the use case demonstrating how interest would be calculated in each case.

**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 to Question 11.** No, not at this time.

**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 to Question 12.** Yes, we request that the ARRC recommend and find a suitable method or vendor to publish spread adjustments that would apply to business loans. We expect there would be different spread adjustments for different tenors, if required.

**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 to Question 13.** The spread adjustment must specifically relate to the benchmark rate being used. If this isn’t possible, the next fallback should be the amendment process. In other words, if loans fall back to a rate different from that adopted by ISDA, it is not appropriate to look to the ISDA spread adjustment. If the spread adjustment selected by ISDA is included in the waterfall, it should only apply if it relates to the same benchmark (e.g. Compounded SOFR).
**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 to Question 14.** Any spread adjustment should be specific to the replacement benchmark, publicly available and its calculation transparent.

**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 to Question 15.** To ease the administrative and operational burden, it would be preferable for the Lender to take the actions and/or make the determinations listed above, unilaterally. In this regard, it is noted that the draft hardwired fallback language proposed by ARRC for bilateral loans does contemplate that the lender will be able to act unilaterally in many circumstances, subject only to the borrower’s right of negative consent, where specified.

As a practical matter, however, it is anticipated that more sophisticated borrowers would expect to be consulted and work with the lender. A more sophisticated client may not accept that the lender acts unilaterally or make determinations in its sole discretion in all instances, and a dual approach may be necessary.

**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 to Question 16.** Please see the response to Question 15, above. Generally, it would be advantageous to a lender to be able to take these steps unilaterally. Such an approach may be appropriate for loans with certain classes of borrowers. As noted above, however, our expectation is that more sophisticated borrowers would resist such clauses and would seek broader consultation or consent rights.

**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 to Question 17.** Yes, we are of the view that both should be published. This is critical for transparency for both lenders and borrowers. In addition, greater transparency supports operational accuracy and automation.
**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 to Question 18.** This seems more relevant to a syndicated loan with an agent. Please see the answer to Question 15, above.

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

**Answer to Question 19.** This largely depends on what alternate benchmark(s) are ultimately chosen by the market. For example, we anticipate that a Term SOFR would, operationally, be very similar to LIBOR and therefore, easier to operationalize. However, developing systems to accommodate a Compounded SOFR in arrears, or an overnight rate, will be more time consuming. Again, we emphasize that the publication of a use case would be of considerable assistance.

**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 to Question 20.** No, not at this time.

**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 to Question 21.** The rates would need to be aligned so either the swaps would be terminated and new swaps executed, or an amendment could be entered into in advance to align the ISDA fallback language for that counterparty with the loan fallback language. This presumes there is a swap market for Term SOFR. If a swap market for Term SOFR does not exist, and the accounting view is that the mismatch between the hedge and the swap results in the client not qualifying for hedge accounting, the loan market may need to accommodate Compound SOFR for hedged loans.

**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 to Question 22.** In our view, alignment with the underlying swap is critical. However, there is also a preference to align with the syndicated loan market.

We also note that many borrowers will have revolving loans (providing for shorter term loans that would not be hedged) as well as term loans (providing for longer term loans that may be hedged). While possible, it would likely be confusing for borrowers, and operationally cumbersome for lenders, to have facilities that fallback to different rates.

**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 to Question 23.** It is not optimal to have the hedged portion of a loan fallback to one rate (eg. Compounded SOFR under the ISDA protocol) and the unhedged portion fallback to another rate (eg. Term SOFR). While technically possible, this would be operationally cumbersome to manage and may create confusion, and a poor borrowing experience for clients at the outset. This may be temporary depending on how well lenders are able to operationalize the offering of two rates.

**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 Question 24.** We re-iterate our concern regarding potential lack of alignment between the approaches to LIBOR replacement in the cash markets and the derivatives markets. As noted, a number of borrowers with LIBOR-based facilities enter into related interest rate swaps. Accordingly, we would expect the fallback rate applicable to the loans to be the same as that available for the hedge. If not, there is a risk for the borrower, which could complicate the origination of new loans, or discourage borrowers from hedging their loans while there is uncertainty as to how this will be handled.

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

**Answer to Question 25.** As stated in response to Question 1, we support a hard-wired approach, in principle. Such an approach would provide all parties with greater certainty, reduce administrative burden and lessen exposure to market risk at the time of transition. Given the number of unknowns at this stage, however, we cannot fully endorse the approach. Borrower education will be critical if lenders seek to have them agree to terms that are not yet defined or known.

We also emphasize the need for consistency in fallback rates across cash (bonds and loans) and derivative products, given that term loans for more sophisticated clients will often have
corresponding interest rate hedges. We can foresee a number of issues if different products adopt different triggers, rates or spread adjustments.