

The Alternative Reference Rate Committee (ARRC)
Federal Reserve Bank of New York
United States of America

February 5, 2019

Credit Suisse Group (Credit Suisse or CS) hereby submits our response to the Bilateral Loans consultation paper published by the ARRC in December 2018. We welcome the consultation and believe it to be a vital prerequisite for a market-wide transition to the new alternative reference rates.

In accordance with existing business practice, CS will seek to utilize the fallback standards that are eventually adopted by global loan industry associations in their respective markets. This letter is intended to highlight our general recommendations for a safe transition to all proposed alternative reference rates, as well as to present a view on topics outlined within the ARRC paper.

CS believes that in principle, an optimal adoption of fallbacks for new Bilateral Loan contracts must:

- a. Minimize the potential for market manipulation by any group of market participants, regardless of the timing of the trigger event.
- b. Minimize interpretation risk, by using transparent data and simple and deterministic terms. This should allow both lenders and borrowers to independently derive the fallback terms without the need for additional validation.
- c. Be synchronized, or at least compatible, with developing fallbacks in other related markets (e.g. Derivatives, CLOs and Floating Rate Notes).
- d. Minimize the possibility of value transfer at the point of transition, or perceived economic harm on parties, so as to reduce risk of litigation and other disputes.
- e. Minimize event risk by limiting impacts from global monetary policy decisions on or around the day of the fallback being triggered.
- f. Be practical to implement across systems, entailing reasonable implementation overhead and complexity.

We think the availability of published forward-looking term rates will be critical to a safe market-wide transition to alternative reference rates (ARRs). Term rates are used in determining interest payments for the vast majority of Loan contracts globally today, and are intuitive and transparent to even unsophisticated borrowers. Not only would term rates be a superior solution to the other waterfall steps proposed in the consultation paper, they would also provide for consistency if adopted in coordination with other markets (e.g. Derivatives). Further, while larger lenders could build the mechanisms necessary to calculate a compounded rate, we think borrowers will highly prefer using simple term rates instead. These term rates could be derived from the developing futures markets in respective ARRAs (e.g. SOFR futures), and ideally should be made available across the range of primary loan contract currencies (USD, GBP, CHF, EUR and JPY).

While the fallback terms proposed in your paper are specific to the SOFR rate alone, we believe it essential to align such provisions across all the globally identified ARRAs (i.e. across currencies). This will minimize the disruption of business practices at large global lenders like CS, which commonly offer multi-currency credit facilities and often deal with borrowers across multiple global loan markets (e.g. across the US, European and Swiss Credit markets). Standardization of approaches will also serve to minimize cross-currency basis risk, thus saving potential hedging costs. A simplified approach across currencies would also reduce implementation costs and complexity for all parties.

Similarly, the alignment or compatibility of fallbacks agreed for Loans with those of Derivatives and Floating Rate Note markets is important. This is because at CS and other large lenders, loan activities are often

hedged using Derivatives, and internal cost of funding measurements help determine prices for our lending activities to clients.

Here are some additional views on the detailed sections within the consultation paper:

General approach of the two fallback proposals (question 1 & 2)

While the 'Amendment approach' is ideal in theory, it may be difficult to practically implement market-wide in its current definition and could create a perception of winning or losing in different market cycles as the paper rightly identifies. For this reason, we believe the 'Hardwired approach' would be preferable for an orderly transition given it provides greater visibility on terms upfront, which we believe will be important to borrowers and investors alike.

However we note that the Hardwired approach as defined uses term SOFR rates with its suggested waterfall, which are not currently available. Similarly the methodology for compounding SOFR, whether in arrears or in advance, has not been agreed. It would thus be difficult for market participants to agree to move to a rate without the necessary conventions for that rate already developed. Regardless of the approach eventually recommended by the ARRC, we think consistency of adoption across lenders and borrowers of all degrees of sophistication to be the most important objective.

Triggers (questions 3 through 5)

We believe the inclusion of 'pre-cessation trigger' 5 is helpful, as its determination is made by a regulatory authority, and as such a situation could not give rise to market manipulation or allegations thereof. Our concern with trigger 3 is that a failure to publish LIBOR for some days should result in permanent LIBOR discontinuation, not a temporary one, to prevent untimely contractual resets and operational issues. If such a trigger is chosen, we recommend arriving at the 'number of days LIBOR fails to publish' through future industry consultation. Our suggestion for trigger 4 is that such a determination would be best made by a regulatory body that the market recognizes, so its definition could be aligned to trigger 5.

In general, any and all pre-cessation triggers should be simple, deterministic and widely known to all market participants. With borrowers and investors differing in their sophistication and capabilities, disagreements on fallback terms would increase litigation risks. Separately, we are concerned that the recent ISDA consultation for Derivative fallbacks did not propose any pre-cessation trigger events, which would present an apparent departure from ARRC papers for FRNs and Loans.

We support the concept of the 'early opt-in trigger' in theory as it can provide an orderly transition of the market standard for a number of issuers, and as it provides flexibility to convert to SOFR prior to LIBOR cessation which borrowers may seek. However, such a trigger needs to have inherent safety provisions to prevent giving too much power to an administrative agent or borrower. Depending on market conditions, lenders may or may not provide the necessary consent, which could result in a bifurcated market. CS stands ready to adopt such a trigger, in as much as it is carefully deliberated in industry associations.

The replacement benchmark (questions 6 through 11)

CS appreciates the ARRC's exclusion of 'Overnight SOFR + a Spread' as a lower level of the Replacement Benchmark waterfall, given the concerns we and other market participants have shared in prior responses.

As mentioned earlier, CS highly prefers published term rates to any other derivations noted in the waterfall. We think it has been rightly proposed at the top of the waterfall.

Within the hardwired approach, in the absence of a published term rate, a ‘compounded in advance’ rate is preferred next. The ‘compounded in advance’ method is operationally the most practical for the loans industry, and reflects current loan market practices and borrower preferences. The selection of a ‘compounded in arrears’ approach for the loan market would require strong industry-wide consensus as it would be a significant departure from how loan contracts are structured today.

With regards to term rates, CS would prefer not to interpolate or eliminate specific interest periods as a lender, but would stand ready to do so if required and provided market conventions are agreed and known to both lenders and borrowers.

Spread adjustments (questions 12 through 14)

We believe the ARRC (or another regulatory body) should consider calculating and reporting a spread adjustment that could apply to cash products, including Bilateral Business Loans. This will provide for consistency between markets and provide transparency to lenders, borrowers and investors and reduce litigation risk. This will prevent the situation described in the paper whereby loan contract could incur fallbacks earlier or on different terms compared to derivatives.

Of the spread adjustments proposed by ISDA for Derivatives, CS has expressed support for the ‘Historical Mean/Median Approach’. While not without its own limitations, this approach allows the least scope for market manipulation, uses readily accessible historical data, and is relatively simple to implement in firm systems. However, the Historical Mean/Median Approach as proposed suggests a simple mean or median on a fixed lookback period. CS has suggested an enhancement where more weight could be given to more recent observation periods by applying a time decay function (e.g. exponential weighing). This would ensure that any extreme market events from the distant past would wield only limited influence on current fallback parameters. Similarly any material moves from the recent past would be appropriately emphasized.

Lender vote (questions 15 through 18)

We defer to the industry associations to provide a more representative view of lender preferences on these proposals.

Operational considerations (questions 19 and 20)

Knowledge of the fallback rate prior to making a borrowing reflects current loan market practices and borrower preferences. The selection of a ‘compounded in arrears’ approach for the loan market would require strong industry-wide consensus as it would be a significant departure from how loan contracts are structured today. This would entail a number of operational changes, as well as changes to hedging strategies for financing portfolios at lenders.

To minimize operational concerns, a transition point to alternative reference rates must be clearly defined and communicated sufficiently in advance. This would allow for better market-wide cooperation on both new contracts and historical amendments.

Hedged loans (questions 21 through 23)

If the fallback rates for loans differ from derivatives, corresponding swap hedges may require recalibration (which may include termination and re-booking upon transition of the hedged loan contract).

The 2018 ISDA consultation on derivative fallbacks assumed that term rates will not be available, and thus proposed compounding approaches using overnight SOFR rates. CS has communicated to ISDA that we believe forward-looking term rates to be a superior approach to compounding for Derivatives, especially since

it ensures consistency with other markets where contracts and clients heavily rely on such rates being available.

We believe loan borrowers prefer simplicity in contract terms. The 'dynamic tranching' of partially hedged loans is likely to be operationally cumbersome and complicated. We would prefer if trigger terms apply to the loan contract as a whole.

Please direct any questions or feedback to Nomita Singh (Managing Director – Head of US Regulatory Affairs) at nomita.singh@credit-suisse.com

Thank you.