Dear Sirs:

Derivative Path, Inc. ("DPI") is an Introducing Broker headquartered in the San Francisco Bay Area, with additional offices in New York City and Chicago. We provide a technology-led solution to assist financial institutions and their commercial borrowers in executing and managing over-the-counter interest rate derivative and FX transactions. The team is comprised of derivative industry veterans who have worked for some of the world’s largest capital market firms. Today we work with over 80 regional and community banks in the United States. We help our clients both manage their own interest rate risk as well as run back-to-back interest rate hedging programs for their commercial borrowers by providing trading, servicing, and hedge accounting support. It will be critical for the country’s regional and community banks and their commercial borrowers to safely navigate the changing landscape from LIBOR to SOFR (or other such replacement indices). DPI is appreciative of the opportunity to present its views on the subject and welcomes the opportunity to participate in continuing efforts within the industry to make a smooth LIBOR transition.

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?

As there is still uncertainty in the mechanics of replacing LIBOR with the SOFR benchmark, Derivative Path believes that it may be premature to consider implementing the hardwired approach without analyzing further impact. The amendment approach allows for more flexibility and provides more comfort that may lead to a more consistent adaptation amongst banks. However, once there is more certainty regarding
the transition to a new benchmark, banks may consider switching from an amendment approach to a hardwired approach due to its convenience.

**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?

For banks who hedge, or allow their commercial borrowers to hedge, bilateral loans with derivatives, it is important to ultimately have an approach that is consistent with ISDA’s approach for derivatives. An inconsistency between the two organization’s approaches would cause a mismatch in hedging, leaving banks and hedging borrowers exposed to potential economic mismatches. Derivative Path understands that the ARRC recognizes that the recommended approach needs to consider the impact on loans hedged with derivatives in its determination. Either approach needs to have enough flexibility to prevent a mismatch between the loan and hedging instrument.

It is also important that hedge accounting requirements are taken into consideration in the proposed LIBOR fallback terms. An alignment between the proposed fallback terms and the derivatives market is required since any mismatch between the hedged item and the hedging instrument could result in income statement volatility. Under the updated hedge accounting rules (ASU 2017-12), though a fairly wide threshold exists on cash flow hedge effectiveness, once outside the threshold, hedge accounting is lost and the entire hedging instrument is marked-to-market through P&L. Additionally, for fair value hedges, any mismatch between the hedged item and the hedging instrument is marked-to-market through P&L thus causing income statement volatility.

**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?

Proposed fallback language should include all three of the pre-cessation triggers. Each of the proposed pre-cessation triggers are good indicators of the deterioration or unreliability of LIBOR that should trigger a bank to move to a fallback benchmark in its bilateral business loans.

(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.

A mismatch in pre-cessation triggers can cause imperfect hedging between a loan and a hedging instrument should the triggers cause the fallback to occur at different times, or if different fallback methodologies are used. This mis-match can impact banks and borrowers by incurring unanticipated consequences that could potentially disrupt the financial expectations for the middle market loan participants. While a large corporate
or bank could handle a temporary mismatch in the cash and hedging instrument, the impact to the middle market loan participant could be financially burdensome.

(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?

Practically speaking, market participants can attempt to renegotiate contractual terms, or exercise prepayment or optional early termination features in currently existing transactions should LIBOR continue to operate but no longer accurately and fairly reflect the cost of making or maintaining the bilateral business loan. If available, participants can also rely on existing bespoke contract terms that may allow the parties to select a new benchmark.

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

Derivative Path believes that the opt-in trigger is appropriate to include because it will help reduce the number of LIBOR based loans while providing flexibility and additionally result in a gradual transition away from LIBOR.

(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).

As long as the opt-in provision does not automatically require use of Term SOFR, it should be viable in either approach.

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

Derivative Path has not identified any additional triggers it would recommend for consideration.

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.

Every attempt should be made to align the primary fallback recommended by ARRC to the approach taken by the derivatives market. If ISDA and the derivative industry concludes that compounded SOFR is expected as the primary reference, the ARRC should make compounded SOFR the primary fallback rather than a forward-looking term rate.
**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?

A Lender should not be able to eliminate interest period options if there are no equivalent SOFR term rates available. Other fallback solutions should be provided for this unlikely occurrence, such as compounding available overnight SOFR or other available term SOFR rates if an interest period without a term SOFR rate is selected from existing interest period options.

**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?

Compounded SOFR should be the primary step in the waterfall if ISDA implements compounded SOFR as the primary fallback for derivatives.

**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”?

The operational issue would be less burdensome to implement compounded SOFR “in advance”, but ARRC should follow the compounding method approach taken by ISDA, even if that is “in arrears”.

**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 should be added as an additional step in the waterfall. Every attempt should be made to reduce the steps and ensure they are closely aligned to the ISDA approach.

**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.

There are no additional replacement rates that we believe should be added.
**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, a Government Body or ARRC should recommend a spread adjustment that could apply to cash products, including bilateral business loans. Without this, there could be endless debates between borrowers and lenders as to the correct spread to apply. That said, every attempt should be made to align the spread methodology recommended by a Government Body or ARRC with the spread adjustment methodology adopted by ISDA for derivatives contracts.

**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.

Including fallbacks that would be aligned with the ISDA/derivative approach would be appropriate, even if bilateral business loans may fall back at a different time or to a different rate from derivatives. The ISDA definitions fallback will still be robust and objective, and should provide a strong second priority in the spread waterfall for bilateral business loans.

**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?

There are no additional spread adjustments that we would recommend adding to the hardwired approach spread waterfall.

**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.

(i) Our financial institution clients would be willing to work with their borrowers to identify a new reference rate and spread adjustment. However, we strongly recommend a more-standardized approach in which the reference rate and spread adjustment are prescribed and published by a third-party as discussed in our response to Question 17.

(ii) While our financial institution clients could monitor whether a trigger event has occurred, we feel that a better approach would be to rely on the guidance of an industry body such as ISDA to determine when such an event has occurred.
(iii) We recommend that all lenders agree to use a common third-party source, such as the New York Fed web site, as the source for reference rates.

(iv) Given that the vast majority of bilateral business loans are indexed to either 1-month or 3-month LIBOR without interpolation, we do not anticipate that there will be many instances where it will be necessary to interpolate SOFR. However, our financial institution clients could perform such calculations if necessary.

(v) Our clients are prepared to make one-time or periodic operational amendments as necessary to administer the new benchmark. However, it is strongly recommended that such amendments be consistently applied across all LIBOR-based credit facilities to avoid the operational challenges associated with a more piece-meal approach.

**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.

Yes. The lender should have the right to take the relevant action to unilaterally designate new loan terms for bilateral business loans simply by notice to the Borrower should a Benchmark Discontinuance Event occur provided that the lender follows the framework outlined in Appendix I or II. Given the sheer number of loan facilities that would be impacted by a cessation of LIBOR, it would be overwhelming from a logistical perspective for many financial institutions to solicit consent from each borrower prior to re-designating loan terms to reflect the new benchmark. The operational burden could create disruptions in the loan market, and the resulting delays in the transition could create operational risk for lenders as well as potential basis risk and accounting risk for borrowers if there is a mismatch between the timing of the conversion of the borrower’s loan and their other financial contracts such as interest rate swap contracts.

**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. We believe that it is highly desirable that the replacement rate and/or applicable spread adjustment should be published by a third party—ideally a Relevant Government Body such as the New York Fed—and freely available to the public. This will ensure that lenders across the industry follow a consistent approach toward transitioning to the new benchmark and will reassure borrowers that their credit facility is being transitioned to the new benchmark in a fair and objective manner.
**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?

We believe that the lender should retain the limited ability to make subsequent conforming changes on a periodic basis beyond the point of transition to reflect evolution in market conventions and conditions that may occur following the introduction of the new benchmark. For example, it may be the case at the initial point of transition that a forward-looking term SOFR does not exist, but such a rate may be introduced by market participants at a later date. The lender should retain the ability to adjust loan terms to reflect such subsequent market developments.

**Questions 19 and 20.** Responses intentionally omitted.

**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?

Borrowers who have entered interest rate swaps to hedge their bilateral loans expect those derivatives to be a highly-effective offset to the interest expense on their floating rate loans. To the extent that the bilateral business loans fall back to a different rate than that of the derivative, it would introduce the potential that the swap would no longer be completely effective which could have both economic and accounting implications for the borrower. Provided that the loan benchmark rate and derivative benchmark rate are highly correlated, some borrowers may elect to accept some small amount of tracking error. However, if the discrepancy is more substantial, we would anticipate that borrowers would elect to terminate their swaps and re-hedge with a new swap hedging the new benchmark rate being used to price the loan.

**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.

Yes. We expect that most borrowers with hedged loans would prefer that the loan fall back to the same rate and spread as their swap to ensure that their swap remains effective, even if a term SOFR is available. Of the three approaches outlined by ISDA for calculating the spread adjustment, we favor a spread adjustment which is based upon the historical average between LIBOR and SOFR over a longer period as we believe this is less prone to manipulation than the approaches of using market forward rates or spot spreads at the time the fallback is triggered. However, one drawback with using the historical average approach to calculating the spread adjustment is how to calculate the
adjustment for early adopters who may wish to transition to the new benchmark prior to a formal Benchmark Discontinuance Event. We are also concerned that financial institutions will face significant operational challenges with using compounded average SOFR in arrears, which ISDA has recommended as the fallback for derivatives, to price their floating rate loan books as many bank loan systems are not flexible enough to utilize this interest rate benchmark without significant modifications.

**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?

For partially-hedged loans, we believe that the entire loan balance should convert to the same fallback rate—ideally the same rate as the fallback rate for the swap. It is not operationally practical for most banks to bifurcate the hedged and unhedged portions of the loan and have each portion convert to different fallback rates. Another challenge to consider is that it may not be immediately obvious whether or not a given loan is hedged, particularly in those instances where a borrower has multiple loans with different lenders and did not specifically identify in the documentation which loan was being hedged (e.g., portfolio hedges).