ARRC CONSULTATION
REGARDING MORE ROBUST LIBOR Fallback CONTRACT LANGUAGE FOR
NEW ISSUANCES OF LIBOR FLOATING RATE NOTES
(dated September 24, 2018)

Question 1(a): Should fallback language for FRNs include any of the pre-cessation triggers (triggers 3, 4, and 5)? If so, which ones?

In order to answer whether triggers 3, 4, or 5 should be included, it seems warranted to start at the basis of what each is trying to achieve.

For the trigger 3 proposal (5 day failure to publish), this would seem to accomplish little as there is already fallback language within existing documents which contemplate a temporary lack of availability of a LIBOR index. Attempting to directly address a period of days (or even weeks) as warranting legal clarification beyond that already included in existing contracts would seem in excess as such a scenario would either already be addressed within the existing terms of a prospectus or would likely be a systemic event significant enough such as to warrant formal direction from the administrator and/or regulators associated with the LIBOR submission process.

As for trigger 4, this would also seem be excessive as the administrator has already provided guidance as to how such occurrences may be handled. While this may result in the IBA having significant discretion in the outcome for how such a scenario may be handled, the markets’ failure to acknowledge existing IBA resolution protocol may result in increased legal risk for the determining party in the event of such an occurrence.

The last proposed pre-cessation clause, trigger 5, may have merit as it addresses a scenario which is likely not appropriately contemplated within current fallback language. Specifically, this could provide additional clarity in the event LIBOR continues to exist, including instances such as that portrayed by triggers 3 or 4, but is formally deemed not appropriate for continued use by the relevant regulatory authority overseeing LIBOR (i.e. the FCA). While specifically excluded within trigger 5, it may also be worthwhile to consider including such a directive by a US regulatory body. This would appear to have limited downside and would address the unlikely scenario in which the UK regulatory agency overseeing LIBOR continues to support the submission process but a US regulator has prohibited US firms’ continued use of LIBOR.

Question 1(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.

As noted, for triggers 3 and 4, the highlighted concerns are specific to the triggers themselves and would likely further complicate matters when compared with derivatives markets. As proposed, trigger 5 could theoretically result in differences between FRNs and derivatives markets; however, it would seem advisable, and likely, that such a scenario could be addressed through updating the standard ISDA
fallback language which should support consistency in interpreting the occurrence of such a trigger “event” (be it for new or ‘legacy’ contracts).

**Question 1(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?

We support the inclusion of clear, pre-cessation triggers (including Triggers 1, 2, and possibly 5) as part of enhancing fallback language in order to avoid market disruption and more clearly address a potential unavailability of LIBOR, whether that cessation is expected or unexpected. Absent clear pre-cessation triggers, any signs of a potential lack of availability of LIBOR would likely foster concerns within the market and thus result in a considerable repricing of basis risk as certain market participants look to reduce LIBOR exposure where possible (i.e. unwind positions, move to alternative indexes, etc.) while others take advantage of the potential uncertainty and dislocation. This would seem likely to result in a considerable transfer of value which would appear contrary to the ARRC’s objectives.

**Question 2:** If the ARRC has recommended a forward-looking term rate, should that rate be the primary fallback for floating rate notes referencing LIBOR even though derivatives are expected to reference overnight versions of SOFR?

The potential misalignment between term rates, as are typically used in FRNs, and overnight rates (i.e., SOFR) is a significant issue which will ultimately complicate the effort to make the transition away from LIBOR a value-neutral proposition. This issue needs further attention but extends well beyond this consultation and the FRN market.

As it relates specifically to FRNs, even though it appears a minority of investors and issuers hedge the interest rate risk of the Floating-Rate-Note product, attempting to address the potential term rate inconsistency would seem preferable. However, a complete alignment with the terms of the derivatives-based SOFR methodology appears unlikely and, therefore, some level of inconsistency between the FRN and derivatives markets is likely to exist regardless of which nuanced fallback methodology is adopted. Though such inconsistencies may impact firms who are attempting to hedge under ASC-815, recent updates to that guidance may better allow for those activities to continue despite some marginal differences in methodology.

**Question 3(a):** Should Compounded SOFR be the second step in the waterfall? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR?

The concept of compounded SOFR as a prescribed fallback has merit and would be reasonably aligned with that of Fed Funds Effective OIS markets. However, at this stage in the process, being overly prescriptive with a deep waterfall would seem premature as each layer in the waterfall is simply an alternative derivation of the same basic concepts. It would seem better founded to first coalesce around a single SOFR methodology and a single spread methodology, and then provide for an
appropriate level of discretion on behalf of the Issuer or its Designee in the event either the rate or the spread are deemed not available. While there is a strong preference toward transitioning to a Term SOFR framework, converting to a Compounded SOFR may indeed be preferable to using Spot SOFR. However, it is worth emphasizing the potential operational challenges this may present for a wide variety of stakeholders. Transitioning to a Compounded SOFR methodology would alter the way payments are calculated and exchanged, so the Committee should be mindful of the operational impacts as well as the potential impact of such a change on the timeliness of contractual coupon payments (i.e. event-of-default).

**Question 3(b): 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”?

While potentially presenting operational issues per above, the “in arrears” methodology would seem most advisable for the FRN market in order to minimize value transfer and, at least philosophically, most closely represent the LIBOR interest rate exposure that exists within these instruments today. The only apparent benefit of using an “in advance” methodology would be to facilitate a level of certainty at the initial setting period for both the borrower and lender. While not comparable in all respects, the “in arrears” methodology that is used within the Fed Funds Effective OIS markets has not appeared to represent a significant operational issue to date.

While not the primary consideration, this preference would indeed be influenced by the position taken by ISDA. Not having consistency with derivatives markets may confuse the effort toward broader market adoption and complicate efforts to hedge such exposures going forward (i.e. ASC-815 or otherwise).

**Question 4(a): Would an overnight rate that remains in effect for the entire interest period be an acceptable option for investors, issuers and agents?

No. This would present issues, particularly to the extent the existing term LIBOR rate differs from an overnight rate. For instance, transitioning from a 3-month term rate to an overnight rate can alter the duration risk of the instrument and thus impact the value of the FRN instrument.

**Question 4(b): Should the waterfall include Compounded SOFR (step 2) and spot SOFR (step 3) and/or a simple average of SOFR (not in the waterfall at this time)? If only one of these options is included, which is preferable? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR?

As stated in question 3(a), being overly prescriptive with an extensive waterfall would seem inadvisable at this time. But as it relates to this consultation and with respect to the three options highlighted above, the first preference would be to use the option that is most consistent with that of the derivatives markets, which currently appears to be Compounded SOFR (step 2). Maintaining a consistent approach between FRN markets and the derivatives markets would most easily facilitate the ability to transfer risk among market participants if/as needed.
**Question 5:** In the future circumstance where there is no SOFR-based fallback rate, is the replacement rate determined by the Relevant Governmental Body the best alternative at this level of the waterfall?

It is perhaps worth making the distinction as to whether this is attempting to contemplate a short-term lack of availability for SOFR or whether, as it would appear, this is addressing a scenario where SOFR is ultimately not deemed to be suitable as a longer-term fallback solution. In the latter instance, it would seem that there should be broader acceptance around defining the ‘Relevant Governmental Body’ given that there is currently no single, authoritative body in the US governing the use of LIBOR. Additionally, it may be worth considering that such body should not be controlled, or represented in the majority, by stakeholders who have a vested financial interest in the outcome of such a decision and, thus, could be perceived as having a potential conflict of interest.

**Question 6(a):** In the future circumstance where there is no SOFR-based fallback rate and the Relevant Governmental Body has not recommended a replacement rate for FRNs, is the fallback for SOFR-linked derivatives set forth in the ISDA definitions the best alternative at this level of the waterfall?

No comment.

**Question 6(b):** Should this step in the waterfall refer expressly to OBFR and then the FOMC Target Rate rather than refer to the fallback rate for SOFR-linked derivatives in the ISDA definitions (which could change in the future)?

Again, the depth of this waterfall seems unduly complicated. If SOFR is temporarily unavailable, it would seem falling to the FOMC Target Rate (as defined) should prove sufficient. If this is contemplating a more permanent substitute for SOFR, then addressing through a formal transition to an alternative index, potentially OBFR, would seem warranted.

**Question 7:** Should the issuer or its designee have the ability to over-ride the ISDA fallback for SOFR-linked derivatives in the ISDA definitions at this level of the waterfall if it determines that another rate that is an industry-accepted successor rate for FRNs exists at such time?

No comment.

**Question 8:** Do you believe that the ARRC should consider recommending a spread adjustment that could apply to cash products, including FRNs?

Yes. However, given the term structure of interest rates and credit spreads, providing a “one size fits all” spread adjustment would not seem to be a viable solution. Such a simplified spread approach if provided by ARRC would be actionable but would likely exacerbate the transfer of value. Conversely, ARRC failing to provide guidance would prevent an orderly transition and potentially increase litigation risk among market participants.

It may be preferable if ARRC provided a recommended methodology for making spread adjustments. This would likely reduce legal liability risk within the system and would hopefully still provide a clear
methodology by which Issuers, or their Designees, might update the terms of the instrument in a way that minimizes the transfer of value.

**Question 9:** Is a spread adjustment applicable to fallbacks for derivatives under the ISDA definitions appropriate as the second priority in the spread waterfall when the Unadjusted Replacement Rate is equivalent to the ISDA fallback rate?

Adhering to the ISDA fallback protocol would seem to be an absolute: either adopt in totality for both rate and spread or adopt neither. To adopt one or the other but not both would seem to increase the risk that value is exchanged as a result of the fallback transition.

**Question 10:** If the ARRC does not recommend a spread adjustment, should the issuer (or its designee) have the ability to determine the spread adjustment (or, if step 2 is applicable, over-ride the spread adjustment for derivatives fallbacks in the ISDA definitions) and select a spread adjustment that would result in a rate that is an industry-accepted successor rate in floating rate notes at such time?

Allowing the issuer to determine the spread may support the ideal of minimizing value transfer upon transition relative to an overly prescriptive approach that lacks methodological consistency. However, this would likely result in less consistency among issuers which could lead to a less orderly transition and increased risk of litigation. Perhaps an alternative would be to provide guidance on a spread methodology which would minimize contract disputes while also allowing an issuer to operationalize the adjustment in a way that still aims to be value neutral.

**Question 11:** Whether as issuer or as calculation agent, would your institution be willing to (i) determine whether the proposed triggers have occurred, (ii) select screens where reference rates or spreads are to be found, (iii) make calculations of a rate or spread in the absence of published screen rates, (iv) interpolate term SOFR if there is a missing middle maturity and (v) make the decisions in step 6 of the Replacement Benchmark waterfall and step 3 of the Replacement Benchmark Spread waterfall?

In general, should there not be an orderly transition away from LIBOR to an industry-accepted replacement standard (with accompanying methodology or guidelines for determining alternate rate and spread for FRNs) we would be reluctant, as either an issuer or as a calculation agent, to exercise significant discretion in performing such duties. Without an industry-accepted methodology, the use of such discretion would be accompanied by significant litigation risk for both calculation agents and issuers. Already, few, if any, banks are willing to accept any discretion in serving as a calculation agent for a FRN with a duration extending beyond the anticipated phase-out of LIBOR, which should be broadly instructive to the ARRC as it considers this Question 11. In the event these duties are being performed as part of an orderly transition:

i. Yes: for triggers 1, 2, 3, and 5; however, we do not believe trigger 3 is advisable as a trigger event. We would be less likely to determine an occurrence of trigger 4 as it may be somewhat more open to interpretation on behalf of an unbiased party and we see certain potential shortcomings in that ‘event’ as a pre-cessation trigger.
ii. Yes: we would support selecting specific screens and/or index reference sources, assuming the index is one which is defined and used broadly within the market.

iii. Unlikely: as an issuer, we would be reluctant to calculate ourselves given the potential appearance of bias. On behalf of other parties, there should be sufficient infrastructure to facilitate such calculations; however, there would need to be sufficient compensation for performing said effort.

iv. Yes: assuming a recognized benchmark rate is published/available and interpolation is a generally accepted market practice. We would consider this not unlike interpolating LIBOR settings which is a frequent occurrence within certain areas of our business.

v. Possibly: this would depend on the size of the relevant exposure for which a fallback is being determined. The appropriate infrastructure and expertise would be available but agreeing to determine would depend on whether we were issuer or agent and in either respect, would involve increased legal risk which would require review by internal stakeholders in order to ensure prudent safety and soundness for our institution.

**Question 12:** Is there any provision in the proposal that would significantly impede FRN issuances? If so, please provide a specific and detailed explanation.

While not necessarily addressing fallback language specifically, encouraging issuers of FRNs to incorporate additional language which would permit the instrument to be called (potentially with a Make Whole) in the event of a trigger event may facilitate an orderly transition in the instance there are different interpretations or broader issues in implementing a prescribed fallback. As an issuer and potential “determining party”, having the ability to retire an impacted FRN instrument without penalty provides a fallback in itself which may avoid the transfer of significant value or potential litigation risk.

**Question 13:** Please provide any additional feedback on any aspect of the proposal.

No comment.