Memorandum

To: arrc@ny.frb.org Date: 11/26/2018
From:
Subject: ARRC Consultation Regarding More Robust Libor Fallback Contract Language for New Originations of Libor Syndicated Business Loans

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respectfully requests that this submission be anonymized pursuant to the response procedures outlined in subsection (j) of the ARRC Consultation Request. respectfully requests that its name be redacted from any publication of this document and that any communication associated with the transmission of this response be afforded confidential treatment pursuant to the Freedom of Information Act, 5 U.S.C. § 552(b), and the Board's regulations thereunder, 12 C.F.R. Part 261 (collectively, "FOIA"), for this letter, on the grounds that this letter and enclosed information concern highly sensitive business, commercial, and financial information and, the disclosure of which would be likely to cause substantial harm to, as applicable, if not anonymized.

Accordingly, we respectfully request that this letter be anonymized and the communication of the response submission not be made available for public inspection or copying. In addition, we request that any memoranda, notes, or other writings of any kind whatsoever by an employee, agent, or other person under the control of the Board or the Federal Reserve Bank that incorporate, include, or relate to any of the matters referred to in this letter that are anonymized not be made part of any public record and not be disclosed to any person.

***Question 1.*** *If the ARRC were to adopt one or more sets of 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?*

**Answer:**

The amendment approach is preferred over the hardwired approach at this time, but without the 'opt in' language so that control over the timing of any switchover remains with the Agent. See Question 3 below.

In order to get comfortable with the hardwired approach, we would like to see (1) the market make further progress in selecting a preferred replacement for LIBOR, whether that is SOFR or another index rate, (2) the preferred replacement rate develop from an overnight rate into a robust index with rates quoted in a central source for 30- 60-90 day terms and beyond, and (3) the development of a reliable mechanism for determining the Replacement Benchmark Spread rather than deferring to a Relevant Government Body to make a selection or recommendation. Implementation of the hardwired approach seems premature given where we are today on these points.

***Question 2.*** *(a) Should fallback language for business loans include any of the pre-cessation triggers (triggers 3, 4 or 5)? If so, which ones?*

**Answer:** The inclusion of triggers 3, 4, and 5 provides flexibility to the Agent, which is desirable because of the uncertainty around how LIBOR will 'wind down' over the next few years. However, the Agent may be reluctant or otherwise unable to utilize triggers 3,4,or 5 if the applicable rates for derivatives associated with a loan are not changed at the same time as the loan.

*(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.*

**Answer:** As noted above, because of the possible link between a loan and any associated derivatives, an Agent will be reluctant to break this link without alignment between the loan and derivatives. Inconsistencies between how triggers are applied between the loan and the hedge could cause basis risk, which could have an impact on hedge effectiveness.

*(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:** If pre-cessation triggers are not included, the options would be to default to base rate or convert to a fixed rate instrument, neither of which would be acceptable to borrowers

***Question 3.*** *(a) Is an "opt-in" trigger appropriate to include? Why or why not? (b) If you do believe an "opt-in" trigger should be included, do you prefer the approach in the hardwired proposal or the amendment proposal? Please explain.*

**Answer:** The Agent should have the ability, in consultation with the borrower and subject to the negative consent of Required Lenders, to trigger an 'opt in' to a market replacement index. However, any 'opt in' language that can be triggered by a borrower or Required Lenders may create issues and potential liability for an Agent who is unready to switch index rates due to system concerns or uncertainty over the market replacement for LIBOR at the time of a request by a borrower or Required Lenders. For this reason, the 'opt in' language in both the amendment and hardwired approaches is not preferred.

It is possible for two or more competing replacement benchmarks exist, without clarity on which one is the market preference, and LIBOR has not had a cessation event, and therefore Agent could be faced with requests from borrowers and Required Lenders for different replacement rates in different deals, which could result in systems and back office issues.

***Question 4.*** *Are there any other trigger events that you believe should be included for consideration? If yes, please explain.*

**Answer:** None at this time.

***Question 5.*** *If the ARRC has recommended a forward-looking term rate, should that rate be the primary fallback for syndicated loans referencing LIBOR even though derivatives are expected to reference overnight versions of SOFR? Please explain.*

**Answer:** We would have concerns applying a forward-looking term rate recommended by the ARRC where the derivatives associated with that loan reference a different rate or an overnight version of the rate recommended by the ARRC. Use of comparable rates for both a loan and associated derivatives is preferable.

***Question 6.*** *Should the administrative agent (by itself or with some other party) be able to eliminate certain interest period options if there are no equivalent SOFR terms available? If so, consider the following options: (i) the administrative agent (and/or some other party) may remove all interest periods for which there is not a published term rate or (ii) the administrative agent (and/or some other party) 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:** The Agent should have the discretion to eliminate from the interest rate period options available to a borrower under a credit document any period for which no equivalent published SOFR term is available. The option to calculate a rate by interpolation raises concerns because of the potential for conflicts among Agent, borrower and lenders since this is a mathematical exercise and may be subject to different interpretations on how it is computed.

***Question 7.*** *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:** Yes, Compound SOFR should be included while SOFR remains an overnight rate and until there is a term component for the index (SOFR). A compounding feature is needed.

***Question 8.*** *If you believe that Compounded SOFR should be included, would a Compounded SOFR in advance* or *Compounded SOFR in arrears be preferable for syndicated loans? Please explain.*

**Answer:** Compounded SOFR in arrears would be preferable but with a look back similar to the conventions followed today for LIBOR where the rate is fixed before the end of the term and adjusted thereafter.

***Question 9.*** *Is Overnight SOFR an appropriate fallback reference rate for syndicated 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)? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR? Please explain.*

**Answer:** Compounded SOFR should be the final step in the waterfall. Since the loan market will often adopt what ISDA implements, this decision would be influenced by whether ISDA implements fallbacks referencing compounded or overnight SOFR.

***Question 10.*** *Is it acceptable to fix one observation of Overnight SOFR as the reference rate for a loan lasting three months (or longer)? Would lenders refuse to offer longer-duration loans if they were priced over one Overnight SOFR observation? Please explain.*

**Answer:** No, fixing one observation of overnight SOFR as the reference rate for a loan lasting three months or longer would not be accepted. Eventually the market would demand either a term rate or compounding.

***Question 11.*** *Is there any another 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?*

**Answer:** Not aware of another suitable replacement rate at this time.

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

**Answer:** The ARRC should consider recommending a spread adjustment for cash products such as syndicated business loans, but the recommendation should not be binding on market participants. The recommendation should include detail on the methodology for calculating the spread adjustment and a discussion of the relationship between the loan market and the market for derivatives.

***Question 13.*** *Is a spread adjustment applicable to fallbacks for derivatives under the ISDA definitions appropriate as the second priority in the spread waterfall even if syndicated business loans may fall back at a different time or to a different rate from derivatives? Please explain.*

**Answer:** Using the same spread at the time the rate is different would be a mismatch. A spread conversion is needed when moving from LIBOR to its replacement.

***Question 14.*** *Is there any another 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:** Unknown at this time.

***Question 15.*** *(a) Under the amendment approach proposal, if parties are selecting a replacement rate through the amendment process, should the objection of the Required Lenders be by class (if applicable) (see clause (b) of the section titled "Effect of Benchmark Discontinuance Event" in Appendix I)? Why or why not?*
*(b) Under the amendment approach proposal, if parties choose to select a replacement rate through the "opt-in" amendment process, should the affirmative consent of the Required Lenders be by class (if applicable) (see clause (b) of the section titled "Effect of Benchmark Discontinuance Event" in Appendix I)? Is affirmative consent appropriate or should negative consent be considered instead? Please explain.*

**Answer:** (a) Yes, ability of Required Lenders to object to a proposed amendment should be by class so that a comparatively smaller number of revolving lenders are not at risk of being forced into a replacement rate by the more numerous term lenders. (b) No, it should be negative consent.

***Question 16.*** *(a) Under the hardwired approach proposal, if parties must fallback to selecting a replacement rate through the amendment process because none of the options in the replacement rate waterfall are available, is the objection of the Required Lenders by a class appropriate (if applicable) (see clause (d) of the section titled "Effect of Benchmark Discontinuance Event" in Appendix II)? Why or why not?*

**Answer:** (a) Yes, See Question 15 above.

*(b) The hardwired approach proposal provides two bracketed options for a successful declaration of the "opt-in" amendment process - Required Lenders (typically a majority) vs. supermajority (2/3) of lenders (see clause (B) of the definition of "Benchmark Transition Determination" in Appendix II). What should be the standard affirmative lender voting threshold for consenting to the "opt-in"? Please explain.*

**Answer:** (b) Without prejudice to previously expressed concerns about the ability of Required Lenders to trigger an 'opt in,' if that trigger remains, the threshold should be a supermajority (2/3).

***Question 17.*** *For respondents that act as administrative agents in the syndicated 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 term SOFR if there is a missing middle maturity and, (v) execute one-time or periodic technical or operational amendments to allow the administrative agent to appropriately administer the replacement benchmark? Please respond to each and explain.*

**Answer:** (i) Yes, we would assume that in the broadly syndicated loan market the borrower would expect to have a say in the identification of a new reference rate and spread adjustment, and likely would require a consent right. (ii) Yes, we would be comfortable determining whether triggers have occurred. (iii) More information is needed on the number of screens and the market before we could respond to (iii) above. (iv) Interpolation gives rise to the potential for disputes if there is more than one way to calculate and therefore is not preferable. (v) Yes, we would be willing to propose and execute one-time and periodic technical and operational amendments, as needed to appropriately administer the replacement benchmark.

***Question 18.*** *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:** Yes, having the replacement rate and/or applicable spread adjust published on a screen by a third party is preferred because it minimizes conflicts among Agent, borrower and lenders on the correct rate and spread and any related litigation risk. Referencing a published rate eliminates ambiguity.

***Question 19.*** *Given that market practices and conventions may change over time, should the administrative agent'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:** The Agent should have the ability to make conforming changes on an ongoing basis, as needed. In the early stages of transitioning from LIBOR to its replacement, the Agent may not be able to foresee all of the impacts that the changeover has on the credit documentation, and therefore should retain the ability to make conforming changes in future as the need arises. .

***Question 20.*** *How important is it for the fallback rate to be available prior to making a borrowing/advancing funds? For instance, if the rate was a compounded three-month rate calculated at the* ***end*** *of the interest period, would that be problematic? Please explain.*

**Answer:** Calculation at the end of a period would be problematic for both internal and external reasons. We accrue interest daily to ledger and this data is used in many ways such as calculating profitability, business planning, etc. We also invoice the customer with payment due at the end of the interest period and we would not be able to generate an invoice on a timely basis if calculation occurs at the end of the period. In addition, the customer may react negatively to not knowing the rate at which the funds they borrow will accrue interest until after the end of the 30-60-90 day period.

***Question 21.*** *Are there operational concerns about having the ability to convert many loans over a very short period of time? Please explain.*

**Answer:** Yes, changing the rate index and spread on the LIBOR portfolio would be a manual effort in each of our servicing systems. Every loan is unique and would have different effective dates, change dates, and spreads that would need to be entered manually.

***Question 22.*** *Do you see other operational challenges that fallback language should acknowledge or of which the ARRC should be aware? Please explain.*

**Answer:** Rate options and rounding are utilized in the current LIBOR environment and the fallback language and the ability to make conforming changes to documents would need to address these types of options if they are going to exist going forward. Additionally, the new credit document language needs to be clear on business days. Currently, with LIBOR, we have issues when holidays are observed in one location and not another (e.g. US only holiday or London only holiday). The same concern applies to the definition of business day. Finally, the two sides of the balance sheet need to be considered. Agent has liabilities at LIBOR that it needs to manage, and the timing of the conversion to LIBOR's replacement will require a shift in the hedging of Agent's liabilities, which is why Agent needs a certain amount of discretion and control over the timing of conversion.

***Question 23.*** *What modifications to the syndicated loan consultative language may be helpful to market participants as they consider more robust fallback language in a bilateral or single-bank business loan context, if any? Please explain. Specifically, what modifications to the language may be appropriate in instances in which the bilateral loan is fully or partially hedged? Please explain.*

**Answer:** No comment at this time.

***Question 24.*** *Are there any provisions in the fallback language proposals that would significantly impede syndicated loan originations? If so, please provide a specific and detailed explanation.*

**Answer:** Borrowers may resist a Replacement Benchmark Spread that is determined by a Regulatory Body rather than being a published spread determined by market forces or a spread resulting from negotiation among/between Agent, borrower and lenders using agreed upon principles.

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

**Answer:** No additional feedback at this time.