Alternative Reference Rates Committee

Via email: arrc@ny.frb.org

26 November, 2018.

RE: Consultation regarding more robust LIBOR fallback contract language for new originations of LIBOR syndicated business loans.

Our firm welcomes the opportunity to respond to the Alternative Reference Rates Committee (ARRC) consultation in relation to U.S.dollar (USD) LIBOR fallback contract language for syndicated business loans. Our firm has set out the responses to the questions contained in the consultation paper released on 24 September 2018 below.

Our firm requests that its response please be posted anonymously.

Question 1: If the ARRC were to adopt one or more sets of business loan fall-back 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?

Currently, our preference is to adopt an amendment approach given the number of variables that are presently unknown.

Specific information that would allow us to be more comfortable adopting a hard-wired approach would include:

1. Clarity on the triggers being adopted for the FRN market (and derivatives to a less extent)
2. Existence of a term SOFR
3. Definition of the mechanism on the spread adjustment for each currency

Item 1 is required to assist with managing the risk of the funding and asset markets adopting SOFR at different times.

Items 2 and 3 would need to be endorsed by the Relevant Governmental Body or accepted as market convention (preferably both). This would be required for all currencies, or at the very least all major currencies, as loans may have limits denominated in one currency but be able to be drawn down in multiple currencies. It would be problematic if there were differently levels of certainty across currencies.

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

All triggers should be included.

Question 2(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.

The concern on the pre-cessation triggers centres on the risk that the triggers will be different across the FRN market (primary concern) and derivative market (secondary concern) creating basis risk between loans and the underlying markets that fund / hedge them.

Question 2(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?

Bilateral / Syndicate level negotiations would have to take place on a loan by loan basis, which would be problematic given volume as well as potential for lack of consistency (in both timing and outcomes).

A market wide approach led by an industry association would be more practical approach but this may not result in 100% consistency given it would be driven by convention rather than regulation.

Question 3(a): Is an "opt-in" trigger appropriate to include? Why or why not?

An opt-in trigger would not be appropriate as this would give rise to potential timing differences on transition. This is especially the case if there were no opt-in triggers in the FRN and derivative markets. If there were opt-in triggers in the FRN market then our firm would consider adoption of an opt-in trigger but would need to carefully consider if this would be of net benefit in managing timing differences.

Question 3(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.

N / A.

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

No.

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

The fall-back rate should be aligned to the fall-back rate in the FRN market.

Assuming FRN markets also adopt this, forward looking Term SOFR should be the primary fall-back as this gives certainty for the 3 month period. A potential consequence of the above is that either:

1. A market mechanism will be developed to allow participants to swap overnight vs Term SOFR
2. Clients looking to borrow at fixed interest rates will seek a fixed rate loan from the banks rather than taking a floating rate loan with a matching floating to fixed rate swap.

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?

Option (ii) would be the preference given it allows the greatest scope for replication of the existing borrower flexibility with regard to interest rate term periods.

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 fall-backs referencing compounded SOFR or overnight SOFR?

The fall-back rate should be aligned to the fall-back rate in the FRN market.

Assuming FRN markets adopt this as second step, the syndicated business loan market should also adopt this as second step. Whether ISDA implements fall-backs referencing compounded SOFR or overnight SOFR will be a consideration but this will be secondary to fall-backs adopted by FRN markets.

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.

Alignment with the FRN market would be the primary consideration and our firm would seek to align to the FRN Market to minimise basis risk. FRN markets appear to be adopting SOFR in arrears and our firm will seek to follow suit if that eventuates as FRN market convention / consensus.

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.

Alignment with FRN market would be the primary consideration and our firm would seek to align to the FRN Market to minimise basis risk.

Whether ISDA implements fall-backs referencing compounded SOFR or overnight SOFR will be a consideration but this will be secondary to fall-backs adopted by FRN markets. Alignment with FRN will take priority with alignment to derivative markets.

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.

It would not be preferable but would be acceptable if that was the only option and it was adopted by the FRN markets as well. If FRN markets were to adopt a different approach our firm would seek to align to that approach in the loan market.

If client demand exists for a longer dated loan that was priced over one Overnight SOFR then our firm would seek to meet that demand subject to the bank being comfortable with the risks involved (risk appetite, prima facie risk exposure, ability to manage and mitigate the prima facie risk).

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?

To ensure alignment with FRN market and minimise basis risk, consideration should be given to incorporating Step 4 (Replacement rate recommended by Relevant Governmental Body + Spread) and Step 5 (replacement rate in ISDA Definitions + Spread) from the FRN waterfall into loan syndication waterfall.

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

Yes. The spread adjustment is a function of average bank credit risk. In the absence of a mandated/recommended spread adjustment on transition there is potential for disputes as clients seek to adopt a spread adjustment that benefits them the most e.g. a client borrowing from a well-rated bank(s) may seek a lower spread adjustment as theoretically that bank's spread should be lower than average.

Question 13: Is a spread adjustment applicable to fall-backs 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.

Yes, on the assumption that FRN markets adopt this as second priority as well (currently Step 2 in the spread waterfalls for FRN and loan syndications are both ISDA definitions).

Notwithstanding the timing differences, adopting the same spread adjustment would align loan markets and derivatives going forward eliminating one potential source of basis risk / value transfer on an ongoing basis. The basis risk from potential differing reference rates is a separate matter and neither worsened nor mitigated by this decision.

It should be noted that for FRNs, it is footnoted that the ISDA spread only applies where the Unadjusted Replacement Benchmark is equivalent to the ISDA Fallback rate. There is no such modifier in the syndicated loans spread waterfall (although it could be interpreted as implicit). It would be preferable to explicitly adopt the same modifier in the syndicated loans language to eliminate a potential source of basis risk.

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?

No.

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?

Currently loan classes use the same reference rate with differentiation across classes achieved by variances in spread / security / seniority. Selection of the reference rate will affect all lender classes equally. Upon transition, there is no logical reason why there should be different replacement reference rates across classes. Hence, having objection by class appears superfluous.

Question 15(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.

Selection of the reference rate will affect all lender classes equally and hence negative consent should be sufficient and preferable from an operational efficiency perspective.

Question 16(a): Under the hardwired approach proposal, if parties must fall-back 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?

Currently loan classes use the same reference rate with differentiation across classes achieved by variances in spread / security / seniority. Selection of the reference rate will affect all lender classes equally. Upon transition, there is no logical reason why there should be different replacement reference rates across classes. Hence, having objection by class appears superfluous.

Question 16(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.

Supermajority should be the threshold. An opt-in means potential adoption of a new reference rate before it becomes mandatory (i.e. potentially moving ahead of market whether that be loan or FRN markets). A higher threshold is required given there may be other considerations that syndicate members need to manage (e.g. timing of their underlying funding to new reference rates, timing of their internal transfer pricing regimes to new reference rates).

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.

Our firm would be comfortable with (i), (ii), (iii) and (iv). It is unclear what may fall under (v), however our firm would not be comfortable with undertaking any activity that results in too much operational risk.

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?

It would be necessary from a transparency and consistency perspective. While the risk would be very low, if these rates were not published, there is a potential for dispute as to the correct rate to apply.

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?

The ability of the agent to make conforming changes should be on an ongoing basis. Given the uncertainty of whether a Term SOFR market will exist at transition or whether one may develop post transition, a certain amount of flexibility would be prudent. Given the high level of uncertainty, the language around this should be fairly open and the threshold should be a supermajority.

Question 20: How important is it for the fall-back 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.

The existing loan market provides certainty of interest rates in advance. The issue of not knowing rates until the end would be more a potential issue for borrowers rather than lenders. It is not possible for us to respond for all borrowers but in our view it would be reasonably important to borrowers (and their treasury departments) as that 3 month window of certainty provides them with a buffer period in which to manage spot interest rate volatility before it hits. A compounded 3 month rate calculated at the end would be problematic for lenders if FRN markets were using rates calculated on a different basis.

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

The multitude of variables that need to be managed means that the inherent operational risk is very high.

Examples of variables that need to be considered include (but are not limited to):

- Timing of definition of “standard” market fall back language and resultant amount of time remaining to amend agreements
- Amendments potentially being required to be in place at least 6 months before 1 January 2022 (e.g. what happens to a LIBOR 6 month drawdown made on a 15th July 2021)
- Complexity of facilities allowing draw-down in multiple currencies (especially non-major currencies)
- Bottlenecks caused by shortages in key operational and legal resources (everyone in the market will be seeking the same key resources at the same time)
- Delays caused by potential client disputes
- Delays caused by inability of syndicate members to reach agreement

Question 22: Do you see other operational challenges that fall-back language should acknowledge or of which the ARRC should be aware? Please explain.

As above.

The key operational consideration is that there are many unknowns and variables which means that, by default, any fall-back language written now has to be generic to cater for those unknowns. As the transition date approaches and key decisions are made, there will be greater certainty allowing for more precise (and better) fall-back language but less time operationally to implement that language.

Question 23: What modifications to the syndicated loan consultative language may be helpful to market participants as they consider more robust fall-back 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.

Bilateral loan language should align to syndicated loan market language. If there are different triggers, reference rates or credit spread adjustments across the syndicated loan and derivative markets and there is a bilateral loan that is fully or partially hedged, it is an open question as to whether the borrower or the lender bears that basis risk. Our default position as a lender would be that the borrower bears that risk. Our firm expects as a bank (and across the market) that there will be considerable negotiation and potential for differing outcomes (and hence value transfer) depending on the relative bargaining power of each party.

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

No.

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

A transition from LIBOR to an alternative reference rate will happen but there are many variables and uncertainty. The “market” will work things out but, at current levels of uncertainty, the risk of market disruption as we transition is not low and it may differ across the loan, FRN and derivatives markets (and may actually be a result of differences across these markets).

The opportunity to manage the risk of market disruption lies in:

1. Maximising alignment across all 3 markets wherever possible (with alignment of loan syndication to FRN a priority from our perspective); and
2. Providing as much certainty on as many key variables as possible.

With regard to 1, our firm strongly recommends that ARRC and ISDA work together to harmonise the proposals across the loan syndication, FRN and derivative markets. Consideration and development of proposals individually across what are essentially interconnected markets runs the risk of unintended consequences which a more holistic approach might help to mitigate.

With regard to 2, our firm recommends that the relevant government authorities give consideration to mandating a transition date/event (certainty of trigger event) or a spread adjustment calculation mechanism or methodology at transition that could be incorporated into fall-back language across all 3 markets.

A point of note on these proposals is that whilst they will be appropriate for the vast majority of situations, there may be complications in implementation in niche markets and stressed loans where co-operation and dialogue will be harder to manage.