

September 23, 2019

Via Electronic Mail

The Honorable Randal K. Quarles
Vice Chairman of Supervision
Board of Governors of the Federal Reserve
System
20th Street and Constitution Avenue, NW
Washington DC, 20551

The Honorable Joseph Otting
Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, D.C. 20219

The Honorable Jelena McWilliams
Chair
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20552

Dear Vice Chairman Quarles, Comptroller Otting, and Chair McWilliams:

We are regional banking organizations that primarily focus on providing traditional retail and commercial banking products and services. Our institutions are significant providers of loans to Main Street and the real economy. Our traditional retail and commercial bank business models focus on the banking and financial services needs of American consumers, small and mid-size businesses, and state and municipal governments.

We wholeheartedly support the efforts of the official sector and the Alternative Reference Rates Committee to facilitate an orderly transition away from the London Interbank Offered Rate (LIBOR) to the Secured Overnight Financing Rate (SOFR). We believe SOFR can and should be the liquid reference rate for the significant majority of derivatives and debt products that currently reference LIBOR.

However, we believe that SOFR, on a stand-alone basis, is not well suited to be a benchmark for lending products and have concerns that this transition will adversely affect credit availability. LIBOR reflects unsecured inter-bank borrowing rates and accordingly contains a credit risk premium. During periods of economic stress, credit spreads on bank debt and other wholesale bank borrowings tend to increase, raising banks' cost of funds. Historically, during these periods, the spreads between LIBOR and other risk-free short-term borrowing rates widened reflecting a higher credit risk premium demanded by debt investors. Because bank loans are benchmarked to LIBOR, bank lending and borrowing rates moved in concert with each other.

SOFR is a credit risk-free benchmark reflecting rates on overnight borrowings secured by U.S. Treasury securities. During times of economic stress, SOFR (unlike LIBOR) will likely decrease disproportionately relative to other market rates as investors seek the safe haven of U.S. Treasury securities. In that event, the return on banks' SOFR-linked loans would decline, while banks' unhedged cost of funds would increase, thus creating a significant mismatch between bank assets

(loans) and liabilities (borrowings). Moreover, banks' SOFR-linked lending commitments to their commercial customers will likely exacerbate this mismatch. Specifically, borrowers may find the availability of low cost credit in the form of SOFR-linked credit lines committed prior to the market stress very attractive and borrowers may draw-down those lines to "hoard" liquidity.

The natural consequence of these forces will either be a reduction in the willingness of lenders to provide credit in a SOFR-only environment, particularly during periods of economic stress, and/or an increase in credit pricing through the cycle. In a SOFR-only environment, lenders may reduce lending even in a stable economic environment, because of the inherent uncertainty regarding how to appropriately price lines of credit committed in stable times that might be drawn during times of economic stress. Moreover, in economically stressed times, these forces could increase pro-cyclicality, put pressure on lenders' liquidity, and generally exacerbate stress in the economy.

We believe a sensible and practical way to address these risks is to create a SOFR-based lending framework that includes a credit risk premium.¹ That framework could consist of a dynamic spread that reflects changes in banks' cost of funds over forward-looking term periods and is added on a periodic basis to SOFR-based rates. With more closely aligned borrowing and lending rates, banks will be more willing and able to extend credit during both good times and bad. Including credit sensitivity as part of the framework is the most straight forward approach to achieve this alignment, as it enjoys the benefits of using SOFR as a robust underlying rate and does not require complex hedging strategies which are ill-suited for smaller Main Street lenders and community banks with less complex balance sheets.

We believe this lending benchmark framework is practical and achievable. The vast majority of borrowers are already familiar with this approach to rates in the lending markets as many loans currently are tied to credit sensitive benchmarks like LIBOR, the prime rate, and COFI (cost of funds index). We also note that in addition to those rates, multiple other rates (e.g., CMT (constant maturity treasury rate) and MTA (monthly treasury average)) are used in lending markets, and that rate types in lending markets are diverse. Accordingly, participants in those markets do not have an expectation that interest rate frameworks will be monolithic (e.g., participants do not expect a SOFR-only environment).² In addition, availability of a credit sensitive rate element would facilitate and likely accelerate the orderly transition from LIBOR given broad market acceptance of credit sensitive rates.

We want to make you aware of our support for SOFR and our desire to explore inclusion of a credit sensitive rate element in the lending markets as a supplement to SOFR. We seek your support in creating a private market participant industry working group, which would include the active participation of the Federal Reserve and other official sector participants, to determine

¹ Duffie/Stein discuss importance of credit sensitive benchmark:

Duffie, Darrell and Stein, Jeremy C. (2015), "Reforming LIBOR and Other Financial Market Benchmarks", *Journal of Economic Perspectives*, Volume 29, Number 2, Spring 2015, pp. 191-212. <https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.29.2.191>

² Conclusion that monolithic credit-risk free rate structures fail to address all market needs and further noting possibility that credit-sensitive rates will co-exist with credit-risk free rates in a post-LIBOR world:

Schrimpf, Andreas and Sushko, Vladyslav (2019), "Beyond LIBOR: a primer on the new reference rates", *BIS Quarterly Review*, March 2019, pp 29-52. https://www.bis.org/publ/qtrpdf/r_qt1903e.pdf

how best to do this. We believe inclusion of a credit risk premium is essential to addressing the concerns outlined above and will make the banking system and, in turn, the U.S. economy more resilient during times of economic stress and facilitate the transition of lending markets from LIBOR.

Sincerely,

R. Christopher Marshall
Executive Vice President and Treasurer
BBVA USA Bancshares, Inc.
Phone: 205-297-3169
chris.marshall@bbva.com

Thomas A. Feil
Senior Vice President, Treasurer
Capital One Financial Corporation
Phone: 703-720-3169
tom.feil@capitalone.com

David C. Lindenauer
Treasurer, Executive Vice President
Citizens Bank
Phone: 617-994-7269
david.c.lindenauer@citizensbank.com

James J. Herzog
Executive Vice President and Treasurer
Comerica Incorporated
Phone: 214-462-6793
jjherzog@comerica.com

James C. Leonard
Executive Vice President, Treasurer
Fifth Third Bancorp
Phone: 513-534-0715
james.leonard@53.com

Scott Warman
Executive Vice President and Corporate Treasurer
M&T Bank Corporation
Phone: 716-842-5813
swarman@mtb.com

John C. Trohan
Managing Director, Treasurer
MUFG Americas Holdings Corporation
Phone: 415-765-4233
john.trohan@unionbank.com

Randall C. King
Executive Vice President, Treasurer
The PNC Financial Services Group, Inc.
Phone: 412-762-2594
randall.king@pnc.com

M. Deron Smithy
Executive Vice President, Treasurer
Regions Financial Corporation
Phone: 205-326-7832
deron.smithy@regions.com

Matthew Tyler
Corporate Treasurer
Zions Bancorporation, National Association
Phone: 801-844-7832
matthew.tyler@zionsbank.com

**Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency**

January 23, 2020

**R. Christopher Marshall
Executive Vice President and Treasurer
BBVA USA Bancshares, Inc.**

**Thomas A. Feil
Senior Vice President, Treasurer
Capital One Financial Corporation**

**David C. Lindenauer
Treasurer, Executive Vice President
Citizens Bank**

**James J. Herzog
Executive Vice President and Treasurer
Comerica Incorporated**

**James C. Leonard
Executive Vice President, Treasurer
Fifth Third Bancorp**

**Scott Warman
Executive Vice President and Corporate Treasurer
M&T Bank Corporation**

**John C. Trohan
Managing Director, Treasurer
MUFG Americas Holdings Corporation**

**Randall C. King
Executive Vice President, Treasurer
The PNC Financial Services Group, Inc.**

**M. Deron Smithy
Executive Vice President, Treasurer
Regions Financial Corporation**

**Matthew Tyler
Corporate Treasurer
Zions Bancorporation, National Association**

Dear Messrs. Marshall, Lindenauer, Leonard, Trohan, Smithy, Feil, Herzog, Warman, King, and Tyler:

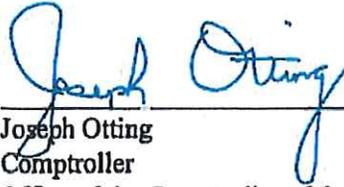
Thank you for your letter dated as of September 23, 2019, supporting the efforts of the official sector and the Alternative Reference Rates Committee to facilitate an orderly transition away from the London Interbank Offered Rate to the Secured Overnight Financing Rate (SOFR). Your letter suggests exploring the inclusion of a credit sensitive rate element in the lending markets as a supplement to SOFR. Attached is an appendix that establishes a plan for exploring such a supplement to SOFR.

Staff from our agencies will be in touch soon to discuss next steps.

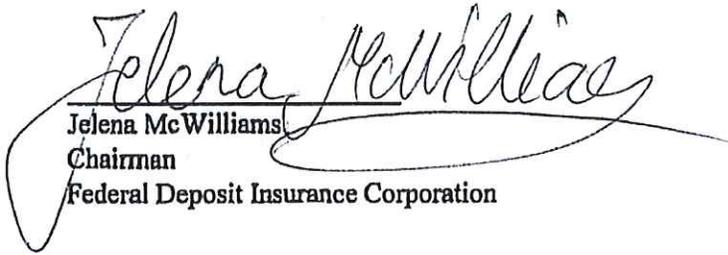
Sincerely,



Randal K. Quarles
Vice Chair for Supervision
Board of Governors of the
Federal Reserve System



Joseph Otting
Comptroller
Office of the Comptroller of the Currency



Jelena McWilliams
Chairman
Federal Deposit Insurance Corporation

Appendix: Plan for LIBOR Transition Credit Sensitivity Group

- 1. A Credit Sensitivity Group (CSG) would be convened to respond to the concerns of many US banks that SOFR – while appropriate for derivatives and securities products – may not be a sufficient reference rate for loan products.**
 - The CSG's work would proceed in two phases. In phase one the official sector would convene the CSG to conduct a series of working sessions among banks of all sizes and borrowers of different types, with the goal of understanding the lending needs of these banks and their borrowers and how a robust credit sensitive rate/spread for loans could be developed to address them.
 - These meetings would include discussions with individual institutions as well as broader working sessions and public forums.
 - The intent will be for the CSG to focus on the issues surrounding a credit sensitive rate/spread that could be added to SOFR, but not to become an "alternative ARRC."
 - The outcome of these discussions would be public, with publically available minutes and possibly a white paper issued at an appropriate point.
 - The secretariat of the CSG would be from the NY Fed to emphasize continuity with the existing transition process, but it would be separate from the existing ARRC.
 - As with the ARRC, relevant agencies such as the Treasury, OCC, and FDIC would have ex officio roles in the CSG process.
 - In Phase two, the CSG would work to recommend a specific credit sensitive rate/spread and determine how to address implementation issues. At this stage, the CSG would likely adopt a formal membership and governance structure as it moves to execution of a concrete plan.
- 2. Simultaneously, the official sector would engage the regional banks and their customers in the work of the ARRC through membership and joint ARRC / official sector outreach to the regional and community banks.**