Date: September 16, 2019

ARRC Consultation
Regarding More Robust LIBOR Fallback Contract Language for
New Closed-end, Residential Adjustable Rate Mortgages

Triggers

1. Should fallback language for ARMs include either of the pre-cessation triggers (triggers 4(G)(ii) and 4(G)(iii))? If so, which ones?

   We generally support the use of pre-cessation triggers in the fallback language for ARMs, and do not have strong objections to the triggers in 4(G)(ii) and 4(G)(iii), but note that there is some ambiguity with the proposed language. The language in 4(G)(ii) is too broad when combined with the general statement in 4(G) that the "Index is deemed to be no longer available and will be replaced."

   Specifically, it is unclear what constitutes a public statement, the Administrator should be a defined term, and the ability for an administrator or its regulator to each issue an undefined public statement that automatically triggers a Replacement Event creates the possibility of conflict. Additionally, the administrator and its regulator are presently foreign entities, which may complicate these possibilities.

   The trigger event in 4(G)(iii) seems appropriate.

2. 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.

   We are not aware of any significant derivatives exposures which are predicated upon the LIBOR-indexed reset period for mortgage hybrid ARMs. Our concerns relate to the pre-cessation triggers themselves.

3. 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?

   We favor thoughtful, discrete pre-cessation language which provides Lenders with the sufficient discretion to implement a transition in a transparent manner across the industry. Absent such language, we are not aware of a means to avoid continuing to use LIBOR if it continues to be published but simply deemed to be not representative.

   We would note that for both Borrower and Lender, given there are rate caps and floors within most Hybrid ARMs, the degree of variance for LIBOR as compared to a more robust, "representative" benchmark is to some degree limited. Admittedly, the variance that is possible would likely be considered material based on current terms.

4. The ARM language proposed uses simplified language in an effort to be more comprehensible for the consumer market. Is the simplified language appropriate or are there concerns with the language not matching ISDA or other cash product language precisely?

   We have no concerns with a lack of consistency with the terms provided by ISDA or that used for other cash products. The mortgage Hybrid ARM product is unique in that it is a consumer product and relies upon 12-month LIBOR. As such, we expect that any transition will need to be managed in a different manner than that for derivatives or other commercial products.

<u>ARRC Replacement Index</u>

5. Is the replacement index determined by the Federal Reserve Board, the Federal Reserve Bank of New York, or a committee endorsed or convened by the Federal Reserve Board or the Federal Reserve Bank of New York the best choice as the first step of the waterfall? Why or why not?

   Yes. We view any transition for Hybrid ARM products as requiring a greater degree of transparency, simplicity, and support from regulators and federal agencies. We believe the bodies listed above would support achieving those objectives and the language would provide a sufficient level of discretion to find a solution which will find the most 'value-neutral' proposition for all parties. We also recommend that the Federal Reserve Board, the Federal Reserve Bank of New York, or a committee endorsed or convened by those entities issue a white paper to support their process for selecting the replacement index (and any adjustments) as the appropriate replacement in order to inform consumers about the replacement index and to limit the risk of challenges, complaints, and litigation when a Replacement Event occurs.

   We would note that the language used in 'Step 1' of this consultation could be interpreted as somewhat vague given that the ARRC has already broadly "selected or recommended" an alternative index (i.e., SOFR). Although this language is only being proposed for hybrid ARM agreements, it may be worthwhile to specifically note that the recommendation of a "Replacement index" in this instance may be specific for Hybrid ARMs to avoid any confusion relative to other ARRC recommended benchmark rates or uses of SOFR.

6. As noted in the narrative, the ARRC has committed to recommending spread adjustments for cash products that reflect the general difference between various tenors of LIBOR and SOFR. In addition, the ARRC has committed to seeing all-in, "spread-adjusted" rates published for use in cash products (e.g., a SOFR-based spread-adjusted replacement index for 1-year LIBOR). Should the ARRC recommend a spread adjustment for LIBOR ARMs and other consumer products, and should the corresponding spread-adjusted rate be the replacement index for the LIBOR ARMs?

   The Federal Reserve, or an ARRC-approved administrator, publishing "spread-adjusted" rates for use in cash products will increase transparency and likely reduce litigation risk throughout the industry. As such, it is highly preferable that a corresponding spread-adjusted rate be published per Step 1 of the ARM Replacement Index Waterfall.

   With that said, we are reluctant to presume that the current instance of SOFR (i.e., non-term rate) is necessarily the ideal alternative for hybrid ARMs as is somewhat implied within this question. To the extent a non-term SOFR is recommended, it is likely that a greater degree of spread adjustment will be required which, even still, may prove less effective in a reaching a value neutral result as compared to if a term rate had been used. Given its unique reliance on 1-year LIBOR and for a host of other consumer considerations, we recommend that the pros and cons of using term benchmark rates (SOFR or otherwise) be carefully considered in order to fully assess whether the benefits of aligning on term possibly outweigh any potential lack of depth for that benchmark relative to SOFR.

Additionally, we would be mindful of potential confusion to the extent there are differences in published "spread-adjusted" rates for the 1-year LIBOR index relative to what may be published as the alternative for ARMs. Presumably, the spread-adjusted rates for those two should align.

7. As noted in the narrative, in addition to recommending SOFR, the ARRC may recommend forward-looking term SOFR rates if it is satisfied that a robust, IOSCO-compliant term rate that meets its criteria can be produced. If the ARRC recommends forward-looking term rates (e.g., 1-month, 3-month, 6-month, etc.) and a corresponding spread adjustment, should a spread-adjusted term rate be the replacement index for LIBOR ARMs, or would a spread-adjusted average (simple or compounded) of SOFR be more appropriate? Please provide support for your answer.

   Ideally, in order to minimize potential value transfer and to facilitate a risk-neutral transition, the replacement index for ARMs would be based upon a comparable term (i.e., 1-year). To the degree that those terms don't align, this will create a more disparate interest rate risk profile and thus increasingly result in the transfer of value and risk. As such, we strongly prefer that some form of term rate be used to facilitate a LIBOR transition for ARM products.

   The use of term rates will not only support a more neutral transfer of risk but should also avoid some of the operational issues that may result from using an overnight index (i.e., in arrears calculations or payments, whether compounded or averaged).

   To the extent an identical term rate cannot be established, it is preferable to use the closest term available in order to minimize the potential for differences in interest rate risk as a result of the transition. However, it should be noted that this still leaves a discrepancy in the reset frequency which, based on existing contracts, is not a term that can be amended in association with a transition and would result in at least some degree of additional value transfer. To the extent it appears the use of a comparable term rate is unlikely, it may be prudent to consider language within the recommended fallback provision which allows for the adjustment of the reset frequency (i.e., to match the index term). This should support reaching a more value neutral result though it may present additional operational and compliance (i.e., disclosure) related issues for servicers and lenders.

<u>Note Holder Determined Replacement Index and Margin</u>

8. Should the Note Holder have the responsibility as the 2nd and last step of the waterfall? Why or why not?

   This is the most logical progression in the waterfall and it should allow for a sufficient level of discretion to manage a transition in the unforeseen circumstance that it occurs without the

Federal Reserve or affiliated bodies having provided sufficient direction.

9. Should the Note Holder have the ability to make adjustments (positive or negative) to the loan's margin to more closely approximate LIBOR at the time of replacement? Why or why not? If you do not believe the Note Holder should make adjustments to the loan's margin, and potential replacement indices diverge from the value of the current Index, what provision or step should be taken to preserve that consistency?

   We believe the note holder should have this discretion specifically within the context of a benchmark rate transition. It is worth noting that if the fallback language provides the discretion to add a spread to an alternative benchmark index, then that may eliminate the need for discretion to adjust the loan's margin and have added benefits in implementation (i.e., operational, compliance disclosures, etc.).

10. If the Note Holder is a trust (for example, as may occur in private label MBS), is there some entity other than the Note Holder that should be responsible for identifying the Replacement Index if Step 1 of the waterfall fails? Please provide sufficient rationale for your answer.

    No comment.

<u>Other Questions</u>

11. Will this language have unintended consequences not considered by the ARRC working group, such as title insurance restrictions, state law endorsement or filing restrictions, etc.? If so, please explain and provide information about why this language would present challenges. If there are concerns with this proposed language, please be sure to specify if concerns relate to this proposed language, or index replacement language in general.

    No comment.

<u>General Feedback</u>

12. Is there any provision in the proposal that would significantly impede ARM originations? If so, please provide a specific and detailed explanation.

    This should not have any incremental impact on ARM originations beyond that which exists today.

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

    While perhaps unlikely, we believe it prudent to provide additional language within the Replacement Index waterfall to contemplate a scenario where the Lender implements a Replacement upon the occurrence of an Event (Step 2 of waterfall) but the FRB subsequently provides guidance on an alternative index (i.e., fulfills Step 1). In this instance, the recommended language is not clear whether the Note Holder would need to then change the index to the one selected by the FRB.

Additionally, we believe it very important to emphasize the distinction between the concept of a "spread adjustment" and an adjustment to a loan "margin". Our strong preference is for any necessary adjustment to support a value neutral transition to be implemented via an additional spread which is applied to the alternative reference index and becomes part of the published Replacement Index (i.e., SOFR + Spread). Incorporating any such adjustment within the FRB (or ARRC) published rate will give it added credibility and will reduce the potential operational risk associated with adjusting a new index as well as implementing a change to the loan margin. With that said, as noted in the response to Question 9, we believe adding a clause within the recommended fallback language which allows for an adjustment to the loan margin may be prudent in the event it is necessary to support the industry transition.