September 24, 2019

Response to ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for Closed-End, Residential Adjustable Rate Mortgages, issued July 12 2019

Question 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?

Answer:
Yes, we support the inclusion of both of the proposed pre-cessation triggers. In the event that LIBOR were deemed non-representative, or if it were illegal to use, we believe it would be impractical to continue to reference LIBOR in an ARM.

Relatedly, we believe that regulators and industry groups should seek to avoid a scenario where LIBOR has been officially determined to be non-representative or unreliable, prior to cessation. An announcement of such a determination may be confusing to market participants, and may lead to greater market uncertainty. We encourage the ARRC to work with ISDA, as well as FCA and the other relevant regulators and industry groups, to reduce the likelihood of such a scenario. While we do support pre-cessation triggers for this product, we believe that whether they are included or not, the industry should seek to avoid a scenario where they would be relevant.

Question 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.

Answer:
As indicated, we support the inclusion of pre-cessation triggers, for the reasons given in our answer to Question 1. However we believe there will be challenges associated with implementing them if a pre-cessation event occurs. Specific challenges include (i) inconsistency between products that have pre-cessation triggers and those that do not (e.g. perhaps derivatives), (ii) operational challenges in tracking which transactions have these triggers and which do not, and (iii) additional complexity due to having another, interim, phase in the LIBOR transition.

Question 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?

Answer:
We believe that if pre-cessation triggers are not included, it will be important that regulators do not forbid entering into new transactions referencing LIBOR upon a regulatory determination that LIBOR is non-representative or unreliable. The reason is that if market participants have exposures to products that continue to reference a Benchmark that has been deemed not representative of the underlying market, these market participants will need to be able to continue to hedge this risk by entering into new trades that reference the Benchmark.

Question 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?

Answer:
With simplified language it is not clear to us how a temporary cessation of the Benchmark would be treated by the ARM fallback language, and we believe it is possible that the behavior would differ from that of other products. We would support more clearly indicating that the fallback language provided is meant to cover permanent cessations but not temporary cessations.

Question 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?

Answer:
Yes, this is appropriate. We believe it is important that the first item in the waterfall be a market standard replacement index; the Fed, the FRBNY, or a committee endorsed by one of those bodies should be capable of identifying that market standard.

Question 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?

Answer:
Yes. In our view, the simplest and best outcome is that the ARRC recommend an all-in, "spread-adjusted" replacement index, such that the Note Holder may use that index directly, with no further adjustments. This approach minimizes the amount of manual work that the Note Holder needs to do, and hence minimizes the risk of errors or disputes.

Question 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.

Answer:
Yes, we support the use of the forward-looking term rates and corresponding spread adjustments, in the event that those are recommended by the ARRC. We support this because it would result in a product that more closely resembles the contract that was originally entered into (i.e. where

the applicable interest rate is known at the beginning of the calculation period), and because it would be consistent with the waterfall in the fallbacks recommended for securitizations.

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

Answer:
We support the inclusion of this step in the waterfall, but in order to reduce the likelihood that it is reached, we recommend that an interim step in the waterfall should be inserted prior to this step – specifically we would recommend that the ISDA Fallback Rate + Adjustment be used as the 2nd step in the waterfall, prior to Note Holder determination. It is desirable to reduce the probability that Note Holder determination is required because in some cases (especially when the ARM is in a securitization) it may be difficult for the Note Holder to make the determination. However, in a scenario where all other items in the waterfall have been exhausted, we believe that the Note Holder determination is a sensible final step in the waterfall.

Question 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?

Answer:
Yes, the Note Holder will need to have the ability to make adjustments to the loan's margin. The ability to make such adjustments is necessary in order to avoid undesirable value transfer upon LIBOR cessation, due to material differences between LIBOR and the Replacement Index. However, we do not support the provision that the Note Holder shall, in the first instance, choose a Replacement Index and a Replacement Margin which the Note Holder "reasonably expects will minimize any change in the cost of the loan". The reason is that "cost" is not precisely defined in the document, and furthermore this provision would require the Note Holder to perform potentially complex calculations. We would instead support language which required the Note Holder to select a Replacement Index and a Replacement Margin which aligns with industry-accepted standards as closely as possible.

Question 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.

Answer:
No, we think the Note Holder should make this determination. In the case of a securitization, the Note Holder determination will be the responsibility of the Trustee, who is expected to rely on the servicer to act on its behalf. Nonetheless, we believe the Note Holder should be the party that has the legal right to identify the Replacement Index in the legal contracts.

Question 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.

Answer:
We do not have any specific feedback on this point.

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

Answer:
We do not see any such provision.

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

Answer:
See the note we have included in our answer to Question 1 where we encourage cooperation between industry groups and regulators to seek to avoid a scenario where pre-cessation triggers would be relevant.