Memorandum

To: arrc@ny.frb.org Date: 02/05/19
From: Wholesale Business Controls, Commercial Legal, Commercial Operations
Subject: ARRC Consultation Regarding More Robust Libor Fallback Contract Language for New Originations of Libor Bilateral Business Loans

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We respectfully request 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 bilateral 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.

Question 2. *Beyond your response to Question 1, are there product or transaction types, or methods of documenting transactions, for which either of the fallback approaches would be problematic? If so, please explain. What other approach would you suggest?*

Answer: The fallback is not problematic to the extent that the process is well known and transparent.

Question 3. *(a) Should fallback language for bilateral 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 Lender, which is desirable because of the uncertainty around how LIBOR will 'wind down' over the next few years. However, the Lender 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, a Lender 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 4. *(a) Is an "opt-in" trigger appropriate to include? Why or why not?*
(b) Do you believe an "opt-in" trigger should be included in both the hardwired and amendment proposals or only in one (please specify which and explain)?

Answer: The Lender should have the ability, in its discretion, to trigger an 'opt in' to a market replacement index. However, any 'opt in' language that can be triggered by a borrower may create issues and potential liability for a Lender 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.

Question 5. *Are there any other trigger events that you believe should be included for consideration? If yes, please explain.*

Answer: None at this time.

Question 6. *If the ARRC has recommended a forward-looking term rate, should that rate be the primary fallback for bilateral business loans referencing LIBOR even though derivatives are expected to reference overnight versions of SOFR? Please explain.*

Answer: We prefer a term rate but only with market consensus in a rate that has been established with a liquid term structure.

Question 7. *Should the Lender be able to eliminate certain interest period options if there are no equivalent SOFR terms available? If so, consider the following options: (i) the Lender may remove all interest periods for which there is not a published term rate or (ii) the Lender 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 Lender 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 between Lender and borrower since this is a mathematical exercise and may be subject to different interpretations on how it is computed.

Question 8. *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 9. *If you believe that Compounded SOFR should be included, which compounding period is preferable ("in arrears" or "in advance")? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR "in arrears" or "in advance"?*

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 10. *As noted, this consultation does not include Overnight SOFR as a final step in the waterfall. Do you believe that Overnight SOFR is an appropriate fallback reference rate for bilateral business 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)?*

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 referenced compounded or overnight SOFR.

Question 11. *Is there any other 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? Please explain.*

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 bilateral business loans?*

Answer: The ARRC should consider recommending a spread adjustment for cash products such as bilateral 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 hardwired approach spread waterfall even if bilateral business loans may fall back at a different time or to a different rate from derivatives? Please explain.*
Other Spread Adjustments

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 other 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. *For respondents that act as Lenders in the bilateral 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 LIBOR or term SOFR if there is a missing middle maturity, and (v) execute one-time or periodic technical or operational amendments to appropriately administer the replacement benchmark? Please respond to each and explain.*

Answer: (i) Yes, we would assume that in the upper end of the bilateral business 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 negative 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 16. *In any of these situations, should the Lender have the right to take the relevant action, for example to designate loan terms unilaterally within the framework of either Appendix I or Appendix II, simply by notice to the Borrower? Alternatively, should the lender have the right to take such action, subject only to the Borrower's right to withhold consent? Please explain which approach, or what alternative approach, you think would be better.*

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Answer: Giving the lender the unilateral right to make changes to the index rate and the spread would make the changeover from LIBOR to its replacement much simpler for the large number of loans that need to be transitioned, but may not be acceptable to all borrowers. Allowing the borrowers to some kind of consent right could be limited to larger negotiated transactions in order to balance the competing interest of operational risk and customer relations.

Question 17. *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 between Lender and borrower on the correct rate and spread and any related litigation risk. Referencing a published rate eliminates ambiguity.

Question 18. *Given that market practices and conventions may change over time, should the Lender'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 Lender 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 Lender 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 19. *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 20. *Do you see other operational challenges that fallback language should acknowledge or of which the ARRC should be aware? For example, both approaches to fallback language involve various notices from the Lender[14] – do these requirements and the resulting communications between parties impose undue operational burdens? Please explain.*

Answer: Yes, 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 21. *If bilateral business loans fall back to a different rate from derivatives, how do market participants expect to handle the interplay of loans and their hedges? Would market participants expect that current swaps would be terminated and new swaps entered into once the loan has transitioned?*

Answer: Yes, material shifts in rate risks would result in alternative hedge strategies which could include termination of current hedges or the execution of new offsetting hedges.

Question 22. *Would market participants that execute interest rate hedges prefer to fall back to the same rate and spread that becomes operative under the ISDA Definitions even if a term SOFR is available? If so, please provide comments on the proposal for hedged loans set forth in Appendix VI, including a discussion of any operational concerns. Please provide comments on any other approaches you think could be useful in addressing fallbacks in loans and related hedges.*

Answer: To avoid increasing rate risks and operational risks, we would prefer consistency in the fallback.

Question 23. *When a loan is only partially hedged, either by a swap that is not coterminous with the loan's maturity or a swap the notional amount of which is less than the loan amount (or the portion of the loan accruing interest based on LIBOR), should a trigger event result in the entire loan balance converting to the fallback benchmark? Would it be operationally practical to align only the hedged portion's terms with the terms of the swap? What other concerns would market participants anticipate in operationalizing dynamic tranching of a partially hedged loan?*

Answer: Fallback considerations for loans should be divorced from any hedge considerations. By fully adjusting loan balances operational and legal risks would be reduced. Banks can adjust their hedge positions without taking undue risks on the underline loans.

Question 24. *Are there any provisions in the fallback language proposals that would significantly impede bilateral business 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 between Lender and borrower using agreed upon principles.

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

Answer: No additional feedback at this time.