Bilateral Loans Consultation - Response to ARRC

Below are our responses to the consultation questions. We do note that our respondees favored the 'amendment approach' by a margin, but they also understand the critical importance of the option of 'hardwired waterfall' fallback language. Accordingly, below we have included discussion and details of our revised preferred 'hardwired waterfall' structure. Please note this reflects the results of extensive consultation with senior loan operations executives.

A. GENERAL APPROACH OF THE TWO FALLBACK PROPOSALS

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 hardwired approach? Why?

> **Composite Response:** We chose the amendment approach. We may accept hardwired if the waterfall is changed as follows: 1. Term SOFR, 2. Choice of: 'Simple Daily SOFR in Advance' or 'Compounded SOFR in Arrears', followed by 3. Mutual agreement on benchmark through accelerated negotiation. A commitment from the ISDA should be sought regarding hedges for 'Term SOFR', and hedges on 'Simple Daily SOFR in Advance'. (Details on the market's need for 'Simple Daily SOFR in Advance' in questions 8 and 11.)

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?

> **Composite Response:** Products that have built-in triggers or reference other LIBOR indices. Such products would require adjustments that the current process does not address. This may entail having the underlying contract amended to reflect the new environment.

B. TRIGGERS

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?

(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.

(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?

Composite Response:

(a) Yes all three triggers.
(b) ISDA pre-cessation triggers should be consistent and aligned.
(c) We do not think there are many viable options available. Our standard loan agreement does contain LIBOR replacement language, though for a temporary disruption, which could be used as a fallback. We agree that this is not an optimal way to address the situation described in clause (c) but it would be utilized if needed. We would in that instance have to continue to tie to LIBOR as long as it is available whether it is a liquid rate or not. Alternatively, market participants would have to agree to include a market standard or current street convention as a default to adjust the loan agreements for market disequilibrium.

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)?

Composite Response:

(a) Yes.
(b) Yes in both.

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

Composite Response: Most of our respondents said no to this question; however trigger raised for consideration was a trigger based on a breach of a minimum number of banks still offering rates to the LIBOR administrator.

C. <u>THE REPLACEMENT BENCHMARK</u>

Step 1 Benchmark: Term SOFR

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.

Composite Response: Yes. Therefore, a commitment should be sought from ISDA to fully support hedging for: 'Term SOFR' as well as for our proposed additional benchmark: ''Simple Daily SOFR in Advance' which is needed by most commercial loan borrowers, particularly the smaller/middle market borrower. (Details on the market's vital need for the latter benchmark in questions 8 and 11.)

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?

Composite Response: Yes, the Lender should be able to eliminate certain interest period options and we would support option (ii) above. The existing market practice, however, must prevail and the Lender should not eliminate interest period options unless there is no possible option to determinate it.

Step 2 Benchmark: Compounded SOFR

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?

Composite Response: Yes, but a choice of two benchmarks within the second step of the Waterfall is needed. Some sophisticated customers will agree to use Compounded SOFR but only because the ISDA so far will only support that one rate. For most of our customers, the option of 'Simple Daily SOFR in Advance' is mandatory (see questions 1 and 11).

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"?

Composite Response: We choose 'in Advance'. We are very aware that the ISDA has chosen to implement swaps only for Compound SOFR in Arrears at this time. We believe both compounding interest and the in arrears method will pose problems as clients will not be aware of their interest rate until the end of the interest period and this may not be acceptable. See also our response to question 6.

Other Fallback Rates

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)?

Composite Response: Overnight SOFR is not needed as a benchmark on the hardwired waterfall; however we use Overnight LIBOR on certain lending transactions and will need a fallback for that rate (i.e., term SOFR which would have a one day option).

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.

Composite Response: Another rate that should be added to the hardwired approach waterfall would be 'Simple Daily SOFR in Advance'. This SOFR benchmark would be operationally attractive for all size and sophistication levels of customers. We understand this rate to be readily hedge-able under currently proposed ISDA SOFR definitions. Operationally this should include provision of a forward-looking projection of the period's interest rate disseminated 1 day in advance of any draw or roll, and interest-period-end handling of any projected versus actual. We highlight the reasons for this request in questions 1 and 8. We highlight the need for ISDA support for hedging this benchmark in questions 6, although we understand this benchmark may be readily hedge-able under the proposed new ISDA SOFR definitions.

D. SPREAD ADJUSTMENTS

Step 1 Spread: ARRC Spread Adjustments

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

Composite Response: Yes. The most useful type of 'Spread Adjustment' would be fully-forward-looking 'Spread Adjustments', which can turn backwards-looking SOFR benchmarks into 'in advance' benchmarks. ARRC should consider including a spread adjustment for cash products, including bilateral business loans. Currently, LIBOR is an unsecured rate while SOFR is a secured rate. Including a spread adjustment would eliminate this initial major difference between the two rates. The spreads adjustment should be published and methodology transparent and reviewed by member banks prior to agreement and implementation.

Step 2 Spread: ISDA Spread Adjustments

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.

Composite Response: Yes, this is the most appropriate methodology to retain fair value. However, the ISDA has chosen backwards looking spread adjustments, something which does not serve commercial lenders well.

Other Spread Adjustment

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?

Composite Response: No other spread adjustment should be added other than what has been discussed above. A spread that accounts for the difference between the secured SOFR rate and unsecured LIBOR rate should be the only adjustment at this stage before proceeding to the next step in the waterfall. The issue that LIBOR increases during market disequilibrium and the SOFR rate decreases during this occurrence should be addressed during the amendment process.

E. THE ROLE OF THE LENDER

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.

Composite response: (i) Yes, (ii) Yes, (iii) Yes, (iv) Yes, (v) Yes.

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.

Composite Response: For these situations, the Lender needs to have the ability to take action, absent a response from customer.

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?

Composite Response: Yes.

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?

Composite Response: The Lender should have the ability to make on going periodic changes until there is standard convention for all market participants. The changes should be done subject to the borrower's right to withhold consent which rights must be defined within parameters.

F. OPERATIONAL CONSIDERATIONS

Question 19: Are there operational concerns about having the ability to convert many loans over a very short period of time? Please explain.

Composite response: Yes. There are operational concerns about converting such a large population of loans over a short period of time, including personnel constraints to systems changes / testing and amending legal documents and confirming with counterparties.

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 – do these requirements and the resulting communications between parties impose undue operational burdens? Please explain.

Composite Response: The ability to communicate to a large population and volume of borrowers on terms that are still a work in progress will definitely impose a major operational and administrative burden on lender. We will need lead time. The industry must be aligned on the set of SOFR choices which must be designed, importantly, so that non-bank and overseas competitors will not be able to take advantage. We also need time to adjust systems and loan contracts to adjust for currency lending and non SOFR Libor replacement rates for other currencies.

G. HEDGED LOANS

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 a new swaps entered into once the loan has transitioned?

Composite Response: Pending on treatment under US GAAP, clients would consider several alternatives. Clients will not want to be forced to recognize a full MTM payout of their current hedge because of the index change and will investigate the following:

- Amending the current Swap rate to take into account the new Index – no cash exchanged
- Adding a Basis swap onto the existing hedge contract to synthetically convert to the new SOFR Index
- Leaving the current swap in place and running the “basis risk” till the trades maturity date
- Neutralizing the current trade with a trade in the opposite direction, and then entering into the new Index

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.

Composite Response: The ISDA consultation is still underway, and the USD LIBOR consultation has not officially launched, so there may still be some evolution on the ultimate ISDA approach. Presumably ISDA’s final conclusions will consider a scenario for where a term SOFR is available, as a visible term structure would be more preferable for operational and liquidity reasons for many corporate borrowers. Currently, the spread adjustments from the first ISDA consultation indicate that a spread adjustment based on compounding SOFR in arrears is the adjustment to be used for existing swaps in the event the fallback trigger event occurs.

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?

Composite Response:

- Borrowers [Corporate End User] can be dynamic in hedging the interest rate exposure from a loan. For instance, they may not hedge all of the exposure initially and may add or subject from the swap notional overtime with further transactions. As such, most corporates would likely anticipate (and prefer) that the loan in full transitions to a single rate, as they would need to make operational changes to have the portions of the same loan referencing two different rates.
- Also, loans are not necessarily hedged with the same market counterparty who provided the loan so this “tranching” would introduce further operational challenges.
- Applying “hedged loan approach” outlined in Appendix IV to the loan in its entirety rather than just the hedged portion would enable the Borrower [Corporate End User] to remain dynamic with its hedging, however, this approach should be at the election of the Borrower [Corporate End User] rather than a default fallback.
- Not transitioning the full loan could complicate the Corporate’s ability to increase hedging and achieve hedge accounting.

H. GENERAL FEEDBACK

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.

Composite Response: Most customers, especially less sophisticated or lower to mid market, will bear great expense and disruption adjusting to either ‘compounding’ math or an ‘in arrears’ protocol that are currently proposed. This will not work for the vast majority of our customers. For this reason we would propose an ‘in-advance’ SOFR rate (non-compounded) ‘Simple Daily SOFR in Advance’ that can be added to hardwired as an option, which would feature forward looking rate ‘projections’.

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

Composite Response: No additional feedback other than what has been stated above.