February 5, 2019

Chatham Financial ("Chatham") thanks the Alternative Reference Rates Committee (ARRC) for the opportunity to comment on this consultation "Regarding More Robust LIBOR Fallback Contract Language for New Originations of LIBOR Bilateral Business Loans."

Chatham is the largest advisor and technology provider to derivatives end users, serving over 2,000 clients worldwide. Chatham serves both financial end users, including regional and community banks, and non-financial end users, touching virtually every segment of the economy.

Chatham undertakes a wide range of activities that make us intimately familiar with the impact of LIBOR transition on both derivatives and cash products. These activities include helping our clients hedge more than $2 billion notional per day, providing systems and software that amongst other things calculates payments and values debt and derivative positions, and providing accounting, regulatory and capital raising advisory services.

Hedged Loans

Many of the bilateral business loans Chatham's clients are party to contain a lender imposed contractual requirement that obligates them to enter interest rate derivatives to manage the associated financial risk of rising interest rates. Even when not faced with a lender requirement to enter a derivative transaction to hedge, our clients may voluntarily enter into derivative transactions when they make risk management and business sense.

Chatham appreciates the difficulty of transitioning to risk-free rate (RFR) alternatives from the London interbank offered rate (LIBOR) and support efforts to ensure that these alternative rates are robust and not readily susceptible to manipulation. In making this transition, it is important to consider that there may be substantial costs and risks to transitioning the cash and derivatives markets if divergent paths are chosen for triggers, replacement benchmarks, and spread adjustments amongst the underlying cash markets that give rise to financial risk and the derivative markets used to hedge those risk.

Chatham is concerned that differences in the currently proposed fallback language for cash instruments published by the ARRC and for derivatives by the International Swaps and Derivatives Association (ISDA) create a divergence that will result in basis risk, operational difficulties and accounting challenges that will need to be navigated. When entering derivatives transactions to hedge loans, best practices are predicated on having close alignment between LIBOR cessation triggers, replacement indexes, and spread adjustments.

This highlights another aspect of the proposed transition that the ARRC appears to be ignoring, the practical application of Secured Overnight Funding Rate (SOFR) for hedging. Derivative markets exist to serve the needs of hedgers. Speculators play an important role in making markets work, but the core purposes of derivative markets are price discovery and risk management.

RFR rates such as SOFR that are based on objective transactions have advantages over quoted rates such as LIBOR when it comes to preventing manipulation. However, they lack the credit risk component embedded in LIBOR, creating intrinsic challenges for borrowers, lenders, and hedgers—the very people the markets exist for—that need to be a priority consideration for the ARRC. It is anything but clear that SOFR will be ideal for hedging, or whether other alterative rates may be created that have greater market acceptance

Chatham recognizes that transitioning away from LIBOR is a massive task where some amount of market engineering is inevitable. The ARRC needs to focus on the stresses the push for RFRs places on borrowers and hedgers who are grossly underrepresented in the ARRC's governance structure and address them to the greatest extent possible as it seeks to push markets away from LIBOR. Particularly, the ARRC needs to carefully consider how the lack of a credit component in RFRs and the proposed misalignment of fallbacks between cash instruments and derivatives will impact hedgers.

As outlined in section G, Hedged Loans, in this consultation, hedging activities associated with loans may be varied and end users may have hedges for only part of a term of a loan or in amounts less than the full principal amount of the loan. End users may also have loans that have future funding requirements, extensions or other provisions that may require a change in the profile of their existing hedges, add additional hedges over time, or unwind the hedged notional. Additionally, end users may execute hedges at a different level in their organization from where the loan exposure sits and with counterparties that differ from the lender.

There is significant uncertainty regarding transition flowing from a myriad of factors, including that ISDA has not yet introduced their consultation specific to U.S. Dollar LIBOR derivative fallbacks and regulators have not yet provided clarity on transitional topics related to derivatives that could influence the regulatory status of terminations or modifications of existing derivatives in a LIBOR fallback scenario.

At a more granular level, since fallbacks to term rates are currently being contemplated for cash instruments, end users face a dilemma in their consideration of what may be the best option for incorporating fallbacks into cash instruments that may be hedged now or in the future. End users may be in favor of term rates for their cash instruments due to their familiarity and the fact that current systems and market practices are based on term rates—conceivably making a transition to term rates easier to administer than a transition to compounded rates. However, the lack of current knowledge of potential costs associated with using term rates for cash instruments could offset a perceived administrative advantage. Alternatively, even if ISDA does not include term rates for SOFR in its fallback waterfalls, end users may prefer to negotiate fallbacks to term rates for derivative contracts, provided they exist and are robust enough to be viable.

Chatham recommends that the ARRC and ISDA recognize the reality that there needs to be symmetry between the fallback rates used for bilateral business loans and the derivatives used to hedge those instruments. A divergence between fallback rates used for cash instruments and those used in derivatives to hedge such cash instruments will cause market disruption and potential operational disruption for end users. The ARRC and ISDA, along with other regulators and market participants, should consider the potential for market abuse as well as the impacts to end users of losing access to derivatives that match cash instruments. Given the need to allow end users as much time as possible to adapt to new rates and market standards, this consideration must be a top priority and should not be put off until later in the transition process.

The lack of a credit component and its impact on hedging must also be considered early in the transition process. Even if RFRs become dominant, it is highly likely that hedging methods will need to evolve to address the lack of a credit component.

Hardwire versus Amendment Approach

While Chatham appreciates the value of legal certainty, given the large number of unknowns regarding transition to LIBOR alternatives, end users are hesitant to lock into a hardwired approach that could create operational or economic uncertainty if alternative rates or spread adjustments do not behave as expected. Once LIBOR alternative markets and products develop, hardwired approaches that provide legal certainty could be beneficial. Currently, approaches that maintain the flexibility of end users to play a role in determining rates and spread adjustments in the event of LIBOR unavailability is critical. However, as the market infrastructure develops around SOFR-based rates and products, Chatham expects that hardwired approaches could benefit end users, lenders, and derivative dealers. Factors that could facilitate broader adoption of hardwired approaches includes the confirmation that if term rates exist for cash instruments, they will also be acceptable for use in the derivatives that hedge those cash instruments. Another factor includes regulatory guidance that may be promulgated to create more certainty on derivative regulatory treatment for hedged loans. This would help mitigate the current market uncertainty regarding the management of potential mismatches in rate structure between cash instruments and derivatives.

Pre-cessation Triggers

Specific to the ARRC's proposed pre-cessation triggers, Triggers 3, 4, and 5 address potential scenarios where LIBOR is unavailable or has degraded to a point where it is no longer fit for its purpose. These triggers could be useful additions to bilateral business loan fallback provisions if agreed to by the lender and borrower. In particular, Trigger 3 provides a useful backstop, addressing a situation where LIBOR has not been published for five days, but the other pre-cessation events have not been triggered. However, in such a situation, Chatham expects either the benchmark supervisor or administrator to take appropriate action or make appropriate announcements.

As discussed above, end users may use derivatives to hedge the underlying bilateral business loans, differences in fallback triggers expose us to basis risk when the loan and derivative fall back at different times and/or to different rates and spread adjustments. Bilateral business loans and derivative hedges associated with those loans are inextricably linked economically. In our experience, once an ISDA Master Agreement and Schedule have been executed, legal terms are not negotiated on a case-by-case basis, and Chatham expects this to be the case for LIBOR fallback language once finalized by ISDA and incorporated into agreements via a protocol. For this reason, Chatham implores the ARRC to harmonize their fallback approach with ISDA and not assume any flexibility on the part of hedge providers. Although ISDA has not yet finalized their trigger language, as currently drafted, no pre-cessation trigger is proposed. It could be beneficial for bilateral business loans to reference the triggers of an associated hedge in order to preserve the symmetry between products.

In addition to the economic impact of differences in triggers, there are potential accounting risks. Basis differences such as this require much more rigorous accounting techniques, and many hedging relationships have been set up to use more simplistic techniques. Chatham is aware that the Financial Accounting Standards Board (FASB) is considering transition relief in this area, but there is currently uncertainty as to the content and timing of such relief.

Chatham strongly recommends the ARRC, ISDA, and FASB harmonize approaches to IBOR fallbacks to minimize the potential for market disruption.

Replacement Benchmarks

Chatham believes that there is insufficient information to assess whether forward-looking term rate should be the primary fallback for bilateral business loans. Chatham is aware of the operational difficulties of incorporating non-term rates into our bilateral loans, but Chatham is concerned that market participants are being asked to make a choice as to whether to endorse term RFR rates into replacement rate waterfalls when such term rates do not currently exist and are not currently being endorsed by ISDA. Chatham is also aware that regulators have expressed willingness to allow term rates in certain circumstances, but it is difficult to ascertain what, if any costs or other considerations may need to be weighed for us to more adequately respond to the ARRC on this topic. For example, if there are wide trading spreads inherent in derivatives tied to term RFRs it could increase our cost in hedging loans referencing such term RFRs to unacceptable levels relatively to the gains in operational efficiency that may come from using term RFRs in loan agreements.

More practically, Chatham would also highlight that certain current loan constructs may not allow for easy transition to certain non-term benchmark rates. A common use case that indicates the challenge of incorporating a non-term rate is a construct where the payment due under the loan might be due mid interest period. For example, a bilateral business loan may have interest periods that roll on the 15th calendar day of the month, while having payments due on the 9th calendar day of the month. The underlying reason for this is that it allows the payment under the loan to be collected by the servicer and processed through any waterfall prior to distribution to investors. The use of this construct is only possible with a rate that allows the payment amount is known on the first day of the interest period.

Of the replacement benchmarks presented in the consultation, only compounded SOFR in arrears would align with ISDA's current thinking for derivative fallback. Compounded setting in arrears is attractive to end users because it reflects the actual rate conditions of the period. Rate movement during the period is appropriately reflected in the cash flows that follow, allowing market changes to be reflected in the final rate.

The consultation's other proposed replacement benchmark, a compounded in advanced rate, does have the benefit from the ability to reference and quickly reproduce the rate throughout the period, the disadvantage of compounding-in-advance is that it is backwards looking, and thus doesn't reflect market-anticipated rate movement. This short-coming could result in market participants attempting to manipulate the market in their favor if they have a view or expectation of where rates will go. For example, if the market anticipates a rate hike during an upcoming period, a borrower would be incentivized to draw more money on a revolving credit facility at the previously lower rate because the increase in interest rates would not be reflected until the next reset date. A forward-looking methodology will eliminate these concerns because the anticipated rate hike already will be incorporated into the rate.

Spread Adjustments

While it could be positive for the ARRC to recommend spread adjustments for consideration by market participants, Chatham does not believe spread waterfalls should reference ARRC recommendations. The issuer should not be able to unilaterally determine the spread adjustment; this should be a negotiated item given the uncertainties about how spread adjustments will work for all products and in all market conditions. Additionally, due to the relationship between the bilateral business loan and its hedging derivative, borrowers should have the right to consent to the actions taken by the lender.

Given that significant work remains to be done in defining and operationalizing LIBOR alternative rates, it is premature to recommend specific spread waterfalls. A threshold determination would indicate whether a specific spread methodology can adequately address a reasonable range of market conditions while preserving—to the greatest extent possible—the original economics of the contracts being transitioned. Given the unknowns, it is important for end users to maintain the flexibility to find the appropriate spread adjustment rather than be locked into a currently unknown spread adjustment between LIBOR and a currently unknown rate.

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We thank you for considering this matter. If you would like to discuss these issues further, please contact Eric Juzenas, Global Chief Compliance Officer and Director of Regulatory Policy, at (484) 731-0061 or ejuzenas@chathamfinancial.com.