



February 5, 2019

Alternative Reference Rates Committee (“ARRC”)

Via email submission to: arrc@ny.frb.org

Re: Consultation Response – Bilateral Business Loans

Wells Fargo & Company (“Wells Fargo”) submits this response to the ARRC Consultation Regarding more Robust LIBOR Fallback Contract Language for New Originations of LIBOR Bilateral Business Loans. Wells Fargo recognizes the critical work of the ARRC to identify best practices for effective contractual fallback language. We hope these efforts will reduce market disruption in the event that LIBOR is discontinued. In addition, Wells Fargo appreciates the tremendous work of the ARRC Business Loans Working Group in developing this consultation, taking into consideration a wide range of views from members regarding the complex issues related to the LIBOR transition.

Responses to Questions:

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 hard-wired approach? Why?*

Answer: Wells Fargo supports the Appendix II hardwired approach because using flexible fallback provisions (like the Appendix I amendment approach) may result in divergent outcomes as well as disputes and ambiguity at a critical time. In addition, we feel it would be very challenging for firms to reopen numerous credit agreements at once. We believe that the hardwired proposal provides clarity and consistency by using clear and observable triggers and fallback rates/spread adjustments, subject to some flexibility at the end of the waterfall.

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: We have no further suggestions in this regard. Wells Fargo looks forward to an ARRC recommendation for multi-currency facilities.

B. Triggers

Pre-cessation 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?*

Answer: Despite reservations expressed below, we believe that fallback language should include triggers 3, 4, and 5. Trigger 3 provides a mechanism to transition when regulators have not acted but market participants are left in limbo. Trigger 4 provides an avenue to transition should LIBOR no longer be appropriate, but a regulatory agency has not yet opined. Trigger 5 allows banks to respond to regulatory guidance. If the regulator opines and triggers are not otherwise engaged elsewhere, nationally-chartered banks will need an opportunity to transition the loan to respond to regulatory requirements or guidance.

(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: Wells Fargo's primary concern around pre-cessation triggers relates to potential basis risk with derivatives. Otherwise, we fully support these proposed pre-cessation triggers.

(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, we would seek to amend loan documents in these circumstances, which would be challenging and likely not achievable.

Early "Opt-in" Triggers

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: We support the inclusion of opt-in triggers in the bilateral business loan fallbacks within the framework set forth in Appendices I and II.

Other Triggers

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

Answer: There are not.

C. The Replacement Benchmark

Step 1: The Forward-Looking 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.*

Answer: Given the structure of most bilateral business loans, Wells Fargo supports a fallback from term LIBOR to a forward-looking term SOFR, should term SOFR be endorsed by the ARRC. If the loan is wholly or partially hedged, please refer to our answer to Question 23.

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: Yes, it should. Of the two options presented, Wells Fargo supports option (i) because any non-published rate presents operational challenges, will not have the desired degree of transparency, and could introduce the possibility of a disputes over the Lender's calculation of an interpolated rate. We support removing any non-published rate options for new loans and for new borrowings under existing loans.

Step 2: "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?*

Answer: Wells Fargo supports Compounded SOFR as step 2. If term SOFR has not been endorsed by the ARRC, we believe that Compounded SOFR appropriately attempts to accommodate for the loss of term structure. Our answer was influenced by the preliminary results of the ISDA Consultation.

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: In the absence of a term SOFR endorsed by the ARRC, Wells Fargo supports Compounded SOFR "in arrears" as the second step in the waterfall, primarily because it is reflective of the relevant interest period. We note that there are significant operational and other considerations related to switching a LIBOR-based loan to an "in arrears" convention because the interest rate would not be known until the end of the payment period, which will require significant changes to invoicing and related loan mechanics. We believe, however, that the industry working together with loan market vendors to develop a consistent methodology for calculating Compounded SOFR in arrears (with a lookback period for operational reasons) would make this rate more transparent and assist market adoption.

We suggest noting in the final fallback language that the methodology for calculating a compounded average of SOFR should be determined by Lenders at the time a fallback is activated, giving due consideration to ARRC recommendations.

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)?*

Answer: We support removing overnight SOFR from the waterfall.

Question 11. *Is there any another 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: We do not have any recommended replacement rates that are not currently included in the proposal.

D. Spread adjustments

Step 1: ARRC Spread Adjustment

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: Yes, we believe it would provide the market greater certainty and reduce market disruption if the ARRC, when recommending a forward-looking term SOFR, also recommends a published corresponding spread adjustment or spread adjustment methodology.

Step 2: ISDA Spread Adjustment

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.*

Answer: Yes, while it may not be ideal (if the replacement rate for bilateral business loans differs from the fallback rate used for derivatives in the ISDA Definitions), it will be a published spread adjustment that Lenders can look to that reduces uncertainty in the absence of an ARRC recommended spread adjustment.

Other Spread Adjustments

Question 14. *Is there any another 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: We did not identify any other spread adjustments to suggest.

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.*

Answer: We believe some of these actions could be challenging and will require operational builds. We believe clause (i) above may be operationally impractical, depending upon the number of impacted loans. We are comfortable determining if triggers have occurred and selecting screen rates. See comment in question 7 regarding missing middle maturities – we do not believe we should be interpolating for missing middle maturities. For (v) we support periodic amendments, as needed, to support the complex nature of expected changes to the loan terms (see also response to question 18).

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.*

Answer: Lenders should have the right to take certain actions by notice to Borrower within the framework of Appendix I and Appendix II. This view is based on our expectation that in the event of a LIBOR cessation, many loans may need to be operationally transitioned to another rate within a short timeframe and we would wish to avoid market disruption in these circumstances.

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: Wells Fargo believes a published rate and applicable spread adjustment would be beneficial to all market participants as it would (a) increase transparency and provide an objective market standard for determining the same, thereby encouraging adoption and minimizing disputes and (b) inject an independent voice into the determination of the rate and spread adjustment, which would reduce potential disputes relating to rate and/or spread adjustment calculation/selection.

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: Given the uncertainty of the timing of many significant market events, and the complexity of related implementation requirements, Lenders should have the ability to make transition-related changes for a limited time period (e.g. 2-3 interest accrual periods).

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.*

Answer: Yes, there would be a high degree of complexity when converting a high volume of loans, especially since at the time of transition there will be several “versions” of fallbacks to evaluate and implement properly.

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.*

Answer: Yes, we have operational concerns about notice requirements and in particular a requirement in Appendix II, “Effect of Benchmark Discontinuance Event” part (b) for Lender to notify all Borrowers “promptly” upon the occurrence of any Benchmark Unavailability Period. In addition, in the Replacement Benchmark waterfall, it would be helpful for step 2 (currently Compounded SOFR) to incorporate an “operational availability” option. In other words, if Term SOFR is not available and if the Lender is not operationally capable of executing step 2, then continue to step 3 of the waterfall to allow the Lender to select an available and appropriate rate. This would still allow a hardwired approach to be utilized, but address the possibility that Lenders are not operationally ready to utilize rates in the waterfall. We suggest that conforming changes be made to the syndicated fallback language to accommodate this concept.

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?*

Answer: Some commercial end user market participants may find this basis risk acceptable, but this may depend upon accounting relief and regulatory relief (e.g. end user exception determinations) for such differences between the loan and related hedge. Other market participants may seek to terminate swaps that are no longer perfect hedges or amend them to reference the loan fallback rate (if that option is available to market participants).

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: The Appendix VI provides for loans to fall back to the same rate as any related derivatives transaction. This may be suitable for commercial end users who do not wish to accept any basis risk between loans and swaps at the time of a LIBOR cessation. It may present operational difficulties and costs for Lenders to implement, as they would need to invest in systems to provide for loans (or portions of loans) that bear interest at the fallback rate selected by ISDA.

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: It may present great operational costs to Lenders to ensure that only the hedged portion of the loan falls back to a particular rate that matches the ISDA Fallback Rate in the event of a LIBOR cessation. However, some Lenders do offer different rate tranches within a single loan and therefore may be able to build the operational capability to provide for loans where certain tranches are designed with a fallback rate that matches the ISDA Fallback Rate for standard derivatives. Where it is possible, this would be a valuable risk-reducing strategy for both the Lenders and borrowers.

G. 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.*

Answer: It would also be important that a hardwired set of fallback language clarifies that the waterfall applies to all borrowings in a loan (i.e., borrowings should not land at different steps in the waterfall – one borrowing at step 1 and one borrowing at step 2); provided that the foregoing may not apply to certain partially hedged loans. Additional clarifications may need to be built into the waterfall to care for these possibilities if interpolations are removed from the fallback language or for borrowings at less than 1-month LIBOR.

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

Answer: ARRC should consider whether the use of a compounded rate would violate any state laws governing usury or interest calculation methods.

Consider changing the defined term “Replacement Benchmark Spread” to “Replacement Benchmark Adjustment” to alleviate confusion with a loan’s spread. It would be best if all fallback language for all working groups use the same wording.

It would be helpful if the working group, in consultation with vendors, addressed the specific conventions for compounding SOFR in arrears (e.g., lookbacks, lockouts, business day conventions, etc.).

Wells Fargo wishes to thank the ARRC Business Loans Working Group for the opportunity to provide this feedback on the Bilateral Business Loans LIBOR Fallback Consultation. We are happy to discuss our responses further or provide any additional information that may be helpful.

Thank you,

Wells Fargo