ARRC Consultation on Floating Rate Notes (FRNs)

Pre-Cessation Triggers

Question 1(a): Should fallback language for FRNs include any of the pre-cessation triggers (triggers 3, 4 and 5)? If so, which ones?

Answer:

- We support triggers 4 and 5.
- We have concerns that trigger 3 may be arbitrary and may not represent a permanent discontinuation of a benchmark. We can contemplate a situation where a benchmark is not available for 5 days (due to operational disruptions), but could resume publication on the 6th day. Further disputes are likely to arise as to what amounts to 5 days (from what time does the 5 day count start).
- If there is a continuous disruption to a benchmark to the point where it may represent a permanent discontinuation, trigger 5 would likely occur in that event.

Question 1(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.

- One concern is that triggers 3-5 would not conform to standard derivatives documents and a misalignment between the FRNs and the associated derivatives documents could result. While the triggers make sense from a FRN perspective, misalignment is a concern.
- There is also a concern as to whether derivatives that include the additional pre-cessation triggers (triggers 3-5) could be cleared.
- Issuers who seek alignment between the FRN and the derivatives could include the pre-cessation triggers in the latter. However, in order to clear those derivatives, those pre-cessation triggers must meet the requirements outlined by the central counterparty. If not, the issuer would have to hedge through the OTC market, potentially incurring increased costs.

Question 1(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?

- We encourage the ARRC to work with ISDA to determine whether the pre-cessation triggers could be included as possible fallback triggers for derivatives contracts (either a mandatory or opt-in trigger).
- We also encourage the ARRC to work with the major central counterparties (CCPs) to ensure that derivatives which include the pre-cessation triggers can be cleared.

Replacement Benchmark

Question 2: If the ARRC has recommended a forward-looking term rate, should that rate be the primary fallback for floating rate notes referencing LIBOR even though derivatives are expected to reference overnight versions of SOFR?

Answer:

- Ideally all product classes would move towards a forward-looking term rate, whether it is term SOFR or another market-agreed benchmark rate. In this situation, the ARRC recommended forward-looking term rate should be the primary fallback for FRNs referencing LIBOR.
- Sophisticated firms (such as banks and other large financial institutions) may manage their exposures to term SOFR and compounded SOFR separately. Firms may have to put capital against, and incur basis risk for, any mismatch between their FRNs and the related hedges; corporations may have more flexibility.
- However, a bifurcation in the market between issuers that use swaps and those which do not is likely not to be sustainable or desirable. It is very likely that the methodologies would ultimately align with the derivatives market.

Question 3(a): Should Compounded SOFR be the second step in the waterfall? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR?

Answer:

- Yes. Alignment with the derivatives market (which is expected to select compounded SOFR) is key. It is important to see what ISDA does in order to keep the FRN and derivatives documentation in line as much as possible.

Question 3(b): 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:

- While compounding in advance is more similar to the current FRN, in that you know the interest payments, alignment with the derivatives products is needed. Compounding in arears is the preferred choice as it is the methodology that ISDA is expected to adopt for derivatives products.
- Further, the market has shown a preference for the compounding in arrears methodology. Most (if not all) of the alternative rate product offerings have used this methodology.

Question 4(a): Would an overnight rate that remains in effect for the entire interest period be an acceptable option for investors, issuers and agents?

Answer:

- No, unless this option is adopted by ISDA. The overnight rate has a lot of variability (there is both month-end and quarter-end spikes), as such our preference is a compounded rate.

Question 4(b): Should the waterfall include Compounded SOFR (step 2) and spot SOFR (step 3) and/or a simple average of SOFR (not in the waterfall at this time)? If only one of these options is included, which is preferable? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR?

Answer:

- In order of preference, we would recommend (i) compounded SOFR, (ii) a simple average of SOFR and (iii) spot SOFR. Compounded and simple average of SOFR would better smooth out the rate's volatility (which is particularly apparent at month and quarter end).
- Our preferences would be influenced by ISDA's decision, alignment between derivatives and FRNs is ideal.

Question 5: In the future circumstance where there is no SOFR-based fallback rate, is the replacement rate determined by the Relevant Governmental Body the best alternative at this level of the waterfall?

Answer:

- Yes.

Question 6(a): In the future circumstance where there is no SOFR-based fallback rate and the Relevant Governmental Body has not recommended a replacement rate for FRNs, is the fallback for SOFR-linked derivatives set forth in the ISDA definitions the best alternative at this level of the waterfall?

Answer:

- Yes.

Question 6(b): Should this step in the waterfall refer expressly to OBFR and then the FOMC Target Rate rather than refer to the fallback rate for SOFR-linked derivatives in the ISDA definitions (which could change in the future)?

Answer:

- Our preference is alignment with ISDA, which is expected to point to OBFR and the FOMC target rate. If the FRNs point to ISDA definitions and those are revised in the future in line with market practices, then FRNs would not need to be modified as those changes would be automatically incorporated.
- As such, the waterfall should first refer to the fallback rate in the ISDA definitions. This would be followed in the waterfall by the OBFR and the FOMC Target Rate.

Question 7: Should the issuer or its designee have the ability to over-ride the ISDA fallback for SOFR-linked derivatives in the ISDA definitions at this level of the waterfall if it determines that another rate that is an industry-accepted successor rate for FRNs exists at such time?

Answer:

- Our preference is to have alignment between FRNs and the associated derivatives; as a result, alignment with the ISDA fallbacks is key.
- Generally, the issuer should not have the ability to over-ride the ISDA fallback; however, if allowed for in the contract, the issuer should appoint a neutral third-party who could recommend that the FRN should adopt another industry-accepted successor rate for FRNs in lieu of the ISDA fallback. To avoid real and perceived conflicts of interests, the third party should be unaffiliated with the issuer. This would apply in a situation where ISDA is slow to adopt the industry consensus successor rate for FRNs.

<u>Replacement Benchmark Spread</u>

Question 8: Do you believe that the ARRC should consider recommending a spread adjustment that could apply to cash products, including FRNs?

Answer:

- Yes, the ARRC should consider recommending a spread adjustment for cash products. The regulators have the authority and clout to recommend a spread adjustment that could be adopted broadly in the market.
- Alternatively, the ARRC could recommend a methodology for the spread adjustment which allow for a more dynamic spread.
- While some vendors are trying to occupy this space (ex. ICE), it is unclear if they would have the authority or influence to recommend a spread adjustment that would be widely accepted.
- If a compounding methodology is used to determine a term rate, the credit spread should be applied after compounding. Convexity issues would arise if the credit spread was first applied and then the rate was compounded.
- If spread adjustments are recommended by the ARRC, the term and credit spreads should be separately quoted.

Question 9: Is a spread adjustment applicable to fallbacks for derivatives under the ISDA definitions appropriate as the second priority in the spread waterfall when the Unadjusted Replacement Rate is equivalent to the ISDA fallback rate?

Answer:

- Yes. Issuers want alignment with the derivatives market, and some may even want to use the ISDA spread as the first priority as it would get rid of basis risk. There are still questions about how ISDA would publish their spreads (would the term structure and credit spread be published separately or as an all-in rate).
- However, it should be noted that if the FRN goes to a term SOFR rate or another market-agreed benchmark rate, there would only be a need for a credit spread adjustment, whereas if an overnight SOFR is used, you would need both a term and credit spread adjustment.

- If a compounding methodology is used to determine a term rate, the credit spread should be applied after compounding. Convexity issues would arise if the credit spread was first applied and then the rate was compounded.
- If spread adjustments are recommended by the ARRC, the term and credit spreads should be separately quoted.

Question 10: If the ARRC does not recommend a spread adjustment, should the issuer (or its designee) have the ability to determine the spread adjustment (or, if step 2 is applicable, over-ride the spread adjustment for derivatives fallbacks in the ISDA definitions) and select a spread adjustment that would result in a rate that is an industry-accepted successor rate in floating rate notes at such time?

- Generally, the issuer should not have the ability select a spread adjustment; however, if allowed for in the contract, the issuer could appoint a neutral third-party who could recommend a spread adjustment that would apply. To avoid real and perceived conflicts of interests, the third party should be unaffiliated with the issuer.

Responsibility for Calculation

Question 11: Whether as issuer or as calculation agent, would your institution be willing to (i) determine whether the proposed triggers have occurred, (ii) select screens where reference rates or spreads are to be found, (iii) make calculations of a rate or spread in the absence of published screen rates, (iv) interpolate term SOFR if there is a missing middle maturity and (v) make the decisions in step 6 of the Replacement Benchmark waterfall and step 3 of the Replacement Benchmark Spread waterfall?

- Whether we, as issuer or calculation agent, are willing to provide the services above would depend on the circumstances.

General Feedback

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

- Other than the items above for which we recommended against, there is nothing else in the proposal which could significantly impede issuances.

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

- Ideally, the fallback would be a forward looking term rate if one develops to be consistent with cash products currently.
- A key goal is alignment between the derivatives and cash products.
- Firms wish to avoid mismatches between the rates at which they access funding and the rates which are charged to clients on FRNs.
- The transition from LIBOR to SOFR or another market-agreed rate will pose significant operational challenges on market participants. These issues include: product valuation and risk management, updating internal systems/models, cross-currency market (the characteristics of

the alternatives rates differ between jurisdictions), harmonization of the transition across products/jurisdictions, and tax/accounting.