

Alternative Reference Rates Committee

Via email: arrc@ny.frb.org

26 November, 2018.

RE: Consultation regarding more robust LIBOR fallback contract language for new issuances of LIBOR floating rate notes.

Our firm welcomes the opportunity to respond to the Alternative Reference Rates Committee (ARRC) consultation in relation to U.S.dollar (USD) LIBOR fallback contract language for floating rate notes. Our firm has set out the responses to the questions contained in the consultation paper released on 24 September 2018 below.

Our firm requests that its response please be posted anonymously.

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

Triggers 4 and 5: Yes. If pre-cessation triggers are not included, there is an increased risk of litigation if bond holders believe the rates published are not representative of what the real LIBOR rate should be.

Trigger 3: Other than as a consequence of a systems glitch/market disruption, our firm would expect that any failure to publish a LIBOR rate for 5 consecutive days would be a consequence of triggers 4 or 5.

Question 1(b): Please indicate whether any concerns you have about these pre-cessation triggers relate to differences between the triggers and those for standard derivatives or relate specifically to the pre-cessation triggers themselves.

Our firm is concerned that, should there be pre-cessation triggers on FRNs but not on derivatives, and the trigger is activated, then it could open up basis risk with any hedging derivative (eg. IRS), including in circumstances where a cross currency swap was executed to convert the proceeds to another currency. This would be sub-optimal. Our strong preference therefore is for identical pre-cessation triggers for FRNs and other debt obligations to be matched with those on derivatives which in turn means ISDA should reconsider their triggers and ideally bring them into line with the ARRC recommendations.

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 administrator acknowledges to be insufficient to allow for production in a standard manner?

For new issuance, our firm has included fallback language that references new Replacement Benchmarks and provides a mechanism to amend the reference rates at a future date.

For legacy issues Issuers have the option to approach noteholders via a consent solicitation process for noteholders to agree to change the existing LIBOR reference rate to a Replacement Benchmark rate. For US bond issuance programs, 100% of noteholder consent is required on a deal by deal basis for any change in payment terms, which is likely to be extremely difficult to obtain. Even if a lower approval threshold applies in other jurisdictions, it may be difficult to achieve the threshold level, particularly where there are a large number of investors in the notes. Issuers also have the option to exchange investors into equivalent notes featuring the new Replacement Benchmark rate or buy back the notes at an agreed price. In the absence of a LIBOR rate the ultimate fallback is for the notes to reference the last published LIBOR level and effectively become a fixed rate note. This is likely to result in a transfer in value to either the issuer or the investor depending on the trajectory of interest rates. This would benefit the issuer in a rising rates environment and vice versa.

An option may be to change to a new alternative Replacement Benchmark rate on an industry wide basis where the Replacement Benchmark is agreed across the industry and the change implemented across all FRNs at the one time. To minimise basis risk, the change to a Replacement Benchmark should occur simultaneously with the derivatives market. However, this "big bang" approach (where all LIBOR derivatives are closed out and new (SOFR derivatives) established at the same time), is likely to bring about extreme volatility and therefore may be unworkable in practice given the volume of transactions that would be affected.

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

Yes, provided that this reflects investor demand and only on the condition that an effective derivative hedge can be executed on the same basis. FRN investors have a strong preference to know what their future interest and cashflows will be at the start of each interest period and require the ability to hedge these exposures. Development of deep and liquid derivatives markets (in SOFR) will be precondition to allow calculation of accurate forward rate curves/rates.

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?

Yes, compounded SOFR should be the second step. (Our firm has assumed here that the ARRC is referring to new ISDA definition of USD-SOFR-COMPOUND insert by supplement 57 to the 2006 Definitions on May 16, 2018). Ideally the ISDA and FRN fallback conventions should align, although if they don't, FRN issuance should be consistent with investor and industry preferences and would require the ability to hedge any mismatch.

Question 3(b): If you believe 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"?

Compounding "In arrears" is preferred and should be consistent with the ISDA fallback and investor and industry preferences.

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?

Unlikely as the overnight rate is subject to volatility (particularly over month and quarter ends) such that the rate on any one day may be unrepresentative of the average rate over the period.

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

Yes with the order of preference being compounded, average and then spot. Again, the preference order will be influenced by the ISDA fallbacks and should be consistent with the ISDA fallbacks and investor and industry preferences.

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?

Yes.

Question 6(a): In future circumstances where there is no SOFR-based fallback 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?

Yes, this would minimise the likelihood/extent of basis risk between the FRN and any underlying derivative hedge.

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)?

It would be premature at this stage to make a determination as to what would be the most appropriate fallback rate under these circumstances, although our firm are aware of the waterfall reference to OBFR and FOMC in the fallbacks in the new ISDA definition of USD-SOFR-COMPOUND insert by supplement 57 to the 2006 Definitions on May 16, 2018.

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?

Yes, if there is an industry accepted rate, it should be used.

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

Yes, having an ARRC recommended spread adjustment (as an industry standard) that could be applied to all FRNs would significantly reduce the risk of disputes between issuers and investors if the negotiations had to be conducted on a bilateral basis. Ideally this would conform to an ISDA or industry agreed standard or calculation, although our firm acknowledges what ISDA is working on will be a voluntary adherence to a protocol, and there is a significant risk that derivatives market participants will not adhere to it where it results in value transfers.

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

Yes, this would help to minimise any basis risk that would otherwise exist if different rates were applied to FRN and derivatives.

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 FRNs at such time?

Yes, if there is an industry accepted rate, it should be used, although current documentation for legacy deals does not allow for this and would require noteholder consent. Benchmark replacement wording that has recently been adopted by most issuers allows for spread adjustments to be applied.

Question 11: Whether as issuer or 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?

Our firm would be less comfortable to undertake (i) and (ii), unlikely to undertake (iii) and (v) and comfortable to undertake (iv).

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

No, after the Benchmark Replacement Date, all future FRN issuance would reference the new Replacement Benchmark rate. The challenge will be to achieve industry/investor support for the new Replacement Benchmark and the Replacement Benchmark Spread that will apply for all legacy deals that reference LIBOR.

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

There is an underlying assumption that investors who had signed up to a LIBOR rate are going to accept SOFR however adjusted. However, it is possible that investors do not agree to the proposed replacement benchmark plus spread adjustments (ARRC assumes that the last known LIBOR rate would apply as a fixed rate until maturity, which depending on the SOFR rate curve at the time may or may not be a good thing for the issuer). This could leave open the risk of material litigation and/or value transfer between investors and issuers.

With the current differences between the ARRC and ISDA recommended approaches, it is highly likely that there will be basis risk between the FRN and any underlying derivative hedge. Our firm considers that the derivatives market participants are not going to accept value transfers on their derivatives when there may be legal avenues open to them to prevent this happening. Our firm therefore again re-iterates the strong preference for the two bodies to work together to bring their recommended methodologies into alignment.