ARRC LIBOR Consultation - Response Instructions
https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-FRN-Consultation.pdf

Market participants may submit responses to the consultation questions by email to arrc@ny.frb.org until November [26], 2018. Please attach your responses in a Word or PDF document and clearly indicate "Consultation Response – FRNs" in the subject line of your email. Please coordinate internally and provide only one response per institution. Responses will be posted on the ARRC's website, but may be anonymized upon request. Following this market-wide consultation, the ARRC plans to recommend fallback language for FRNs for voluntary adoption in the marketplace.

November 26, 2018

Dear Sir or Madam,

ARRC CONSULTATION REGARDING MORE ROBUST LIBOR FALLBACK CONTRACT LANGUAGE FOR NEW ISSUANCES OF LIBOR FLOATING RATE NOTES

On behalf of our Central Treasury function, we thank the Alternative Reference Rates Committee (**ARRC**) for the opportunity to comment on their Consultation (24 September 2018) on recommended fallback language for market participants to consider for new issuances of various types of cash products referencing LIBOR. We note that these proposals are intended to set forth robust fallback provisions that define the trigger events, and allow for the selection of a successor rate and a spread adjustment between LIBOR and the successor rate to account for differences between these two benchmarks; and we note that these proposals are also intended to address timing and operational mechanics so that the fallbacks function effectively.

We note that alternative risk-free rates (RFRs) that have been identified for the relevant IBORs as part of recent global benchmark reform work; therefore we have not commented on the ARRC's choice of SOFR as the underlying RFR for USD. We agree that adjustments would be necessary because of the differences between the IBORs and the RFRs.

As a large corporate issuer, we typically issue debt at fixed rates but some Floating Rate Notes (FRNs) have been issued that reference USD LIBOR. The terms and conditions typically would allow the issuer to set an alternative rate in certain circumstances (e.g. if LIBOR were discontinued); whilst it would be operationally preferable to adopt a market-standard fallback, we should wish (as noted by ARRC) as issuer (i) to adhere to existing terms and conditions of the FRN; and (ii) to retain an 'over-ride' capability in the event that the fallback rate itself was unexpectedly distorted (e.g. if the fallback trigger coincided with a period of crisis in financial markets). In this respect we note ARRC proposes that adoption of ARRC fallback methodology would be voluntary.

A 'fallback' rate is exactly that and in the perfect world, there would be two possible outcomes:

(i) All references to LIBOR are actively removed by users (whether by existing fallback clauses that remain effective, renegotiation or other means) and the fallback rate is not needed.

(ii) A fallback rate is developed that is value neutral, both on a fair/mark-to-market value and a cash basis, and the entire market adheres to the protocol.

While the second of these would be an ideal outcome, requiring minimal implementation effort, we suspect that it is impossible to achieve. In practice the fallback is likely to be used by entities – particularly corporates – who do not have the expertise or resources to achieve (i). The value-neutral nature of the fallback becomes the key criterion in this scenario.

Key Response 1 - We should like to emphasise that our commercial exposures to IBORs are much wider than FRNs and Interest Rate Swaps. *Corporates may wish to use the fallback methodology for other purposes, such as the fallback for the transfer pricing of intra-group (i.e. inter affiliate) loans*, which typically reference LIBOR 3M rates, as well as for other legacy financial instruments (e.g. loan facilities) or other legacy commercial contracts where a fallback RFR may be unspecified in existing documentation. If a proposed fallback becomes 'market standard' it may simplify transfer pricing discussions or other commercial negotiations.

Key Response 2 – Our preference as a non-financial corporate user of LIBORs would be to have consistent fallback language across currency and tenor, particularly for the same class of instruments. *For this reason, to avoid a proliferation of LIBOR alternatives, we advocate close international cooperation on fallback (and term rate) consultations.*

Key Response 3 – where there is existing contractual language that effectively mitigates a fallback scenario, we should continue to adhere to existing terms and conditions wherever possible.

Key Response 4 - We have approached this consultation by considering our key criteria for a "good" fallback rate from our perspective as a multinational Non-Financial corporate:

(i) Continuity of contract is most important, avoiding "cliff edge" impacts. The LIBOR fallback should be capable of wider utilisation for many outstanding commercial contracts that presently reference LIBOR as published in London 11am (including, for example, late payment clauses, loan facilities, intra-group transfer pricing etc.).

(ii) As much advance notice as possible would be needed by corporates (potentially requiring longer than the banking sector) to adapt to the cessation of LIBOR and the triggering of fallback rates.

(iii) Avoidance of any value transfer that would create 'winners' and 'losers', or any cash transfer (including margin payments).

(iv) Avoidance of competing LIBOR fallback outcomes that would have implications for hedge accounting of derivative transactions or for the fiscal treatment of intra group funding arrangements;

(v) Avoidance of high daily volatility and pricing aberrations, especially if markets would anticipate the imminent cessation of a reference rate;

(vi) Use of a methodology that is transparent and easy to understand for all market participants (including non-financial counterparties), not a proprietary "black box" calculation;

(vii) Use of a methodology that is robust and can be produced daily for at least 10 years after the cessation of LIBOR. We expect that the resultant fallback rates will be calculated and published centrally, available timely to all market participants in lieu of the usual "LIBOR" rate at circa 11am UK time, to align with current LIBOR operating processes.

(viii) Due to operating processes/constraints, a fallback rate that is available at the beginning of the relevant IBOR tenor would be preferable.

(ix) An approach that is as similar as possible across all currencies (including those not covered by this consultation). This covers both the operational protocol (e.g. all rates for a particular period published on the same day) and a desire not to create a new basis exposure between currencies.

We are aware that some of these criteria are mutually exclusive.

With regard to your specific questions, in line with key observations above, we comment as follows:

[Questions about 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?*
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.*
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 would recommend that the cessation triggers for LIBOR FRNs should be consistent with the cessation triggers applicable to derivatives,as per the fallback language being developed by ISDA. We do not want there to be a scenario where a LIBOR FRN has 'triggered' but a related derivative (or an interest rate swap on a fixed rate bond) has not as this would create operational difficulties and could lead to an existing hedge relationship becoming ineffective.

- We would envisage that a temporary (less than 2 days rather than 5) operational discontinuance of LIBOR may be announced by the benchmark administrator and could utilise the last (or recently) published LIBOR rate. However, a longer or permanent 'benchmark discontinuance event' should require a public statement by the regulatory supervisor for the administrator of such Benchmark announcing that such Benchmark is no longer representative or may no longer be used. ARRC's paper refers also to a statement by the central bank for the currency of such benchmark. Since USD LIBOR is published by a UK administrator, in practice this would necessitate a co-ordinated international response by the relevant authorities in the UK (Bank of England) and USA (Federal Reserve). The Consultation paper does not explicitly address how to avoid a hypothetical situation where e.g. LIBOR fallbacks were deemed to have been triggered by the USA but not by the UK authorities. Potentially this scenario could result in an issuer in the UK and an investor in USA having different legal interpretations of the applicable interest rate.

[Questions regarding the FRN fallback Replacement Benchmark waterfall:]

FRN Replacement Benchmark Waterfall
***Step 1*:** Term SOFR recommended by Relevant Governmental Body + Spread
***Step 2*:** Compounded SOFR + Spread
***Step 3*:** Spot SOFR[11] + Spread
***Step 4*:** Replacement rate recommended by Relevant Governmental Body + Spread
***Step 5*: Replacement rate in ISDA Definitions at such time[12] + Spread**
***Step 6*:** Replacement rate determined by issuer or its designee + Spread

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?*

- If the ISDA fallback methodology is compatible with FRNs (e.g. operational or value issues can be overcome) then ideally the same methodology would be used for all instruments.
- If not, then yes.

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?*

- Our preference would be for the same method (average/spot/compounded) to be used across instruments (e.g. the ISDA fallbacks) and across currencies (e.g. SONIA)

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"?*

- [see above]

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?*

- The ARRC's proposed fallback provisions reference the last printed LIBOR. Whilst this may be acceptable for [2] days, a permanent fallback should not be based upon the last daily LIBOR because there is a significant risk that the 'final' day(s) rate(s) is / (are) likely to have been distorted, or could be "gamed", under such circumstances.

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?*

- [As above]

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?*

- [see above]

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?*

- [see above]

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)?*

- [see above]

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?*

- Terms and Conditions of the FRN should be respected, including where the Issuer is granted the right to determine an appropriate fallback.
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[Spread considerations]

The table below displays **the FRN spread waterfall:**

FRN Replacement Benchmark Spread Waterfall
Step 1: Spread recommended by Relevant Governmental Body
Step 2: Spread in fallbacks for derivatives in ISDA definitions[19]
Step 3: Spread determined by issuer or its designee

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

- If the ISDA fallback methodology is compatible with FRNs (e.g. operational or value issues can be overcome) then ideally the same methodology would be used for all instruments.
- If not, then yes.

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?*

- We agree that use of the ISDA spread adjustment would be consistent with adoption of the ISDA fallback methodology.
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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?*

- Terms and Conditions of the FRN should be respected, including where the Issuer is granted the right to determine an appropriate fallback.
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[Operational considerations]

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?*

- No; we believe that corporates have limited resources and would prefer that a seamless transition be provided to the market as a whole.
- Publication of reference rates/spreads should be made available free of charge (i.e. not only through a subscription service such as Bloomberg) and published by a regulated benchmark administrator or regulatory body.

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

- Uncertainty in the event that a choice had to be made between competing fallback rates produced under alternative methodologies.

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

- **Please refer to our key observations and criteria stated in the introductory section.**
- We would wish to draw attention to the Report (July 2014) of the FSB Market Participants' Group on Reforming Interest Rate Benchmarks, specifically Appendix F which outlines the impact of LIBOR reform upon corporate users, including examples of wider commercial usages of LIBOR and potential transition issues.

Further Information

This response is given purely from our own corporate perspective and no wider significance should be inferred. For that reason, *we request that you do **not** publish any of our comments in an attributable form*. We would, however, be happy to engage further on this topic and you would be welcome to contact me in the first instance.

Yours sincerely,