

ARRC Consultation Regarding More Robust LIBOR Fallback Language For New Issuance of Libor Floating Rate Notes – BMO Capital Markets

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

Response: BMO Capital Markets (“BMO CM”) is of the opinion that the fallback language should include all three pre-cessation triggers. The pre-cessation triggers are important tools for issuers and counterparties to mitigate the risk of a drawn-out period of LIBOR failure and will provide more certainty for both clients and counterparties. BMO CM recognizes that there are concerns with pre-cessation triggers (as indicated in the response to Question 1(b) below), but we believe that the positives here outweigh the negatives and that such concerns can be mitigated with foresight and consideration.

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.

Response: BMO CM has concerns about potential basis risk arising from pre-cessation triggers mainly in connection with standard derivatives. ISDA agreements do not contain these triggers; therefore there is a misalignment between the FRNs and the derivative contracts used to hedge them at the point of a pre-cessation trigger occurrence.

In addition, because these triggers will occur significantly earlier than the termination of LIBOR, there may not be a viable market for SOFR based derivatives at the time of the pre-cessation trigger occurrence. This concern, however, will diminish as markets in SOFR continue to develop.

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?

Response: With no pre-cessation triggers, a predetermined alternative to LIBOR that has sufficient liquidity could be incorporated into FRNs so that in the pre-cessation period, the issuer will not be tied to a tight LIBOR market or a tight SOFR market.

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?

Response: BMO CM believes the market is best served by having consistency between ARRC and ISDA, but if active and liquid basis markets exist then ARRC recommending a forward-looking rate would be

less of an issue as those participants needing to hedge any basis risks would be able to do so. Under a forward-looking rate the basis between FRNs and derivatives will develop and could actively trade.

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?

Response: BMO CM believes Compounded SOFR should be "in arrears" and this would be more widely accepted by the marketplace.]

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"?

Response: BMO CM is of the opinion that Compounded SOFR should be "in arrears." We believe Compounded SOFR "in arrears" would be more widely accepted by the marketplace. This decision will be influenced by the decisions made by ISDA concerning fallbacks.

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?

Response: BMO CM does not believe that this is a good approach. Keeping an overnight rate over the period can lead to FRNs having a rate based on one-time overnight rate anomalies and can lead to manipulation in rates setting that can create unnecessary risks for stakeholders. The interest period must reflect the actual future paths for the period in question in order to be an effective risk management tool.

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?

Response: BMO CM believes the waterfall should include Compounded SOFR; we do not believe spot SOFR and a simple average of SOFR should be used as they add unnecessary risks.

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?

Response: This scenario is hard to envision but at this point of the waterfall, it seems to be a reasonable alternative, assuming the Relevant Government Body would have sufficient justification and rationale for its selection of the best alternative rate; best practices need to be considered.

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?

Response: BMO CM is of the opinion that at this point of the waterfall it seems reasonable that the fallback for SOFR-linked derivatives set forth in the ISDA definitions would be the best alternative and we continue to be supportive of aligning cash and derivatives solutions, where it makes sense to do so.

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)?

Response: BMO CM believes this step of the waterfall should 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. It would benefit market participants to have certainty at this point of the waterfall.

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?

Response: BMO CM believes the issuer or its designee should have the ability to over-ride the ISDA fallback for SOFR-linked derivatives in the ISDA definitions at this level of the waterfall, if an industry-accepted successor rate for FRNs exists at such time.

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

Response: Yes, the ARRC should consider recommending a spread adjustment that could apply to cash products, including FRNs, as long as the recommendation is markets-based and observable. We would support a spread adjustment similar to those in the ISDA Fallback Consultation.

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?

Response: BMO CM believes aligning the cash and derivatives spread adjustments when the Unadjusted Replacement Rate is the same for both makes sense and is encouraged.

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?

Response: Yes, the issuer (or its designee) should 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, if the spread adjustment is a rate that is an industry-accepted successor rate in FRNs at such time.

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?

Response: As issuer or as calculation agent, BMO CM would be willing to perform any or all of the five duties outlined. However, the absence of industry-accepted rate and/or methodology in calculating the rate or spread would make performing these tasks to every stakeholder's satisfaction much more difficult.

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

Response: BMO CM does not see anything in the proposal that would impede issuances as long as it is accepted by our clients and counterparties.

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

Response: BMO CM does not have any additional feedback to add on any aspect of the proposal at this time.