The Alternative Reference Rates Committee
Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045

(Submitted by email to arrc@ny.frb.org)

16 November 2018

Dear Sirs,

ARRC Consultation regarding more robust LIBOR fallback contract language for new issuances of USD-LIBOR floating rate notes[1]

The International Capital Market Association (ICMA) is responding to the above.

ICMA is a membership association, headquartered in Switzerland, committed to serving the needs of its wide range of members. These include private and public sector issuers, financial intermediaries, asset managers and other investors, capital market infrastructure providers, central banks, law firms and others worldwide. ICMA currently has 540 members located in over 60 countries. See: www.icmagroup.org.

ICMA has been engaging with regulators and members on the global issue of benchmark reform for several years. In particular, ICMA is a member of the Working Group on Sterling Risk-Free Reference Rates[2], a non-voting member of the Working group on euro risk-free rates[3] and participates in the National Working Group on Swiss Franc Reference Rates[4].

ICMA chairs a Sub-Group of the Working Group on Sterling Risk-Free Reference Rates focusing on benchmark transition issues in bond markets (the **Sub-Group**). In accordance with its terms of reference[5], the Sub-Group is considering the extent to which the concepts in the ARRC's consultation could be applied to GBP LIBOR bonds.

This response is not submitted by the Sub-Group. Rather, this response is submitted by the ICMA Legal and Documentation Committee[6], which gathers the heads and senior members of the legal transaction management teams of 21 ICMA member banks, in each case active in lead-managing

[1] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-FRN-Consultation.pdf

[2] https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor

[3] https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/html/index.en.html

[4] https://www.snb.ch/en/ifor/finmkt/fnmkt_benchm/id/finmkt_reformrates

[5] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/sub-group-benchmark-transition-issues-bond-markets.pdf?la=en&hash=1DDA128B01181F36CFEDA045DB2162EC80988241

[6] http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/Legal-and-Documentation-Sub-committee/.

syndicated debt securities issues in Europe. It sets out considerations that may be relevant for participants in the cross-border European and Asian bond markets in relation to the proposed fallbacks in the ARRC consultation.

Our response is not made from the perspective of the securitisation market. We understand that there will be a separate ARRC consultation related to the securitisation market.

We set out our response below and would be pleased to discuss it with you at your convenience.

Yours faithfully,

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RESPONSE

1. The suggestions of the Alternative Reference Rates Committee (**ARRC**) for more robust LIBOR fallback language in new issuances of USD-LIBOR floating rate notes is of great interest to ICMA members, who are issuing, underwriting, purchasing, trading and repo-ing such securities, as well as LIBOR linked floating rate notes in other currencies, in Europe, Asia and beyond.

2. In the light of the speech[7] given by Andrew Bailey of the FCA in July 2017 regarding the future of LIBOR and other developments such as the introduction of the EU Benchmarks Regulation[8] and an IOSCO Statement[9] of January 2018 relating to, among other things, robust fallback provisions, European and Asian bond market participants have been considering the need to use alternative fallback provisions in new floating rate bonds referencing LIBOR where those bonds mature beyond the end of 2021 when LIBOR may cease to be available[10] (referred to in this response as "long-dated" bonds).

3. As noted in the Working Group on Sterling Risk-Free Reference Rates' paper of July 2018 on new issuance of sterling bonds referencing LIBOR[11], provisions which contemplate discontinuation (or the market generally moving away from use) of a benchmark are being included in some long-dated bond terms and conditions. This approach is being adopted primarily in the vanilla bond market, and market practice has evolved since July 2017 to a point where alternative fallbacks are now common in new issues of long-dated floating rate bonds and updated or newly established multi-currency debt issuance programmes that envisage the issuance of long-dated floating rate bonds.

4. The general approach in these new provisions is different from the approach set out in the ARRC consultation paper in a number of respects. For example, alternative fallbacks typically seen in new European and Asian floating rate bonds and multi-currency debt issuance programmes are designed to apply across currencies and in respect of different benchmarks (not just LIBOR and/or other IBORs) and do not refer to specific alternative rates such as SOFR or term SOFR to address the permanent discontinuation of a rate or benchmark. Rather than referring to specific alternative RFRs or term RFRs, alternative fallbacks in European and Asian documentation typically envisage (broadly) the issuer appointing an independent adviser to select (or to advise the issuer in the selection of) an alternative or successor rate and adjustment spread to be applied to such rate on the basis of (a) any recommendations made by relevant official bodies or (b) if no such recommendations have been made, customary market practice[12]. Notwithstanding the differences in approach, it is possible that current alternative fallbacks in European and Asian documentation would

[7] https://www.fca.org.uk/news/speeches/the-future-of-libor

[8] https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A32016R1011

[9] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD589.pdf

[10] See Andrew Bailey, Chief Executive of the FCA: https://www.fca.org.uk/news/speeches/the-future-of-libor and https://www.fca.org.uk/news/speeches/interest-rate-benchmark-reform-transition-world-without-libor. See also Chairman J. Christopher Giancarlo, U.S. Commodity Futures Trading Commission https://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement071218.

[11] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/risk-free-reference-rates-new-issuance-of-sterling-bonds-referencing-libor.pdf?la=en&hash=12F13D37E21F4B789813ED7386F34DA347370323

[12] The alternative fallbacks contained in some regulatory capital securities are stated to be subject to compliance with any regulatory requirements.

result in the same outcome as the proposed ARRC fallbacks if they were to be applied in the case of USD-LIBOR floating rate notes. This is particularly likely if the ARRC was to endorse a fallback rate and/or adjustment spread. See further paragraph 9 below.

5. In the case of the European securitisation market, AFME has developed standard language to provide for certain changes to be made to bond terms and conditions via a simplified consent mechanism with the involvement of the bond trustee[13]. To date such a mechanism has not been seen in the vanilla bond markets, where a trustee may not be a feature of many transactions.

6. With this background, many ICMA members are considering the following points in relation to the proposed ARRC fallback language.

General observations and considerations

Legal certainty, commercial acceptability and official endorsement

7. It is important that any alternative fallbacks are both commercially acceptable and sufficiently legally certain to operate as expected by the parties in the event of LIBOR discontinuation. Bond market participants may therefore wish to consider if the degree of legal certainty and/or the commercial acceptability in respect of the proposed ARRC fallbacks is sufficiently increased from current alternative fallbacks to justify amending practice in the European and Asian international bond market now (see further paragraphs 10 and 15 below).

8. Several limbs of the ARRC fallbacks refer to selection, endorsement or recommendation by a "Relevant Governmental Body", which is defined to include "a committee officially endorsed or convened by the Federal Reserve Board and/or the Federal Reserve Bank of New York or any successor thereto" (e.g. the ARRC). Market participants may infer from the ARRC's publication of this suggested fallback language that the ARRC is currently expecting to select, endorse or recommend the fallback rate(s) and an adjustment spread as envisaged in the ARRC consultation paper. It is not clear at the moment whether official sector-sponsored working groups in other LIBOR jurisdictions would take a similar approach or not.

9. Any selection, endorsement or recommendation of an alternative rate and adjustment spread by official sector working groups or authorities is likely to help in the operation of alternative fallback language that is currently being used in European and Asian bond markets, which typically refer to a rate and/or adjustment spread selected by an independent adviser (or the issuer) on the basis of any recommendation by a relevant official body.

Timing for use of alternative LIBOR fallbacks, including the ARRC fallbacks

10. As noted in the Working Group on Sterling Risk-Free Reference Rates' paper of July 2018 on new issuance of sterling bonds referencing LIBOR[14], it is anticipated that LIBOR will continue to be referenced only in the interim period before market conventions and infrastructure for

[13] https://www.afme.eu/globalassets/downloads/briefing-notes/2017/afme-benchmarl-rate-modification-language-april-2018.pdf

[14] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/risk-free-reference-rates-new-issuance-of-sterling-bonds-referencing-libor.pdf?la=en&hash=12F13D37E21F4B789813ED7386F34DA347370323

referencing alternatives to LIBOR are fully developed. Therefore it is assumed that the ARRC fallback language is intended for use only in the period of time between the time that such language is finalised and the time when all new floating rate bonds reference alternatives to USD-LIBOR, such as SOFR or term SOFR[15]. For certain currencies (e.g. sterling), this period may be relatively short.

11. While the new markets for floating rate notes referencing SOFR and other alternative RFRs (e.g. SONIA) are in their infancy, these markets are expected to develop as market participants invest in relevant infrastructure to issue, hedge, purchase, trade and repo SOFR and other RFR-referenced bonds. The development of these markets is very important given the need for financial markets to transition away from LIBOR[16]. It is hoped that the publication of LIBOR fallbacks will not undermine, or detract attention away from, efforts to develop such markets in the period between now and the end of 2021 when LIBOR publication could end.

Interaction with ISDA Benchmarks Supplement

12. The ARRC consultation refers to interaction with ISDA's IBOR fallback work. There are some conceptual differences between the fallback provisions set out in the ARRC consultation and those set out in the ISDA Benchmarks Supplement[17]. Because the ISDA Benchmarks Supplement was developed in response to the EU Benchmark Regulation, it is anticipated that European entities in particular may incorporate the provisions of the ISDA Benchmarks Supplement into their swap transactions. While ISDA's IBOR fallbacks (triggered by actual discontinuation) will take precedence for USD-LIBOR and other specified IBORs once implemented, the provisions of the ISDA Benchmarks Supplement may be used in advance of the ISDA IBOR fallbacks being implemented[18] and, after implementation of the ISDA IBOR fallbacks, would apply if the ISDA IBOR fallbacks fail and/or at the occurrence of certain trigger events other than actual discontinuation (e.g. illegality). Bond market participants may therefore wish to consider whether the extent of the mismatch between the terms of a bond that uses the ARRC fallbacks and any associated swap that uses the fallbacks set out in the ISDA Benchmarks Supplement would be problematic.

Multi-currency debt issuance programmes

13. The ARRC consultation appears to relate to standard fallback language for any floating rate note denominated in US dollars, regardless of whether there is any other nexus with the US (e.g. a US issuer or New York governing law). It is not clear whether the proposed ARRC

[15] Although any alternative IBOR fallbacks may only be used for a limited period of time while IBORs are still being referenced in new bond issues, the concept of more robust fallbacks for a permanent discontinuation of a rate (including alternative RFRs) will be relevant going forward in the light of the requirements of the EU Benchmark Regulation and the IOSCO Statement referenced in paragraph 2 above.

[16] See, for example, Andrew Bailey of the FCA's speech of 12 July 2018 (https://www.fca.org.uk/news/speeches/the-future-of-libor) and the opening statement of Chairman J. Christopher Giancarlo before the U.S. Commodity Futures Trading Commission Market Risk Advisory Committee Meeting, Washington, D.C. on 12 July 2018: https://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement071218

[17] For example, the ISDA Benchmarks Supplement does not envisage pre-cessation triggers. In addition, the waterfall of fallbacks in the ISDA Benchmarks Supplement is different to that set out in the ARRC consultation paper (although, depending on the precise circumstances, it is possible that the two waterfalls could nevertheless result in a similar outcome). The provisions relating to adjustment spread are also different.

[18] It is worth noting that ISDA has not yet consulted on IBOR fallbacks for USD-LIBOR.

fallbacks are intended to apply to new bonds issued on a standalone basis or under a multi-currency debt issuance programme or both.

14. Many international bonds are issued under multi-currency debt issuance programmes. Historically, one set of fallbacks has applied to any issuance of bonds under the programme, regardless of the currency or reference rate of the particular bond issue. Some bond market participants may consider it desirable to try to maintain that approach.

    a. Maintaining the current approach could be achieved by considering whether the concepts in the proposed ARRC fallbacks could be applied to other currencies[19] or, alternatively, continuing to use current alternative fallbacks in their multi-currency debt issuance programmes and using the proposed ARRC fallbacks in the case of USD-denominated standalone floating rate note issuance only.

    b. Alternatively, issuers could consider departing from traditional practice and including different provisions for bonds denominated in different currencies and referencing different rates in their multi-currency programmes. However, this could result in lengthy fallback provisions in multi-currency debt issuance programmes and increase the risk of operational error and confusion.

15. In addition, multi-currency debt issuance programmes are typically updated on an annual basis (although in some cases it is possible to update a programme during the annual cycle using a prospectus supplement). This practical consideration, coupled with the timing points noted in paragraph 10 above, could impact upon an issuer's approach to updating their alternative fallbacks in the context of a European or Asian multi-currency debt issuance programme.

Specific considerations: ARRC trigger events

16. ARRC is consulting on several fallback triggers including events that would match the events that ISDA is anticipating using in its IBOR fallbacks, as well as several additional "pre-cessation" triggers. ARRC is asking for feedback on the pre-cessation triggers and indicates that some market participants might be concerned by any differences between floating rate note triggers and triggers for standard derivatives. ARRC also asks market participants to consider 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.

17. As noted above, consistency with ISDA's ongoing IBOR fallback work is one important consideration for bond issuers and investors that will be hedging their positions. However, they may also wish to consider consistency with fallbacks in the ISDA Benchmarks Supplement (as noted above) and, potentially, fallbacks in their floating rate note issuance/holdings in different currencies.

18. A general consideration is the need to ensure that fallback triggers are objective and reduce to the extent possible any uncertainty as to whether the fallback has been triggered or not.

[19] This may also be considered by official-sector sponsored RFR working groups in other IBOR jurisdictions, noting that this is referenced in the Terms of Reference for the Sterling RFR Working Group's Sub-Group on Benchmark Transition Issues in Bond Markets and the Terms of Reference for the Sub-Group to the Working Group on Euro Risk-Free Rates on contract issues (work stream #3).

In this respect, issuers in Europe and Asia do not currently tend to include "pre-cessation" triggers in new, long-dated, floating rate note issues.

Specific considerations: ARRC replacement benchmark waterfall

19. ARRC summarises its proposed floating rate note replacement benchmark waterfall as follows:

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

Term SOFR as the first fallback rate

20. The first proposed fallback in the ARRC consultation is to forward-looking term SOFR that is selected, endorsed or recommended by the Relevant Governmental Body plus an adjustment spread. In order to adopt this approach, it seems likely that bond market participants would wish to feel reasonably confident that: (a) a term SOFR will be developed, and (b) that it will be selected, endorsed or recommended by a Relevant Governmental Body, in each case before the end of 2021. Alternatively, they would need to feel comfortable relying on the alternative fallback provisions lower down the waterfall. As noted above, market participants may infer from the ARRC's publication of this suggested fallback language that the ARRC is currently expecting to select, endorse or recommend a term SOFR.

21. Market participants are also likely to need to feel comfortable that any term SOFR or other term RFR that is used as a fallback will, once developed, be sufficiently robust to be relied upon as a first fallback. The FSB has noted that it does not expect RFR-derived term rates to be as robust as the RFRs themselves, and they should be used only where necessary[20]. In this regard, it is worth noting that several bonds referencing compounded overnight SONIA have already been issued.

Compounded SOFR as the second fallback

22. The second proposed fallback is to compounded SOFR plus an adjustment spread.

23. The operation of this fallback (and indeed possibly other fallbacks further down the waterfall) would result in a bond that currently references a forward-looking term rate referencing a backward-looking rate after the operation of the fallback. Market participants would need to consider the implications of this, including from the perspectives of cash flow management, IT systems and infrastructure.

24. It is proposed that the method for compounding daily SOFR would refer to the methodology used in the ISDA definition of USD-SOFR-COMPOUND calculated either (i) over the relevant interest period with a lock-up period prior to the end of the interest period or (ii) at the start of the interest period using the historic compounded SOFR rate for the period that ends

[20] http://www.fsb.org/wp-content/uploads/P120718.pdf

immediately prior to that date. As noted above, the new SOFR bond market is in its infancy and market conventions are arguably not yet fully developed or settled. Bond market participants may wish to consider the extent to which it would be problematic if a USD-LIBOR bond were to fall back to a compounded SOFR where the interest was calculated in a different manner to any new SOFR bonds.

25. This aspect may also be relevant in the context of applying ARRC-style fallbacks to floating rate notes denominated in other currencies. For example, neither of the proposed methods for calculating interest using compounded SOFR would match the market conventions that have been adopted in new SONIA bonds to date.

Spot SOFR as the third fallback

26. The third proposed fallback is to spot SOFR plus an adjustment spread. In using this fallback, market participants would need to feel comfortable accepting the risk associated with the possibility that any unusual volatility in SOFR on a particular day could be "locked-in" for an entire interest period.

Issuer-determined replacement rate as the final fallback

27. It is proposed that if the issuer (or its designated agent) determines that the ISDA fallback for SOFR-based derivatives in the ISDA definitions is not an industry-accepted successor rate for floating rate note issuances, then the issuer or its designated agent has discretion to select a replacement rate. Similarly, the final step in the adjustment spread waterfall is to a spread selected by the issuer or its designee. Bond market participants may wish to consider:

    a. the extent to which this would be appropriate in the context of all types of floating rate note issuances including corporate floating rate notes (where the issuer may not be as willing or able to determine a replacement rate or spread as a financial institution issuer);

    b. whether investors would be comfortable accepting this as a final fallback/spread in all circumstances; and

    c. possibly, the use of the independent adviser concept that is currently used in alternative European and Asian fallbacks (see paragraph 4 above) if this element of the ARRC proposal is not felt to be workable in all cases.

Specific considerations: ARRC spread

28. ARRC is also consulting on provisions relating to an adjustment spread, which are summarised as follows:

FRN Replacement Benchmark Spread Waterfall
Step 1: Spread recommended by Relevant Governmental Body
Step 2: Spread in fallbacks for derivatives in ISDA definitions (only applicable in certain scenarios)
Step 3: Spread determined by issuer or its designee

29. See paragraphs 8 and 20 in relation to the possible considerations associated with a spread recommended by the Relevant Governmental Body.

30. See paragraph 27 above in relation to the possible considerations associated with a spread determined by the issuer or its designee. In addition, the question of whether a particular spread adjustment will produce a replacement benchmark that is an "industry-accepted successor rate" may not be straight-forward and, if that were to be the case, it is possible that a selection of any spread adjustment by the issuer, or its designee, could be open to challenge. Some issuers may be unwilling to make a selection in these circumstances, in which case it is not clear what spread would apply.

Conclusion

31. The above considerations may be relevant for bond market participants (particularly those based in Europe and Asia) in determining whether and how to adopt the proposed ARRC fallback provisions. ICMA members will continue to discuss and consider the most appropriate methods of managing their risk in relation to continued use of LIBOR in the interim period before market conventions and infrastructure for referencing alternatives to LIBOR are fully developed.