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ARRC Securitization Consultation Answers



Submitted by Federal Home Loan Bank of Cincinnati

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Question 1: Which securitization asset classes are you referring to in your response to this consultation if limited to only certain asset classes? If there are particular features of these asset classes that shape your responses to the questions in this survey, please describe them to the extent possible.

Mortgage Backed Securitizations including both residential and commercial mortgage securities.

Question 2: The ISDA triggers contemplate a permanent cessation of LIBOR as of a date certain which may be announced in advance (the “Cessation Date”), at which point the transition from LIBOR to SOFR would occur. As there may be operational challenges for securitizations as both assets and liabilities will have to be transitioned, some have asked for the ability to transition in advance of the Cessation Date in order to address any operational issues that may arise. Specifically, the Designated Transaction Representative (as defined in Appendix I) will have the ability to pick one date within a 30-day period prior to the Cessation Date to facilitate an orderly transition. Do you feel the inclusion of this ability to transfer prior to the Cessation Date is needed? If so, please explain the specific, critical and tangible needs that support its inclusion?

Yes. Having the ability to pick a transition date will allow all parties to the securitization more time to prepare for a date-certain adjustment to the reference rate. Also, having the ability to transition possibly earlier than the announced cessation date will allow investors the ability to trigger other contracts that may require some type of notification period. The Bank does not necessarily agree that only the Designated Transaction Representative should arbitrarily be able to pick a transition date if market factors are not in place to support the movement to the new benchmark.

Question 3(a): Should fallback language for Securitizations include any of the pre-cessation triggers (clauses (3), (4), (5) and (6) of the Benchmark Discontinuance Event definition)? If so, which ones? Also, please identify any pre-cessation triggers that you do not believe should be utilized for a particular securitization product and explain why.

Yes, all of the pre-cessation triggers should be included, except for (6). If, as time progresses and the market approaches the 2021 deadline, LIBOR may become more difficult to trade due to liquidity or uncertainty and a regulator has yet to make a public statement, the pre-cessation triggers will become more important. We believe that the regulator of LIBOR (the FCA) has indicated that they are willing to determine that LIBOR is not representative of the market which would invalidate LIBOR as a reference rate. The Bank views this as a positive and would lead it to favor trigger (5), as that would better-enable the synchronization of triggers between the securitization market and derivatives market.

Question 3(b): Please indicate whether any concerns you have about these pre-cessation triggers relate to the differences between these securitization triggers and those for standard derivatives or whether your concerns relate specifically to the pre-cessation triggers themselves.

We believe that as there are different market participants in the standard derivatives products markets versus the securitization markets, and there are different regulators and trade organizations in the standard derivatives markets versus the securitization markets, differences between the two markets are to be expected and one market cannot limit itself by what is happening in the other market. To the extent possible harmonization of the triggers between the securitization market and derivatives market should be the goal to



limit the exchange of value between market participants. This is not meant to say that there cannot be differences between the two. The Bank also questions the immediate assumption that the derivatives market language is the “gold standard” to strive towards.

Question 3(c): If you believe that the pre-cessation trigger in clause (6) (Asset Replacement Percentage) should not be retained, please note any specific concerns leading to this conclusion. If you believe that it should be retained, are there any changes you believe should be made to this trigger? Please explain.

Clause (6) seems vague and open-ended in terms of a Designated Transaction Representative’s ability to select and implement an alternative reference rate. The percentage of underlying assets moving to a new benchmark (not necessarily SOFR) may present basis risk within the structure and collapse the structure, if the cash flows are insufficient, long before the 50% level is reached. This trigger seems ill conceived as a trigger for all securitizations to move to a new reference rate. The 50% seems arbitrary and to give the Designated Transaction Representative the ability to determine the replacement percentage requirement for the trigger seems open to manipulation and possible legal action by bond holders. This option does not present the bright line that investors are seeking for a trigger event.

Question 3(d): If you believe the pre-cessation trigger in clause (6) (Asset Replacement Percentage) should be retained, how would you address concerns that it could result in a transfer of value in a transaction where the Designated Transaction Representative has the ability to change the benchmark used on the underlying assets and, as a result, determine the timing of this pre-cessation trigger? Are there other changes that should be made to the Asset Replacement Percentage trigger? Note that this trigger relates to a mismatch between the securities and the Securitization assets that results from changes in the assets. A mismatch may also arise from a change in the securities due to a trigger event under these fallback provisions. Any concerns with the latter scenario can be addressed in responses to Question 16.

N/A

Question 3(e): If pre-cessation triggers are not included, are there options available to market participants to manage the potential risks involved in continuing to reference a Benchmark in the circumstances contemplated by each of these pre-cessation triggers?

The Bank believes pre-cessation triggers should be included as there are not widely available options for market participants to hedge risk related to the cessation of the benchmark, apart from selling the asset into the market at a depressed price or reverting to legal action. If ISDA adopts pre-cessation triggers, the lack of pre-cessation triggers in the securitization market would create potential value exchange scenarios at the time of reference rate transition for securitization transactions.

Question 4: Should the proposed securitization fallback language permit the Designated Transaction Representative to transition the securities after a trigger has occurred but before the Benchmark Replacement Date? Should any limitations be placed on its use? Should there be a limited date range (e.g., 60 days) prior to the Benchmark Replacement Date in which this could be used? Should the Designated Transaction Representative be limited in the circumstances under which it could elect to utilize the additional time? If so, what standard should be utilized to assess whether the additional time is necessary? In each case, please explain why.



Yes, the ability to transition securities to a new reference rate after a trigger event, but before the Benchmark Replacement Date, is key to ensuring a smooth rate transition process as it will allow time for communication and transition coordination among the transaction parties. The 60-day timeframe seems reasonable. Limiting the time for cessation ensures the least amount of opportunities for manipulation of the market for those participants that wish to liquidate or hedge their positions. The requirement should be for an “orderly movement” to a new benchmark rate which would call on all market participants to clearly communicate deadlines and actions that need to be taken. By having all securitizations move to the new benchmark on the same cessation date without the option to move at an earlier date you are forcing a “big bang” date in which the market may not be ready for the volume of transactions that may be created.

Question 5(a): If ARRC has recommended a forward-looking term rate, should that rate be the primary fallback for the securities referencing LIBOR even though derivatives are expected to reference overnight versions of SOFR? Please explain why.

Yes. The derivatives market is utilized for a myriad of purposes by investors. In the securitization market, mortgage holders want to know what their payments are going to be instead of waiting to calculate the payment in arrears at some point. Underwriters want to be able to estimate the payments for the mortgage holder to underwrite their ability to replay the mortgage. Holders of the securitizations want to be able to calculate accruals for mortgages that pay at times other than month-ends. The derivatives market is very efficient at developing products that support the hedging of cash products and we believe they would also adapt.

Question 5(b): Is there a specific reason that the securitization market should first fall back to forward-looking term SOFR instead of another rate? Please explain why.

ARRC has chosen SOFR as the primary alternative reference rate for LIBOR transactions. To the extent term SOFR has been established and accepted by the market participants it should be utilized as the benchmark rate. SOFR meets the IOSCO standards as far as transparency and being transaction based. If another benchmark were to be developed that met these requirements and the market were to accept the benchmark, one would assume that the benchmark would be acceptable for use by the investment community. In all SOFR transactions, fallback language needs to be incorporated that anticipates that SOFR may cease at some point and a fallback rate would need to be utilized. This could be any rate that meets the stated requirements of the market and regulators.

Question 5(c): Is the use of an Interpolated Period appropriate in the securitization markets? Please explain any limitations that should be applied to the use of an Interpolated Period.

The use of an interpolated period is standard in the pricing of stub periods for swaps transactions. Interpolated periods is not a new concept to the market and is appropriate. This would be appropriate provided there were enough points to be able to create a valid interpolation. For example a one-week term rate and a ten-year term rate being the only points to establish a 6-month rate may not be appropriate. Analysis will have to be done to determine the correct points for interpolation and if the markets utilized to create the base data (such as the futures markets) are appropriate given their possible flaws.



Question 5(d): In the event a Replacement Benchmark is determined other than under Step 1 of the waterfall, should the waterfall provide that the Replacement Benchmark be changed in the future as soon as a rate can be established under Step 1 of the waterfall?

Yes, unless the Replacement Benchmark was determined in step 3 of the waterfall. Both step 1 and step 3 use the recommendation of a Relevant Government Body to establish the new benchmark. By reverting to step 1 of the waterfall, it should make the securitization market more consistent in its application of benchmark rates for new and legacy investments.

Question 6(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?

No. Current bond market issuance has shown that simple average SOFR has become the market standard. Investor systems require major changes to be able to accept compounded SOFR for debt instruments (information we have gleaned from Dealer feedback). This would cause a hardship for issuers and investors and the difference for compounding could be incorporated in the spread adjustment.

Question 6(b): If you believe that Compounded SOFR should be included, which compounding period is preferable (“in arrears” or “in advance”)? Please explain why. Would this preference be influenced by whether ISDA implements fallbacks referencing Compounded SOFR “in arrears” or “in advance?” Please explain whether your preference is based on operational concerns in implementing a particular approach or on economic concerns.

In arrears. This would allow less manipulation of the rate by market participants and we believe it matches the preference from the ISDA non-USD LIBOR consultation.

Question 6(c): If it was necessary to calculate Compounded SOFR and a third party was not available to perform those calculations, are there parties to the Securitization transactions with sufficient resources to perform those calculations accurately and efficiently? Are there other considerations relating to the calculation of Compound SOFR that would make it an undesirable Replacement Benchmark without the availability of a third party provider?

The trustees in the securitizations would demand more compensation to modify their systems to be able to calculate a compounded SOFR rate and to answer questions from investors regarding the calculations. Investors would then need to have systems to also be able to complete the calculations to assure correct interest payments.

Question 7: As noted, this consultation does not include Spot SOFR as a third step in the waterfall. Do you believe that Spot SOFR is an appropriate fallback reference rate for Securitization contracts or should the second step in the replacement rate waterfall be Compounded SOFR, after which the replacement rate would be, first, recommended by the Relevant Governmental Body, second, default to then-current ISDA Definitions, and third, proposed by the Designated Transaction Representative?

No, Spot SOFR is not an appropriate fallback reference rate for securitization transactions other than overnight. Spot SOFR is much too volatile to be utilized as a fallback reference rate. The Bank would



recommend omitting compounded SOFR in the waterfall and moving directly to the rate recommended by Relevant Government Body + Spread.

Question 8: 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? Please explain why.

We believe that the fall backs should incorporate OBFR with the final fallback being Fed Funds at this point but this may not always hold true, and the event that SOFR or Fed Funds may not exist in the future needs to be planned for by falling back to a rate determined by the relevant government body. The Bank makes the assumption that a similar process to the ARRC and its working groups would be convened to assist the government body in determining the replacement rate. This process has been beneficial as it has brought together buy and sell side investors, trade organizations, regulators and government bodies to work together to come to a series compromises and decisions.

Question 9: In the future circumstance where there is no SOFR-based fallback rate and the Relevant Governmental Body has not recommended a replacement rate for Securitizations, is the fallback for SOFR-linked derivatives set forth in the ISDA definitions at the time of cessation the best alternative at this level of the waterfall? Is this fallback appropriate if ISDA Definitions only include overnight fallback rates? Please explain why.

At this time we feel that the ISDA fallbacks would be the best alternatives for this level of the waterfall but that government bodies should be aware of the consequences of not prioritizing the decision making process for reference rate recommendations and the possible market ramifications.

Question 10(a): Since it is unlikely that there will be no ISDA fallback (clause (a) above), this provision is more likely to occur (if at all) when the ISDA fallback is deemed not appropriate for securitization securities (clause (b) above). In that scenario, is this provision appropriate as the final step in the Replacement Benchmark waterfall? Please explain why.

No. The Bank is unclear as to the criteria that the Designated Transaction Representative would utilize to make the determination that the ISDA fallback rate is not appropriate for securitization securities, and it does not appear feasible to be able to create an equitable voting mechanism for bond holders to approve/veto this decision.

Question 10(b): Should the provision allow for “re-testing” the waterfall to determine whether another Replacement Benchmark has become available in the scenario where investors have rejected the Proposed Replacement Benchmark? Should the waterfall be re-tested in any other circumstances (e.g., any time the Replacement Benchmark has been determined under a “less-desirable” clause)? How often? Please explain why.

N/A, as the Bank is not in favor of this step in the waterfall. Once an alternative reference rate has been established for a securitization transaction, that rate should stay in effect until the rate is no longer available or governmental or regulatory body has determined the rate unfit for use.



Question 11: Are there any concerns if a spread adjustment was utilized with cash products that was calculated by a spot rate comparison of the difference between LIBOR and the Replacement Base Rate at the time of conversion? Should this option be included in the spread waterfall? If so, where?

Yes, the spot spread adjustment at the time of conversion may not be representative of the recent behavior of the spread component or the projected behavior of the spread component. As the spread will remain in place for the life of the securitization it is important that it is representative of the value to each participant and that there is not an inadvertent value transfer based on timing of the conversion.

Question 12: Do you believe that the ARRC should consider recommending a spread adjustment that could apply to cash products, including Securitizations?

Yes, the ARRC should provide a framework for the spread adjustment. Whether it be the Fed or the Fed directing a third party to set the adjustment (similar to ISDA employing a third-party contractor), it would be a more secure process for investors and issuers.

Question 13(a): Is a spread adjustment applicable to fallbacks for derivatives under the ISDA definitions appropriate as the second priority in the spread waterfall? Please explain why.

Yes, assuming the spread adjustment calculation incorporates both a term adjustment and a credit adjustment between the risk free SOFR versus LIBOR and a simple average SOFR versus a forward looking LIBOR rate.

Question 13(b): If the ARRC has recommended a forward-looking term SOFR but has not recommended a corresponding spread adjustment under Step 1 above, do you believe that the ISDA spread adjustment described in Step 2 (which may be intended to apply to a different Replacement Base Rate) should apply to Securitizations? Please explain why.

This would need to be determined based on the two replacement rates. This may not be appropriate. The ARRC should be recommending a corresponding spread adjustment as part of its deliverables.

Question 13(c): Given that ISDA has not yet decided upon the spread calculation methodology, should Step 2 be excluded from the waterfall? Please explain why.

No. If ISDA has not yet decided on the spread calculation methodology at the time of the Replacement Benchmark selection, then that step of the waterfall would be ignored because the ISDA spread is unavailable. To suggest not including the step in the spread selection waterfall, just because ISDA has not determined the calculation methodology for the spread as of this moment, is a bit premature. The Bank does believe that the step should include analysis as to the appropriateness of the spread adjustment recommended by ISDA and the criteria for that analysis.

Question 14(a): What type of institution can and should take on the responsibility 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/or (v) elect to cause an early transition under the proviso to the definition of Benchmark Replacement Date?



Ideally, a set of provincial regulators would make all of the determinations noted above. In the absence of a provincial regulators determining trigger occurrence or an early transition event, any other determination agent would risk litigation when making such determinations. Items ii, iii, and iv could be done by a reputable industry group (ISDA; SIFMA; etc.).

Question 14(b): Whether as issuer, sponsor, servicer 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/or (v) elect to cause an early transition under the proviso to the definition of Benchmark Replacement Date?

No. We do not feel that the Federal Home Loan Banks are representative of both the buy and sell side of investors and we are limited in the types of securitizations that we may enter into by our regulator.

Question 15: Is there any provision in the proposal that would significantly impede Securitization issuances? If so, please provide a specific and detailed explanation.

The lack of a specific plan to help coordinate the reference rate transition triggers between securitization assets and associated cash market debt and derivatives is the biggest issue. Products triggering at different times leads to value transfer among market participants. This should be minimized as much as possible.

Question 16: Given the fallback language for the Securitization and the underlying assets may operate independently, please identify any sources of misalignment between those components that are not addressed in the consultation.

If underlying assets of securitization's trigger at different times, highly structured instruments such as certain Collateralized Mortgage Obligations which depend on modeled cash flows may not function as modeled or priced and cause harm to investors which could harm the securitization market due to the uncertainty.

Question 17: Are there specific operational challenges that implementing the proposed fallback language might create for securitizations? If so, what are those challenges and under what circumstances might they occur? How might they be mitigated?

Operationally it will be difficult to maintain a portfolio of securitizations, MBS, CMO which have the ability to trigger to different rates and may have done so. Having to have systems that can support multiple benchmarks for floating rate assets will be costly and time consuming. The modeling of these assets for accounting and portfolio optimization purposes will also be much more complex.

Question 18: Please provide any additional feedback on any aspect of the proposal.