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The Secretariat of the
Alternative Reference Rates Committee
(via Email: arrc@ny.frb.org)

Comments on the ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for New Originations of LIBOR Syndicated Business Loans

Dear Sirs/Madams:

We, the Japanese Bankers Association (JBA), would like to express our gratitude for this opportunity to comment on the "Consultation Regarding More Robust LIBOR Fallback Contract Language for New Originations of LIBOR Syndicated Business Loans" (hereafter, "The Consultation") published on September 24, 2018 by the Alternative Reference Rates Committee (ARRC). We respectfully expect that the following comments will contribute to your further discussion.

1. General Comments

(1) Development of term rates

The development of term rates is being discussed globally and consultation concerning Term SONIA was published by Sterling RFR WG in the UK.

We believe that there are practical difficulties in using the compounded overnight rate (setting in arrears) for cash products, and that there are issues in referencing the compounded overnight rate (setting in advance), which does not reflect actual market conditions due to the gap between its reference period and interest period, as we have indicated in our comments[1] to the consultation "Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA Definitions[2]," published by International Swaps and Derivatives Association (ISDA) on July 12, 2018.

We welcome the waterfall approach for replacement benchmark proposed by the ARRC, which places the forward-looking term Secured Overnight Financing Rate (SOFR) in the first step of the waterfall. We believe this appropriately reflects the needs of cash products users. However, as indicated in The Consultation, the forward-looking term SOFR has not been developed yet and its publication is not ensured at present. While we strongly expect that

[1] See https://www.zenginkyo.or.jp/fileadmin/res/en/news/news301022.pdf
[2] http://assets.isda.org/media/f253b540-193/42c13663-pdf/

robust forward-looking term SOFR will be developed as planned, we also understand that the replacement rate included in the second step in the waterfall could be applied alternatively. If the ARRC considers placing the compounded SOFR in the second step, it should carefully consider the impacts on existing operations and systems and the practical feasibility for related parties in syndicated loans.

(2) Consistency between derivatives and cash products

We think it is important that the respective fallbacks for derivatives and cash products are consistent from the hedge effectiveness perspective, particularly in terms of both the replacement rate and the triggers as mentioned below. If the hedge relationship between cash products and derivatives cannot be effectively maintained after a fallback is triggered, it would be extremely difficult to gain acceptance from financial institutions participating in the syndicated loans and borrowers.

Generally, the hedging needs of cash products underlie derivative transactions. Considering this, we believe that the ARRC's proposal appropriately reflects the needs of cash products users, with Term SOFR being the first priority replacement rate in the waterfall, and spread recommended by relevant governmental body being placed higher in the waterfall than spread in fallbacks for derivatives in ISDA definitions.

a. Replacement rate

While The Consultation refers to the benefits of aligning the replacement rate across products (i.e. derivatives, loans, bonds and securitizations), the proposed replacement rate is, to our understanding, not completely consistent with ISDA's proposed fallbacks for derivatives[3]. We request the ARRC to sufficiently take this point into account in its discussion because the consistency between derivatives and cash products is important from the hedge effectiveness perspective.

b. Triggers

While ISDA's consultation defines an IBOR's permanent discontinuation as a fallback trigger, The Consultation includes those events taking place prior to the IBOR's permanent discontinuation into the fallback triggers as well. If such triggers that can effectuate the fallback prior to LIBOR cessation are applicable solely for syndicated loans, the hedge relationship with derivatives may not be maintained when such a trigger occurs. In this regard, the ARRC should ensure consistency between derivatives and cash products as much as

[3] ISDA's proposed fallbacks for derivatives are intended to solely apply overnight RFRs because the availability of term RFRs is uncertain at this point. ISDA does not give any indication for future reviews once the term RFRs become available going forward.

possible, although we understand that the ARRC recognizes differences in characters between ISDA fallback triggers used for standard derivatives contracts and proposed fallback provisions used for flexible syndicated loan contracts.

In addition, in developing Pre-cessation triggers, etc., we believe that the ARRC should also take into account whether syndicated loan users will be able to complete their preparation in advance and to take necessary actions in a smooth manner once a trigger occurs.

(3) Publication

Syndicated loans have characteristics that it is necessary to obtain an approval from many related parties involved.

In order for the administrative agent to notify rates promptly to related parties upon the occurrence of a trigger, the replacement rate needs to be published by a third-party organization. To ensure this, it is necessary to have in place a mechanism where replacement rates are published by a third-party organization prior to LIBOR cessation and are made readily accessible to all parties to the contract including the administrative agent. In addition, the fact that the trigger has occurred should also be published so that all related parties will be able to know about the fact in a timely manner.

(4) Timing of finalization and application

In finalizing the fallback language, it is necessary to ensure that financial institutions and end users have in place sufficient infrastructures necessary for the fallbacks. For example, it is important to ensure that end users have a sufficient degree of recognition and understanding about the fallback in order to obtain their approval and that the front and middle offices have appropriately established revenue management and risk management frameworks, including systems development.

In this view, the ARRC should carefully consider the timing of finalization and application.

2. Answers to the Questions

A. General Approach of the Two Fallback Proposals

Question 1 *If the ARRC were to adopt one or more sets of business loan fallback language, which one or both of the recommended provisions (i.e., amendment approach and/or hardwired approach), in your view, is an appropriate policy? If you believe the amendment approach is more appropriate at present, what specific information (for instance, existence of term SOFR) would you need in order to get comfortable eventually adopting a hard-wired approach? Why?*

(Answer)

Both of the approaches are considered to be appropriate at this time.

(Rationale)

Eventually, the hardwired approach is preferable because provisions with more streamlined process are expected to result in a smoother and broader transition to a replacement rate upon benchmark cessation. However, the hardwired approach incorporates interest rates and spreads that do not currently exist, giving rise to a risk that the actual interest rate and spread that will be set might differ from what is originally expected at the time of concluding a contract based on the hardwired approach. From this viewpoint, it would be realistic to enter into a contract based on the amendment approach first and then agree to amend the contract to apply the hardwired approach once the relevant interest rates and spreads are developed.

B. Triggers

Question 2 *(a) Should fallback language for business loans include any of the pre-cessation triggers (triggers 3, 4 or 5)? If so, which ones?*

(Answer)

Any of the pre-cessation triggers could be included so long as consistency with ISDA fallback triggers is ensured. If triggers vary between the ARRC and ISDA frameworks, the timing of occurrence of triggers could differ, which may result in failure to maintain the hedge relationship with derivatives. In that case, the ARRC should note that it is not preferable to include the pre-cessation triggers. In developing pre-cessation triggers, the ARRC should also take into account whether syndicated loan users will be able to complete their preparation prior to the occurrence of triggers and to take necessary actions in a smooth manner once a trigger occurs.

(Rationale)

As commented in the “Answer” above.

Question 2 *(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.*

(Answer)

Preferably, the pre-cessation triggers should be consistent with those for derivatives serving as hedging instrument.

(Rationale)

If the hedge relationship between cash products including syndicated loans and derivatives cannot be effectively maintained after a fallback is triggered, it would be extremely difficult to gain acceptance from financial institutions participating in the syndicated loans and borrowers.

Question 2 *(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?*

(Answer)

One possible option would be for industry organizations (e.g. LSTA or LMA) to make public in advance the template of fallback language including pre-cessation triggers that has been agreed among members of the organization and to declare that the trigger has occurred.

(Rationale)

Without any provision pertaining to pre-cessation triggers, the parties to the contract will need to decide on a contract-by-contract basis whether to continue using the reference benchmark. This could undermine the stability of contractual relationships in the case of syndicated loans where reaching an agreement is extremely difficult as there are many parties involved.

Question 3 *(a) Is an "opt-in" trigger appropriate to include? Why or why not?*

(Answer)

The consistency with ISDA fallback triggers should be taken into account in order to avoid that a difference in the timing of occurrence of triggers would fail to maintain the hedge relationship with derivatives. In developing "opt-in" trigger, the ARRC should also take into account whether syndicated loan users will be able to complete their preparation in advance and take necessary actions in a smooth manner once a trigger occurs.

(Rationale)

With "opt-in" trigger, it would be possible to minimize the concentration risk of operations arising from the simultaneous occurrence of transitions to the replacement rate upon the occurrence of triggers 1 to 5. When using derivatives for hedging purposes, it is essentially necessary to maintain the hedge relationship after the conversion to the replacement rate and to provide adequate time for users of syndicated loans to complete their preparations.

Question 3 *(b) If you do believe an "opt-in" trigger should be included, do you prefer the approach in the hardwired proposal or the amendment proposal? Please explain.*

(Answer)

The "opt-in" trigger should be included in both the hardwired approach and the amendment approach. However, consistency with ISDA fallback triggers should be taken into account in order to avoid that a difference in the timing of the occurrence of triggers would fail

to maintain the hedge relationship with derivatives.
(Rationale)

The same as our comment to Question 3 (a).

C. The Replacement Benchmark

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

(Answer)

From practical perspectives of syndicated loans solely, it is preferable that a forward-looking term rate be the first step of the waterfall so long as the same reference benchmark is available in derivatives serving as hedging instrument. Therefore, the assumption referred to in the question cannot be accepted from the perspective of ensuring the hedge effectiveness.

(Rationale)

As commented in the "Answer" above.

Question 6 *Should the administrative agent (by itself or with some other party) be able to eliminate certain interest period options if there are no equivalent SOFR terms available? If so, consider the following options: (i) the administrative agent (and/or some other party) may remove all interest periods for which there is not a published term rate or (ii) the administrative agent (and/or some other party) may remove only the interest periods for which there is not a published term rate and a term rate cannot be interpolated. Which of the options do you support? Why?*

(Answer)

Generally, a loan contract specifies how to determine interest rates for the period which the screen rate is unavailable (i.e. odd term). If interpolation is to be applied, this should be specified in the syndicated loan contract.

(Rationale)

It would be difficult for the administrative agent to take necessary actions unless respective syndicated loan contracts contain relevant provisions.

Question 7 *Should "Compounded SOFR" be included as the second step in the waterfall? Why or why not? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR?*

(Answer)

If the "Compounded SOFR" is to be included in the waterfall, it would be appropriate to include it as the second step.

(Rationale)

Given the relationship with derivatives transactions serving as hedging instrument, it would be acceptable to incorporate the Compounded SOFR into the fallback waterfall for syndicated loans so long as ISDA determines to select the Compounded SOFR for its fallback definition. Furthermore it would be appropriate to place the Compounded SOFR at a higher level compared to overnight SOFR in the waterfall as it mitigates volatility associated with fixing on a certain day.

From practical perspectives of syndicated loans alone, a forward-looking term rate (e.g. the term SOFR in the first step) is essentially preferable as a replacement rate.

Question 8 *If you believe that Compounded SOFR should be included, would a Compounded SOFR in advance or Compounded SOFR in arrears be preferable for syndicated loans? Please explain.*

(Answer)

The Compounded SOFR in arrears is preferable from the perspective that it appropriately reflects actual market conditions. A sufficient transition period, however, will be needed because its compatibility with current practices is low as the rate cannot be known till the end of the interest period in the case of the "in arrears" approach, which may hinder smooth operations (e.g. notifying interest rates) of related parties in syndicated loans. Therefore, the ARRC should take into account the possibility that it might be difficult to complete necessary preparations by the end of 2021. In this view, if the Compounded SOFR is to be included in replacement benchmark, it is necessary that the rate will be fixed in advance to some extent in order to execute a series of interest payment operations.

(Rationale)

As commented in the "Answer" above.

Question 9 *Is Overnight SOFR an appropriate fallback reference rate for syndicated loans or should the final step in the replacement rate waterfall be Compounded SOFR (after which the hardwired approach defaults to a streamlined amendment process)? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR? Please explain.*

(Answer)

An overnight rate is not an appropriate fallback reference rate, considering that interest rates currently used widely are rates with a term structure. However, it could be placed at the lowest level of the waterfall from the perspective of ensuring consistency with fallbacks discussed by ISDA. In such a case, it would be necessary to develop a methodology to adjust its difference from an interest rate with a term structure by reflecting the difference into the spread.

(Rationale)

It is important for borrowers and lenders that economic value of a transaction is retained as much as possible after a fallback is triggered.

Question 10 *Is it acceptable to fix one observation of Overnight SOFR as the reference rate for a loan lasting three months (or longer)? Would lenders refuse to offer longer-duration loans if they were priced over one Overnight SOFR observation? Please explain.*

(Answer)

Basically, many cash products users should be reluctant to accept Overnight SOFR, but it could be accepted only if a spread reflects the term structure. Nonetheless, interest rates that do not cover the lender's funding cost may not be accepted by lenders.

(Rationale)

For both borrowers and lenders, a replacement rate applied should be a rate that retains economic value of a transaction as much as possible after a fallback is triggered.

D. Spread adjustments

Question 12 *Do you believe that the ARRC should consider recommending a spread adjustment that could apply to cash products, including syndicated business loans?*

(Answer)

The ARRC should recommend a spread adjustment that could apply to cash products, including syndicated business loans. For smooth execution of fallback procedures, it would be necessary to in advance inform related parties of the calculation method for such a spread adjustment and reach an agreement thereon. Therefore, as is mentioned in the FAQ published on October 29, 2018 concerning the ARRC Consultation Regarding More Robust Libor Fallback Contract Language for New Issuances of Libor Floating Rate Notes[4], the ARRC should develop some guidance through market consultation or other similar processes to solicit the views of market participants.

(Rationale)

A spread adjustment entails a high risk of a conflict of interest between the borrowers and lenders, which may fail to make the adjustment between the related parties. Furthermore, if a spread adjustment method varies among individual products, it may confuse investors and increase the litigation risk.

Question 13 *Is a spread adjustment applicable to fallbacks for derivatives under the ISDA definitions appropriate as the second priority in the spread waterfall even if syndicated business loans may fall back at a different time or to a different rate from derivatives? Please explain.*

(Answer)

While it is a precondition that the relationship with derivatives transactions is taken into account, the ARRC should first consider spread adjustments appropriate for syndicated loans

4 https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/FRN-Consultation-FAQs.pdf

alone and thus should position a spread adjustment under ISDA definitions at a lower level than the first step in the waterfall. Therefore, we believe that it is appropriate to develop a waterfall where the spread in fallbacks for derivatives in ISDA definitions is applied only when a recommended spread is not developed as a result of such consideration.

(Rationale)

If the spread adjustment methodology varies between the ARRC and ISDA, the hedge effectiveness may not be maintained.

F. The role of the administrative agent

Question 18 *Is it necessary that any replacement rate and/or applicable spread adjustment be published on a screen by a third party? Why or why not?*

(Answer)

In order to share information among related parties in a timely manner, replacement rates and applicable spreads adjustment should be published by a third party.

(Rationale)

As commented in the "Answer" above.

Question 19 *Given that market practices and conventions may change over time, should the administrative agent's limited ability to make conforming changes be available only at the point of transition or on a periodic, ongoing basis? Why or why not?*

(Answer)

It should be on an ongoing basis rather than on a one-time basis since such an ability may change according to market practices and conventions.

(Rationale)

At present, it is uncertain as to how new benchmarks will be developed. In such circumstances, we cannot conclude that the administrative agent's such ability should be available only at the point of transition.

G. Operational considerations

Question 20 *How important is it for the fallback rate to be available prior to making a borrowing/advancing funds? For instance, if the rate was a compounded three-month rate calculated at the end of the interest period, would that be problematic? Please explain.*

(Answer)

It is preferable that the fallback rate is determined prior to the interest period from the perspectives of business planning and calculation of accrued interest at the end of each financial period.

(Rationale)

In the case of the "in arrears" approach, the rate cannot be determined by the start of the interest period, which may hinder smooth operations (e.g. notifying interest rates) of related parties in syndicated loans

Question 21 *Are there operational concerns about having the ability to convert many loans over a very short period of time? Please explain.*

(Answer)

In the case of loans, as a number of individual contracts are concluded, it would be extremely difficult to convert them over a short period of time. While there is a trend that the interest payment day (interest reset day) concentrates on a specific date, transitioning to a replacement rate for many loan contracts in a short period of time may hinder smooth operations. Therefore, a sufficient transition period would be necessary.

Question 22 *Do you see other operational challenges that fallback language should acknowledge or of which the ARRC should be aware? Please explain.*

(Answer)

The ARRC should be aware of operational challenges associated with the development of the method to calculate accrued interest for the period-end closing and with the rules to calculate break funding cost in the event that prepayments occur.

(Rationale)

It is difficult for users to make preparations for the above operational challenges unless the spread adjustment methods are determined.

I. General feedback

Question 24 *Are there any provisions in the fallback language proposals that would significantly impede syndicated loan originations? If so, please provide a specific and detailed explanation.*

(Answer)

The definition of the term “currently outstanding syndicated loans” in the hardwired approach is unclear (especially from the viewpoint of non-U.S. companies, the meaning of “outstanding” is uncertain) and therefore needs to be improved.

In addition, the definition of the terms “Required Lenders” and “Supermajority Lenders” is also unclear. The ARRC’s intention can be presumed from the explanatory descriptions in The Consultation that the former means “a majority” and the latter means “two-thirds” of lenders. This should be specified in the template and be subject to change, as necessary.

Furthermore, since the provisions related to the terms, such as “Screen Rate[5]”,

[5] Taking the Screen Rate for example, the guidelines, etc. should include a description specifying the web page that each syndicated loan party can reference (e.g. “the Screen Rate of SOFR is a rate posted on: https://apps.newyorkfed.org/markets/autorates/sofr”) and also add a description regarding the web page to be referenced for a successor rate.

"Quotation Date", "Break Funding Cost" and "Interpolation Rate", also needs to be modified, we request the ARRC to rephrase these terms, or provide guidelines, in the fallback provisions as much as practicable. More specifically, it is requested that the ARRC will define those terms that are not covered in fallback language of the amendment approach and are included in that of hardwired approach (e.g. "Benchmark Reset Date", "Interest Period", "Interpolated SOFR" and "Reference Time").

Question 25	*Please provide any additional feedback on any aspect of the proposals.*

(Answer)

With respect to the spread adjustment calculation methodology, we believe that the ARRC should conduct public consultation so that market participants can understand and make preparations, and then publish the methodology determined as a result of such consultation together with the draft contractual language.

Furthermore, in order to enable spread adjustments that better reflect actual market conditions, corporate bonds and CDS markets may also be referenced.

(Rationale)

As commented for the questions 12 and 22.

Sincerely,

H. Iwamoto

Hideharu Iwamoto
Vice Chairman and Senior Executive Director