

LIBOR REPLACEMENT ARRC'S Consultation for Bilateral Business Loans

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Summary

- The Challenge
 - LIBOR future uncertain
- The Response
 - The ARRC and Its Mission
- The Consultations
 - Fallback language components
 - Triggers
 - Transition language
 - Consultation questions

LIBOR Market Evolution

- Based on voluntary bank submissions
- Agreement to submit will end in December 2021
- Current market:
 - \$200T of US\$ LIBOR contracts
 - Yet, only \$500M of 3-month US\$ LIBOR transactions
 - So, current market depends on tiny volume of actual economic activity. As a result most banks are forced to base their submissions on expert judgement.

Possible Alternatives to LIBOR

- Given LIBOR's defects, markets and public authorities want robust, transactions-based benchmarks with dependable trading activity.
- Other alternative liquid markets are readily available.
 - Most are overnight funds
- Possible alternatives considered:
 - SOFR
 - ~\$800BB in daily transactions
 - Fed funds
 - ~\$80BB of daily transactions
 - 3-month T-bills
 - ~\$13BB of daily transactions

LIBOR vs. SOFR – Key Contrasts

- Low transaction volume and reliant on expert judgement (LIBOR) vs. very deep, liquid market and fully transactions based (SOFR)
- Unsecured, has counterparty risk (LIBOR) vs. secured, risk-free (SOFR)
- Term (LIBOR) vs. overnight (SOFR, at present)
- Implications:
 - LIBOR typically higher than SOFR because LIBOR is unsecured, means counterparty exposure
 - SOFR not subject to same risks of manipulation

ARRC Structure and Mission

- Formed in 2014 by the Federal Reserve to identify a replacement benchmark for LIBOR.
- Since early 2018, the revised membership has focused on loans and other cash instruments, as well as on derivatives.
 - Objective is to assist markets in arriving at strategies for transition to a new benchmark.
- Oversees working groups (market participants) focused on specific products
 - Loans
 - Securitizations
 - Floating Rate Notes

ARRC Membership

Members (Market Participants)	
AXA Bank of America BlackRock Citigroup CME Group Deutsche Bank Federal National Mortgage Association Federal Home Loan Mortgage Corporation GE Capital Goldman Sachs Government Finance Officers Association HSBC Intercontinental Exchange International Swaps and Derivatives Association JP Morgan Chase & Co.	LCH MetLife Morgan Stanley National Association of Corporate Treasurers Pacific Investment Management Company TD Bank The Federal Home Loan Banks, through FHLBNY The Independent Community Bankers of America The Loan Syndications and Trading Association The Securities Industry and Financial Markets Association Wells Fargo World Bank Group

ARRC Membership (cont'd)

Ex Officio Members

U.S. Commodity Futures Trading Commission
Consumer Financial Protection Bureau
Federal Deposit Insurance Corporation
Federal Housing Finance Agency
Federal Reserve Bank of New York
Board of Governors of the Federal Reserve System
Office of Financial Research
Office of the Comptroller of the Currency
U.S. Securities and Exchange Commission
U.S. Treasury Department

Business Loans Working Group

- Composed of many ARRC member institutions and other interested market participants.
 - Lending institutions make up the majority of the membership.
 - Also includes buy-side firms, trade associations, some major borrowers and industry experts
- Loan Syndication and Trading Association and ABA are co-chairs.
- Key objective: contract fallback language that:
 - Is practical and broadly usable if LIBOR ceases, and
 - Minimizes the risk of value transfer and damage to financial stability

Bilateral Loan Consultation

- Fallback Language:
 - Credit agreement language that answers the question, “If LIBOR ceased tomorrow, how would the contract rate be determined?”
- Fallback elements:
 - Triggers: What, exactly, starts a transition to a new rate?
 - Replacement benchmark: e.g., SOFR
 - Spread adjustment: How is approximate economic equivalence maintained?
 - Amendment process: some fallback approaches contemplate contract amendment when more information is known

Two Fallback Proposals

- “Amendment” approach
 - Builds on similar concepts that have been used recently in the syndicated loan market while incorporating some improvements.
 - Reserves parties’ options at a time when some market developments (e.g., a SOFR term structure) are still evolving.
- “Hardwired” approach
 - Provides more certainty at point that language is put into place.
 - Avoids need for complex amendments after credit agreement is finalized.

Triggers – Start Transition to New Rate

- Amendment and hardwired approaches recommend same basic triggers:
 - **“Benchmark Discontinuance Event”** indicates the current or upcoming discontinuance of LIBOR.
 - An announcement that the benchmark has or will cease;
 - Unannounced cessation of publishing of the benchmark;
 - A statement that the administrator has or will invoke its insufficient submissions policy; or
 - A statement by a relevant regulator that a benchmark is no longer representative.

Triggers (cont'd)

- Also, both have similar, but different, optional or “opt-in” triggers:
 - Amendment approach:
A determination by Lender that new or amended bilateral loans are incorporating a new benchmark interest rate to replace LIBOR.
 - Hardwired approach:
At least [two] outstanding publicly filed syndicated loans are priced over Term SOFR, subject to negative consent by Borrower.

Amendment Approach

- Replacement benchmark and spread adjustment:
 - The amendment approach proposal does not contain a specific replacement benchmark or spread adjustment.
 - The lender will propose a successor rate, which may or may not be a version of SOFR, plus an applicable spread adjustment at the time that the fallback is triggered.
 - Benchmark and spread adjustment may include any selection, endorsement or recommendation by government authorities for such transactions, but does not have to do so.
 - The rate and spread adjustment proposed could be subject to negative consent by the Borrower.

Hardwired Approach

- Triggers are as discussed above; distinctions relate to “opt-in” language.
- Replacement benchmark: language includes a “waterfall”
 - Term SOFR (if a term rate has been endorsed by the ARRC)
 - Otherwise, compounded SOFR, if available;
 - Otherwise, an alternate rate of interest to replace LIBOR selected by the Lender.

Hardwired Approach (cont'd)

- Spread adjustment:
 - A spread adjustment (or its methodology) as selected, endorsed or recommended by the Fed or ARRC;
 - If there is no such selected, endorsed, or recommended spread adjustment, a spread adjustment (or its methodology) applicable to fallbacks for derivatives that ISDA anticipates implementing in its definitions; or
 - If the replacement benchmark is an alternate rate selected by the Lender, then a spread adjustment that shall be selected by the Lender.

Hedging Issues

- Market participants who hedge exposure to LIBOR cash instruments may wish to avoid basis risk when contracts transition to a new benchmark.
- In several areas, draft language proposed in the Consultation may differ from the structure of fallbacks for derivatives that ISDA has proposed.
 - E.g., the ARRC consultation includes “pre-cessation” triggers, while the language in ISDA’s consultation would only trigger if LIBOR stops
 - Fallback benchmarks other than compounded overnight rates (ISDA’s preferred choice)

Hedging Issues (cont'd)

- To avoid basis mismatch, market participants may consider using loan document language aligned more closely with ISDA standard form documentation, as eventually amended.
 - The Consultation's Appendix VI is an example of a fallback approach for hedged or partially hedged loans that would fall back to rate and spread terms selected by ISDA for derivatives after LIBOR cessation.
- Operational, accounting and other aspects of these questions require careful consideration.

Consultation Questions

- Eight categories of specific questions on which the ARRC seeks input:
 - Of the two general approaches, what is the preference?
 - Triggers
 - Replacement benchmarks
 - Spread adjustments
 - The role of the Lender
 - Operational considerations
 - Hedging issues
 - General feedback

Preferred General Approach

- **Question 1.** If the ARRC were to adopt one or more sets of bilateral 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?
- **Question 2.** Beyond your response to Question 1, are there product or transaction types, or methods of documenting transactions, for which either of the fallback approaches would be problematic? If so, please explain. What other approach would you suggest?

Triggers

■ Question 3.

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

Triggers (cont'd)

- **Question 4.**
 - Is an “opt-in” trigger appropriate to include? Why or why not?
 - (b) Do you believe an “opt-in” trigger should be included in both the hardwired and amendment proposals or only in one (please specify which and explain).

- **Question 5.** Are there any other trigger events that you believe should be included for consideration? If yes, please explain.

Replacement Benchmarks

- **Question 6.** If the ARRC has recommended a forward-looking term rate, should that rate be the primary fallback for bilateral business loans referencing LIBOR even though derivatives are expected to reference overnight versions of SOFR? Please explain.
- **Question 7.** Should the Lender be able to eliminate certain interest period options if there are no equivalent SOFR terms available? If so, consider the following options: (i) the Lender may remove all interest periods for which there is not a published term rate or (ii) the Lender 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?
- **Question 8.** 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?

Replacement Benchmarks (cont'd)

- **Question 9.** 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”?
- **Question 10.** As noted, this consultation does not include Overnight SOFR as a final step in the waterfall. Do you believe that Overnight SOFR is an appropriate fallback reference rate for bilateral business 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)?
- **Question 11.** Is there any other replacement rate that should be added to the hardwired approach waterfall before parties move to the streamlined amendment process? If so, what is the appropriate rate or rates and at which stage in the waterfall should they be applied? Please explain.

Spread Adjustments

- **Question 12.** Do you believe that the ARRC should consider recommending a spread adjustment that could apply to cash products, including bilateral business loans?
- **Question 13.** Is a spread adjustment applicable to fallbacks for derivatives under the ISDA definitions appropriate as the second priority in the hardwired approach spread waterfall even if bilateral business loans may fall back at a different time or to a different rate from derivatives? Please explain.
- **Question 14.** Is there any other spread adjustment that should be added to the hardwired approach spread waterfall before parties move to the streamlined amendment process? If so, what is the appropriate spread and at which stage in the waterfall should it be applied?

Role of the Lender

- **Question 15.** For respondents that act as Lenders in the bilateral business loan market, would your institution be willing to (i) work with the Borrower to identify a new reference rate or spread adjustment, (ii) determine whether triggers have occurred, (iii) select screen rates where reference rates are to be found, (iv) interpolate LIBOR or term SOFR if there is a missing middle maturity, and (v) execute one-time or periodic technical or operational amendments to appropriately administer the replacement benchmark? Please respond to each and explain.
- **Question 16.** In any of these situations, should the Lender have the right to take the relevant action, for example to designate loan terms unilaterally within the framework of either Appendix I or Appendix II, simply by notice to the Borrower? Alternatively, should the lender have the right to take such action, subject only to the Borrower's right to withhold consent? Please explain which approach, or what alternative approach, you think would be better.

Role of the Lender (cont'd)

- **Question 17.** 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?
- **Question 18.** Given that market practices and conventions may change over time, should the Lender'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?

Operational Considerations

- **Question 19.** Are there operational concerns about having the ability to convert many loans over a very short period of time? Please explain.
- **Question 20.** Do you see other operational challenges that fallback language should acknowledge or of which the ARRC should be aware? For example, both approaches to fallback language involve various notices from the Lender – do these requirements and the resulting communications between parties impose undue operational burdens? Please explain.

Hedging Issues

- **Question 21.** If bilateral business loans fall back to a different rate from derivatives, how do market participants expect to handle the interplay of loans and their hedges? Would market participants expect that current swaps would be terminated and a new swaps entered into once the loan has transitioned?
- **Question 22.** Would market participants that execute interest rate hedges prefer to fall back to the same rate and spread that becomes operative under the ISDA Definitions even if a term SOFR is available? If so, please provide comments on the proposal for hedged loans set forth in Appendix VI, including a discussion of any operational concerns. Please provide comments on any other approaches you think could be useful in addressing fallbacks in loans and related hedges.
- **Question 23.** When a loan is only partially hedged, either by a swap that is not coterminous with the loan's maturity or a swap the notional amount of which is less than the loan amount (or the portion of the loan accruing interest based on LIBOR), should a trigger event result in the entire loan balance converting to the fallback benchmark? Would it be operationally practical to align only the hedged portion's terms with the terms of the swap? What other concerns would market participants anticipate in operationalizing dynamic tranching of a partially hedged loan?

General Feedback

- **Question 24.** Are there any provisions in the fallback language proposals that would significantly impede bilateral business loan originations? If so, please provide a specific and detailed explanation.
- **Question 25.** Please provide any additional feedback on any aspect of the proposals.

Next Steps

- The Consultation will be open through February 5, 2019.
- Respondents can email their responses to arrc@ny.frb.org.
- ARRC will post responses on its website, but if respondents request, postings will be anonymous.
- ABA will not submit comments – individual institution perspectives are critical.