February 5, 2019

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 Bilateral Business Loans*

Dear Sirs/Madams:

We, the Japanese Bankers Association (JBA), would like to express our gratitude for this opportunity to comment on *Consultation Regarding More Robust LIBOR Fallback Contract Language for New Originations of LIBOR Bilateral Business Loans* published on December 7, 2018 by the Alternative Reference Rates Committee (ARRC). We respectfully expect that the following comments will contribute to your further discussion. Please also refer to our comments[1] on *Consultation Regarding More Robust LIBOR Fallback Contract Language for New Originations of LIBOR Syndicated Business Loans* published by the ARRC in September 2018 since these two consultations have many issues in common.

1. General Comments

(1) Reflecting international discussions

Fallbacks are being discussed globally, and the International Swaps and Derivatives Association (ISDA) published final results to adopt compounded setting in arrears rate as the adjusted risk free rate (RFR) and the historical mean/median approach as the spread adjustment for ISDA-based derivatives.

As noted in our comments on *Consultation Regarding More Robust LIBOR Fallback Contract Language for New Originations of LIBOR Syndicated Business Loans* ("Syndicated Loan Consultation"), we believe that there is a strong needs to ensure that the respective fallbacks for derivatives and cash products are consistent, particularly in terms of both the replacement rate and the timing of the occurrence of triggers, since the hedging needs of cash products underlie most derivative transactions.

[1] https://www.zenginkyo.or.jp/fileadmin/res/en/news/news181126.pdf

In this regard, we understand this consultation on bilateral business loans also covers considerations on differences in trigger events and fallback rates between cash products and ISDA-based derivatives. For instance, this consultation discusses fallback language for new originations of hedged LIBOR bilateral business loans in Appendix VI, and also indicates that the ISDA is considering to take certain actions for the pre-cessation triggers. We welcome that both discussion bodies for cash products and derivatives are undertaking initiatives in light of the requests from market participants, and expect that the ARRC would continuously take into account such views of market participants in finalizing this consultation.

(2) Needs for developing term RFRs for cash products

With respect to the waterfall under the hardwired approach for the fallbacks proposed in this consultation, we welcome that the forward-looking term Secured Overnight Financing Rate (SOFR) is placed as the first step, reflecting the needs of cash product users, which is consistent with the Syndicated Loan Consultation.

If a term SOFR does not exist at the time the fallback takes effect, Compounded SOFR (which would be SOFR compounded setting in arrears if it is so chosen to be consistent with ISDA's final conclusion) would be applied as a fallback rate. However, as indicated in comments from a broad range of stakeholders of cash products on the Syndicated Loan Consultation, the "in arrears" approach has lower compatibility with current practices since the rate for an interest period cannot be known till the end of the period, which may hinder smooth operations (e.g. notifying interest amount) of borrowers and lenders in bilateral business loans. We, therefore, expect that robust forward-looking term SOFR will be developed at an early stage and the ARRC will continue undertaking its initiatives on the further developments of SOFR markets. Moreover, the "Transition from U. S. Dollar LIBOR - Timeline" published in October 2018 shows ARRC's intention to produce an indicative SOFR-based term reference rate in the first quarter of 2019. We highly welcome this movement since indicative term SOFR would be very useful for potential users of a term SOFR in preparing for their transition.

(3) Consistency between bilateral business loans and syndicated business loans

While bilateral business loans and syndicated business loans contain different elements, such as the number of parties and the involvement of an agent, these two cash products have many similarities. In this respect, we believe that there are also many similarities in the characteristics which fallback framework for each of these two products should have, in terms of, for example, triggers, fallback rates and spread adjustments. Therefore, fallback language of both products should be basically consistent, except those issues specific to bilateral

business loans and syndicated business loans respectively.

As one of the examples of inconsistency, we would like to point out that a replacement rate under the hardwired approach for bilateral business loans does not include “overnight SOFR + adjusted spread” taking into account the final conclusion published by the ISDA. On the other hand, under the waterfall approach proposed in the Syndicated Loan Consultation, this replacement rate is included as the third step in the waterfall. We request the ARRC to adjust such differences to ensure consistency when finalizing the proposals.

(4) The amendment approach and the hardwired approach

From practical perspectives, the hardwired approach that allows less flexibility in procedures is expected to result in smoother and broader transition to a replacement rate at the time of the occurrence of the trigger. However, since the development of term rates involves uncertainties, there is a risk that the replacement rate at the time of the fallback might differ from what is originally expected at the time of concluding a contract. Therefore, the ARRC should take into account the progress of developing the term SOFR in determining the approach to be selected, and should avoid reaching a hasty conclusion.

(5) Timing of the finalization and implementation

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, as in the case with the Syndicated Loan Consultation, several triggers other than those suggested in the ISDA Consultation are proposed in this consultation. We believe that such triggers would be useful because they facilitate transition before an announcement of a permanent discontinuation of a financial benchmark, thereby enabling market participants to avoid concentration risk.

On the other hand, in order to ensure the effectiveness of new fallback language, it is necessary to thoroughly review whether borrowers have completed their preparation, whether borrowers recognize and understand the fallback well enough, and whether 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 implementation.

We have answered to the questions specified below based on the same attitude in the

general comments discussed above.

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 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?*

(Answer)

ARRC should take into account the progress of developing the term SOFR, and avoid reaching a hasty conclusion.

(Rationale)

Given that entities need to take certain actions for a number of bilateral business loans, eventually, the hardwired approach is preferable because it incurs less practical burdens and is expected to result in smoother transition to a replacement rate. It is however uncertain at this moment whether a robust term SOFR will be developed, and therefore the ARRC should not reach a hasty conclusion.

We believe that it would be realistic to enter into a contract based on the amendment approach that allows more flexibility at this stage, and apply the hardwired approach at a stage when considerations on fallback rates and spread adjustments have made progress.

B. 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?*

(Answer)

We believe that any of the pre-cessation triggers could be included in contracts for bilateral business loans which are hedged using ISDA-based derivatives so long as these triggers are consistent with those of ISDA-based derivatives and agreed on by the parties in advance. However, in developing pre-cessation triggers, the ARRC should also take into account whether bilateral business 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.

Question 3(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)

If the hedge relationship between bilateral business loans and derivatives cannot be maintained after a fallback is triggered, it will be extremely difficult to gain acceptance from market participants and borrowers. In this regard, ISDA's effort to offer templates or other tools for derivative contracts for inserting pre-cessation triggers on a bilateral basis would be useful.

Question 3(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)

Each entity is capable of making decisions and amendments individually. However, practical burdens would be high.

(Rationale)

If pre-cessation triggers are not included in the contract, each entity will need to decide whether to continue using the reference benchmark one by one, which imposes significant practical burdens on them.

Question 4(a) *Is an "opt-in" trigger appropriate to include? Why or why not?*

(Answer)

For including an "opt-in" trigger, the ARRC should also consider whether bilateral business loan users have completed their preparation, and are able to take necessary actions in a smooth manner once a trigger occurs. For bilateral business loans that are hedged using ISDA-based derivatives, an "opt-in" trigger could be included in contracts so long as the opt-in trigger is consistent with that of ISDA-based derivatives and is agreed on by the parties in advance.

(Rationale)

Although basis risk may arise, it is expected that including an "opt-in" trigger in both amendment and hardwired approaches could mitigate the concentration risk of operations arising from the simultaneous occurrence of transitions to the replacement rate.

C. The Replacement Benchmark

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.

(Answer)

The forward-looking term rate should be the primary fallback.

(Rationale)

This is preferable from the practical perspective for bilateral business loans. (As discussed in (2) in the General Comments)

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?*

(Answer)

We believe that (ii) is the preferable option.

(Rationale)

For cash products, such as bilateral business loans, it is preferable to reference forward-looking term rates as much as possible.

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?*

(Answer)

If Compounded SOFR is incorporated in the waterfall, it is appropriate to place as the second step.

(Rationale)

In light of the relationship with derivatives transactions used as hedging instruments, we accept the inclusion of Compounded SOFR in the waterfall for bilateral business loans, since it is highly likely that ISDA selects Compounded SOFR in arrears as a fallback for USD LIBOR. As discussed in (2) in the General Comments, however, forward-looking term rates are preferable from a viewpoint of cash product users, and hence Compounded SOFR should be placed in a lower level than the term SOFR.

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"?*

(Answer)

"In arrears" is the preferable compounding period in terms of ensuring consistency with

ISDA-based derivatives. However, the ARRC should also take into account the possibility that it might be difficult to complete necessary preparations by the end of 2021.

(Rationale)

Compounded SOFR in arrears is preferable to ensure consistency with ISDA-based derivatives. 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, which may hinder smooth operations (e.g. notifying interest amount) of related parties in bilateral business loans.

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)?*

(Answer)

Overnight SOFR is not an appropriate fallback reference rate for bilateral business loans.

(Rationale)

As we have answered to the Question 9 in our comments on Syndicated Loans Consultation, an overnight rate is not an appropriate fallback reference rate, considering that interest rates currently used widely are rates with a term structure. In addition, as the ISDA is reaching a conclusion not to use overnight rates as fallback rates, there is no need to use an overnight rate in terms of ensuring the consistency with ISDA-based derivatives. The ARRC should consider this point in finalizing the Syndicated Loan Consultation as well.

D. 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?*

(Answer)

ARRC should recommend a spread adjustment that could apply to cash products in advance through guidance or other means.

(Rationale)

A spread adjustment entails a high risk of a conflict of interest between the borrowers and lenders; therefore related parties may fail to reach an agreement. Furthermore, if a spread adjustment method varies among individual contracts, it may cause confusion and increase the litigation risk. 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. For reaching agreement smoothly, the ARRC should develop some guidance through market consultation or other similar processes.

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.*

(Answer)

We believe such a spread adjustment is appropriate.

(Rationale)

While it is a precondition that the relationship with derivatives transactions is taken into account, the ARRC should first consider spread adjustments appropriate for bilateral business loans. We therefore believe that it is appropriate to develop a waterfall where the logic of spread adjustments in fallbacks under the ISDA definition is placed as the second step and will be applied only when a spread recommended specifically for bilateral business loans as the first step is not developed.

E. The role of the Lender

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.*

(Answer)

A better approach depends on the circumstances of borrowers.

(Rationale)

If the borrower understands and agrees in advance on significant matters, such as a fallback rate and an adjustment spread, and is able to reasonably predict an actual applicable rate, we believe that the lender need not seek consent again at the time the fallback trigger occurs and should simply give a notice to the borrower. On the other hand, if it is unable, or difficult for the borrower, to know in advance such matters, taking the relevant action simply by a notice from the lender would harm the borrower's interests, which may lead to heightened litigation risk. It would therefore be appropriate for the borrower to have the right to reaffirm his or her intention.

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?*

(Answer)

A fallback rate and/or applicable spread adjustment should be published on a screen by a third party.

(Rationale)

It is necessary from the viewpoint of sharing information among related parties in a timely manner and avoiding litigation risk.

F. 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.*

(Answer)

Transition in a very short period of time raises operational concerns. It is therefore important to secure an appropriate transition period, and for bilateral business loan users to complete their preparation and to take necessary actions in a smooth manner once a trigger occurs. Furthermore, for reducing operational concerns, it would be useful to consider the timing when a transition to a fallback rate takes effect as one of pre-agreed items, in addition to considerations and agreement about the timing of a trigger.

(Rationale)

As compared to syndicated business loans, a considerable number of agreements are entered into individually for bilateral business loans, and therefore it may be extremely difficult to complete a transition in a short period of time. While there is a trend that interest payment dates (interest reset dates) concentrate on a particular date, transitioning a number of transactions in a short period of time may hinder smooth operations. Insights that may be useful includes *Guiding principles for fallback provisions in new contracts for euro-denominated cash products*[2] issued by the working group on euro risk-free rates in January 21, 2019.

G. Hedged loans

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?*

(Answer)

If bilateral business loans fall back to a different rate from derivatives, one of the

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[2] See https://www.ecb.europa.eu/pub/pdf/other/ecb.sg3guidingprinciples201901.en.pdf
Paragraph 23 states that "[t]he date from which the fallback rate will apply after one or more of the trigger events has occurred should also be specified clearly in fallback provisions."

approaches would be to terminate a swap and enter into a new swap referencing the same rate as the loan's fallback rate. However, cancellation of the swap, or entering into a new swap (in particular, the case where a counterparty providing a loan and a counterparty providing a swap for hedging purposes are different) may increase burdens in terms of negotiations and contract-related operations, requiring a significant amount of time. A solution to avoid such operational burdens and basis risk that may arise before entering into a new contract would be to include the same fallback language for a swap used as a hedging instrument individually when including fallback language in a loan contract in advance.

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.*

(Answer)

When a robust term SOFR becomes available, the use of term SOFR is preferable from the practical perspective of bilateral business loans.