



October 22, 2018

International Swaps and Derivatives Association, Inc.

Via online submission at: <https://www.isda.org/2018/07/10/interbank-offered-rate-ibor-fallbacks-for-2006-isda-definitions>

Re: Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA Definitions - Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW

The Structured Finance Industry Group (“SFIG”)¹ appreciates the opportunity to respond to the International Swaps and Derivatives Association, Inc. (“ISDA”) Consultation (“Consultation”) on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR, and BBSW.

SFIG is a member-based trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG’s core charge is to support a robust and liquid securitization market, recognizing that securitization is an essential source of funding for the real economy. While the comments expressed in this letter represent the consensus views of our broad membership, this letter does not necessarily represent the perspectives of all SFIG members. None of the recommendations expressed herein are binding on, or should be attributed to, any individual SFIG member, each of which will decide for itself whether and to what extent to submit individual comments in response to the Consultation.

SFIG views the Consultation as an important step in the overall process of transitioning globally from the various IBORs to new benchmarks representing market-based risk-free rates (“RFRs”). The Consultation seeks commentary on adjusted RFRs and related spread adjustments, which take into account key differences between the IBORs and the RFRs. The Consultation seeks commentary from all market participants, both users of derivatives and users of financial instruments that are hedged by derivatives. While the Consultation is limited to the IBORs listed

¹ SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG’s core charge is to support a robust and liquid securitization market, recognizing that securitization is an essential source of funding for the real economy. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, to drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. Members of SFIG represent all sectors of the securitization market, including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. Further information can be found at www.sfindustry.org.



above, the Consultation requests preliminary views on the application of these concepts to other IBORs, including USD LIBOR.

Our response to the Consultation will be principles-based, as we anticipate making a more detailed and technically-robust response to the upcoming ISDA consultation addressing USD LIBOR. This letter focuses at a high level on the proposed adjusted RFRs and spread adjustments as they would replace various IBORs. Our perspective in these responses is not limited to the derivatives market, but rather takes into account the transition away from USD LIBOR in the cash markets as well, where USD LIBOR is currently used as a reference rate in approximately \$1.8² trillion of securitizations. As importantly, USD LIBOR is used as the benchmark rate for approximately \$4.7³ trillion in business and consumer loans, such as mortgages, credit cards and student loans, many of which are the underlying financial assets backing those securitization transactions.

Given the very important role securitization plays in the U.S. economy, representing \$2.4 trillion⁴ or slightly over 33% of the nation's roughly \$7.5 trillion of bond issuance in 2017 and approximately 55%⁵ of household debt as of Q3 2017, it is imperative that the transition away from LIBOR for securitization transactions not cause a market dislocation, which could result in either a significant increase in the cost of credit and/or a reduction in credit availability for consumers or corporate borrowers. In addition, with more than \$2 trillion⁶ in small business loans, over \$1 trillion⁷ of home mortgages, and \$100 billion⁸ in other consumer loans based on LIBOR, many of which have a maturity beyond the 2021 deadline, it is important to ensure the transition away from LIBOR limits the impact to consumers.

1. Forward-Looking Term Market-Based Benchmark

Our comments in the following sections discuss the proposed adjusted RFRs and spread adjustments. However, none of those combined approaches provides a forward-looking term market-based rate, which is greatly preferred by SFIG members and elaborated on below.

LIBOR, as produced today, has several attractive attributes, including: (i) an indication of market participants' expectations about anticipated funding costs over a future accrual period; (ii) a rate

² Source: Federal Reserve Bank of NY, "Second Report of the Alternative Reference Rates Committee," March 2018.

³ Source: Federal Reserve Bank of NY, "Second Report of the Alternative Reference Rates Committee," March 2018.

⁴ Source: SIFMA

⁵ Source: Moody's Investors Service, "Structured finance – US: Securitization remains major funding source for economy, while government still dominates housing and higher education", 15 Feb. 2018, p. 9, Sector In-Depth Structured finance – US.

⁶ Source: Marketwatch, "How the End Of This Key Borrowing Rate Could Impact Mortgages and Other Loans", 28 June 2018, Robert Pozen-Adam Schneider

⁷ Federal Reserve Bank of NY, "Second Report of the Alternative Reference Rates Committee," March 2018.

⁸ Federal Reserve Bank of NY, "Second Report of the Alternative Reference Rates Committee," March 2018.



that is known at the beginning of the accrual period; and (iii) a rate that is produced using a substantially similar methodology across the various regions that produce IBOR. Ideally, we would like the replacement rate to have each of these features to the extent possible. Neither the compounded setting in advance nor the compounded setting in arrears provides a rate that is both forward-looking and known at the beginning of the accrual period; rather one reflects actual funding costs over a recent past time period on a lookback basis, and the other is not known until the end of the future accrual period.

The Alternative Reference Rates Committee (“ARRC”) has a number of working groups that are developing LIBOR replacement fallback language for various types of cash products. These working groups are each independently moving towards a flexible LIBOR fallback “waterfall” with a forward-looking, term market-based RFR as the ‘first choice’. See the following from a recent ARRC consultation:

The first priority for the Unadjusted Replacement Benchmark is a forward-looking term SOFR (e.g., 1-month SOFR, 3-month SOFR) that is selected, endorsed or recommended by the Relevant Governmental Body. While there is currently no commitment by a regulatory authority or third party to publish forward-looking term SOFR rates, the ARRC intends to endorse forward-looking term SOFR rates provided a consensus among its members can be reached that a robust, IOSCO-compliant term benchmark that meets appropriate criteria set by the ARRC can be produced.⁹

Additionally, in SFIG’s working draft of fallback language for new securitizations, the first fallback base rate to be used following a benchmark discontinuance event (including a cessation of LIBOR) would be the SOFR rate related to the tenor in question; i.e. **the forward-looking term SOFR over a period corresponding to the relevant interest accrual period**. This term SOFR would have been selected, endorsed or recommended by the Federal Reserve Board and/or the Federal Reserve Bank of New York (“NY Fed”), or by a committee officially endorsed or convened thereby (including the ARRC). Our expectation is that the NY Fed and/or the ARRC would not recommend a forward-looking term SOFR rate unless they were satisfied that such rate was sufficiently based on market transactions. If no such term rate is available then within our flexible fallback framework the next option would be some form of compounded SOFR, followed by a spot SOFR.

We also note that forward-looking term RFRs are contemplated in other markets as new benchmarks. As an example, the Working Group on Sterling Risk-Free Reference Rates’ consultation on Term SONIA Rates recently closed, and the Working Group anticipates that term rates could be available in the second half of 2019. Edwin Schooling-Latter, head of markets policy at the UK’s Financial Conduct Authority (FCA), recently stated at a conference organized by ISDA that he believes it will be possible to derive term rates without weakening the regulatory framework.¹⁰

⁹ ARRC Consultation regarding more robust LIBOR fallback contract language for new issuances of LIBOR floating rate notes, September 24, 2018

¹⁰ See “Term versions of RFRs will work - FCA official”, Risk.net, September 26, 2018.



We understand that the near-term development of derivatives contracts linked to some variant of term SOFR is needed to develop sufficient market data. Given that a true forward-looking term SOFR does not yet exist, the adoption now for derivatives of adjusted RFRs, such as compounded setting in advance and compounded setting in arrears, is a necessary step towards this ultimate goal. However, we believe that for derivatives contracts that reference LIBOR, the ISDA fallback language should not stop there.

We believe it could be very difficult to convert millions of floating rate consumer and business loans, worth trillions of dollars, from the current market convention of setting interest rates in advance based on forward-looking term rates to compounded overnight RFR either in advance or in arrears. Switching from LIBOR to either of these approaches would likely result in borrower confusion and frustration, for the reasons described in the following section.

SFIG thinks it would, therefore, make sense for the securities backed by these loans to also fall back to a forward-looking term RFR. Similarly, many market participants would then like derivatives to follow suit and allow for a fallback to a forward-looking term RFR. If not, basis risk would emerge in transactions that were appropriately hedged at deal execution, but following a trigger event have loans, bonds, and derivatives falling back to different reference rates.

We, therefore, recommend that ISDA implement a flexible fallback waterfall for USD LIBOR that prioritizes forward-looking term SOFR rates selected, endorsed or recommended as the replacement for LIBOR by the Federal Reserve Board and/or the NY Fed, or by the ARRC. Although these rates do not exist today, ARRC expects that such rates will be available ahead of LIBOR cessation.¹¹ A flexible fallback waterfall structure that allows the affected parties to replicate as closely as possible the pre-transition economics of a transaction and any related hedges would both support cash flow management and minimize market disruption.

Use of this flexible approach will avoid the market complexity and risks that are likely to be created if different fallback rates are employed for cash products and derivatives, and will promote consistency between cash products and derivatives, thus avoiding basis risk. It would also be in keeping with ISDA's long-standing practice of allowing the parties to a transaction to select specific terms (in this case, the fallbacks) in connection with disruption events that are tailored to that specific transaction.

2. Perspectives on ISDA's Proposed Approaches

In this section, we will provide general commentary on the proposed approaches for derivatives fallback language from a securitization perspective. As stated in the introduction to this letter,

¹¹ The ARRC's Paced Transition Plan calls for the development of derivatives contracts and futures trading that will reference SOFR. Trading in SOFR linked futures contracts on the CME began in May 2018. As these products become more and more widely traded, the Plan contemplates that by the end of 2021 (or sooner) there will be enough market data to be able to create forward-looking term SOFR rates based on market transactions.



however, we will keep our comments at a high level with an expectation of more fully addressing various approaches when ISDA issues a Consultation focused on USD LIBOR.

The ordering of the following discussion is not intended to convey a preferred ranking of the alternatives.

Adjusted Risk-Free Rates

- **Spot and Convexity-Adjusted Overnight Rates**

SFIG members, at this preliminary point, are leaning away from the spot and convexity-adjusted overnight rate approaches even though they offer operational simplicity, which could be an important consideration for some institutions. The spot overnight rate would reference the overnight SOFR rate on a specific day shortly before the start of an interest accrual period and apply that rate to the entire interest accrual period. Interest accrual periods on LIBOR-linked instruments generally are 1, 3, 6 or 12 months. On a day-to-day basis under normal circumstances, SOFR varies more than LIBOR does, and SOFR may also have a tendency to spike at or near the last days of a month or quarter. We are, therefore, concerned that spot overnight SOFR applied to an interest accrual period of 1 month or more would magnify these day-to-day changes and period end spikes over an extended period of time.

The convexity-adjusted overnight rate is derived from the overnight SOFR rate on a specific day shortly before the start of an interest accrual period, which is then applied as a single daily rate to the entire interest accrual period, with the difference being that the interest accruing each day in the accrual period is compounded. This compounding effect results in a higher rate than the overnight rate, and therefore moves closer to recognizing that term rates are typically higher than an overnight rate. But this approach is still derived from the SOFR overnight rate on a specific day, which when applied to an interest accrual period of one month or more would again magnify these day-to-day changes and period end spikes over an extended period of time. This magnification effect would be even greater due to the use of compounding.

- **Compounded Setting in Advance**

The compounded setting in advance approach uses an observation period equal to the tenor of the LIBOR being replaced, which ends immediately prior to the beginning of the interest rate accrual period for which the rate will be applied. This rate would smooth out the day-to-day fluctuations in the benchmark as well as period-end spikes. The major drawback with this approach is that it is based on backward-looking information. Unlike LIBOR, it would not take into account anticipated changes in market rates during the upcoming period. This approach could be viewed as acceptable over a shorter duration such as a one-month tenor, but might not be viewed as acceptable by market participants for longer interest accrual periods, such as 3, 6 or 12 months, because the rate would be based on stale information over an extended period. In a declining rate environment, borrowers would be disfavored; in a rising rate environment, investors would be disfavored. For borrowings with long tenors these effects may or may not offset each other over time, but, nevertheless, for any given accrual period the index would be based on stale information.



To the extent that this approach is not accepted in the cash markets, derivatives using this approach to hedge cash assets would be subject to basis risk.

- **Compounded Setting in Arrears**

The compounded setting in arrears approach uses an observation period equal to the tenor of the LIBOR being replaced, which is coterminous with the interest rate accrual period for which the rate will be applied. This rate also would smooth out the day-to-day fluctuations in the benchmark as well as period end spikes. Rather than prospectively taking into account anticipated changes in market rates during the interest accrual period, this rate would retroactively take into account actual changes in market rates during the interest accrual period by reason of its period-end calculation. In terms of accurately reflecting the RFR during the interest accrual period, some market participants might prefer this approach. However, for borrowers with floating rate debt linked to 3, 6 and 12-month tenors of LIBOR (and accustomed to knowing what their rates are in advance), we are concerned that this approach could result in confusion and frustration, and also could require substantial changes in servicing systems. For consumer adjustable-rate debt today, both the interest rate and the payment amount are established at the beginning of each accrual period. If a compounded setting in arrears approach were used, the rate could increase during the accrual period and any upward spikes in the rate during the accrual period would require either mid-period payment increases or a true-up at the end of the period. Either of these developments could be considered unacceptable features for consumer financial products. Corporate borrowers would likely also object to such features.

Again, to the extent that this approach is not accepted in the cash markets, derivatives using this approach to hedge cash assets would be subject to basis risk.

We also have the following technical comments on this approach:

- Instead of compounding, consideration could also be given to averaging over the interest accrual period and adding an additional component to account for the length of the accrual period.
- Inclusion of a lock-out period¹² might be needed to operationally support the “in arrears” methodology, otherwise Trust Administrators and Trustees will not be able to calculate the payment until the payment date.

¹² A lock-out period is a pre-defined number of days prior to the end of the interest period whereby the benchmark rate will be calculated over the relevant interest period up to that pre-defined number of days (“lock-out period”) prior to the end of the interest period.



Credit Spread Adjustments

- **Spot-Spread Approach**

This approach observes the spread of the LIBOR being replaced over the adjusted RFR on a specific day or for a brief time period (up to one month) immediately prior to the conversion away from LIBOR. We believe that the spread between LIBOR and adjusted SOFR has and will vary considerably over time due to market condition and other factors. Historically, LIBOR has spiked considerably in times of financial stress. Therefore, we are concerned that the LIBOR-adjusted SOFR spread during the relatively brief observation time period prior to the announcement triggering the fallback will not necessarily be reflective of that spread over a longer view, and that any variances in the spread during that time period from historical norms would be magnified by applying that spread over the remaining term of the contract.

The greatest advantages of the spot-spread approach are its simplicity and its ability to maintain borrower interest expense at a steady level throughout the transition.

- **Historical Mean/Median Approach**

This approach could be a sound approach for a credit spread adjustment. We would offer the following considerations in developing this approach:

- Using the historical mean, rather than historical median, may better take into account any spikes over the period.
- The longest possible lookback period should be used, depending on the quality, comparability and availability of data. Ideally, at least 10 years would be used. The industry has access to a SOFR proxy going back several years. While SOFR's official publication only began in April 2018, in March 2018 the NY Fed released historical data based on its Overnight Treasury GC Repo Primary Dealer Survey Rate series that dates to 1998 as an approximate SOFR proxy (albeit with a number of technical differences¹³)
- From our perspective, further review of the quality and comparability of historical data is needed before we could recommend a specific lookback period.

- **Forward Approach**

While requiring more supporting infrastructure than the historic mean/median approach, we believe the forward approach could be feasible and achievable. The fact that the approach minimizes value transfer at the time of conversion is important. We would also note that if this approach is feasible, then the creation of forward-looking term SOFR rates based on market transactions should also be feasible. As to the specific questions posed:

¹³ NY Fed, Statement Regarding the Publication of Historical Repo Rate Data, at https://www.newyorkfed.org/markets/opolicy/operating_policy_180309



- We would suggest that the forward approach be based on data from a brief period immediately prior to the trigger date so that the data be relatively current but avoid spike effects. We would suggest a one-month period.
- We would suggest that a 30-year forward curve would be sufficient for USD securitizations.
- We would suggest a flexible approach, so that if by the time of conversion it was determined that the term SOFR curve required for the forward approach was not available, the credit spread adjustment would then fall back to the historical mean/median approach.

3. General Questions Posed

Importance of the fallbacks being present value neutral at trigger:

We believe the transition to fallbacks should be approximately present value (“PV”) neutral, with economic gains and/or losses minimized for all market participants. We believe this should be the case for tax purposes as well.

The assumption that PV neutrality can be achieved under the forward approach depends on whether deep and liquid term markets exist for IBORs and the corresponding RFRs (the IBOR curve and the corresponding RFR curve) at the time of trigger. If not, it would be difficult to build a robust forward spread path. In addition, the forward approach would require several assumptions and modeling decisions, for example, interpolation and extrapolation methods for the IBOR and related RFR curves, the difficulty of which should not be understated.

The historical mean/median approach to calculating the spread adjustment could also achieve PV neutrality. When and if ISDA recommends the historical mean/median approach, the actual spot LIBOR/SOFR basis would likely converge to the anticipated historical 10-year mean LIBOR/SOFR difference thus ensuring PV neutrality on the trigger date. The efficiency of the convergence would be dependent upon the amount of time in which the market could adjust to the target LIBOR/SOFR basis prior to the trigger and market consensus regarding the anticipated trigger date.

Importance of fallback rates being available in advance of accrual period:

As discussed above in this letter, for most cash products the fallback rate should be available at the start of the accrual period, at least for tenors longer than one month. While there have been a few debt issuances to date using SOFR on an in arrears basis, this approach might not be acceptable for tenors longer than one month for consumer assets generally as well as for the vast majority of corporate debt and floating rate notes. Accordingly, we recommend incorporating into the ISDA fallbacks, as the first priority, forward-looking term SOFR rates based on market transactions, if such term SOFR rates have been officially selected, endorsed or recommended.



4. Conclusion

While the dollar amount of securitizations and underlying consumer and business debt that is linked to LIBOR is relatively small compared to the size of the total LIBOR-linked derivatives market, the exposure still runs in the trillions of dollars. Currently, LIBOR is defined essentially the same in these cash instruments as in the derivatives market. We do believe that following a LIBOR termination, the cash markets will strongly favor a forward-looking term rate structure. As a replacement for LIBOR, we believe that a forward-looking term SOFR is a fundamentally different construct than the proposals contemplated in the Consultation, including compounded daily SOFR in advance or in arrears. We believe that alignment between the ISDA fallbacks and the cash market fallbacks is essential for the successful launch of SOFR, insofar as derivatives are used to hedge these cash market exposures. Accordingly, we strongly encourage ISDA to implement a flexible fallback waterfall for USD LIBOR that prioritizes forward-looking term SOFR rates selected, endorsed or recommended as the replacement for LIBOR by the Federal Reserve Board and/or the NY Fed, or by the ARRC.

SFIG appreciates your consideration of these comments and welcomes the opportunity to discuss further. If you have any questions about this matter, please contact Sairah Burki, Head of ABS Policy, at (202) 524-6302 or sairah.burki@sfindustry.org.

Very truly yours,

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