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Re: Request for Information Relating to Production of Rates

Federal Reserve Docket No. OP-1573

Ladies and Gentlemen:

The Loan Syndications and Trading Association ("LSTA")[1] is pleased to submit these comments in response to the Request for Information Relating to Production of Rates ("Request for Information"). At the invitation of agency staff and officials, the LSTA submits these comments to provide information on the syndicated loan market, which may help inform the production of new reference rates based on data from overnight repurchase agreement transactions secured by Treasury securities. We first provide information on the syndicated loan market and then provide additional information in response to Question 3 in the Request for Information.

I. Background

In 2014, in response to recommendations made by the Financial Stability Oversight Counsel and the Financial Stability Board to develop and encourage the use of alternative benchmark rates (instead of LIBOR), the Federal Reserve convened the Alternative Reference Rate Committee ("ARRC"). The ARRC's mandate was to: (1) identify a set of alternative reference rates that are more firmly based on transactions from a robust underlying market and that comply with emerging standards; and (2) identify an adoption plan. On June 22, 2017, the ARRC identified a broad Treasuries repo financing rate or secured overnight financing rate ("SOFR") as the rate that, in its consensus view, represents best practice for use in certain new U.S. dollar derivatives and other financial contracts.

SOFR is different from U.S. dollar LIBOR, which it would replace. LIBOR is an average

1 The LSTA, founded in 1995, is the trade association for the syndicated corporate loan market and is dedicated to advancing the interests of the market as a whole. The LSTA is active on a wide variety of activities intended to foster the development of policies and market practices designed to promote a liquid and transparent marketplace. LSTA's members include more than 400 banks, non-bank lenders, law firms and other service providers. More information about the LSTA is available at www.lsta.org.

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of the rates at which surveyed banks estimate they can borrow in the interbank market for seven different periods, ranging from overnight to 12 months into the future. LIBOR takes into account interest rate differences which would result from the credit risk of one bank lending to another bank and the changes in the pricing of that credit risk over time, from overnight to 12 months. In contrast, SOFR is the rate at which banks secure overnight funding through a repurchase transaction collateralized by Treasury securities and generally reflects neither credit risk nor term risk, the risk of lending over time. Any maturity other than overnight must be determined on an as-yet undetermined basis, which may include the price of a futures contract based on the quoted overnight rate. Because SOFR reflects neither credit nor term risk it runs lower than LIBOR, on an overnight basis and on an interpolated term basis. That differential increases as term extends. If these differentials are not addressed by ARRC or within industry groups, they have the potential to disrupt a number of markets, including the loan market on which many American businesses depend.

Much of the focus of ARRC to date has been on the $140 trillion of derivatives contracts that reference LIBOR.[2] However, many other types of credit and lending transactions, including syndicated and bilateral loans, rely on LIBOR as the basis for their interest rate determination. These LIBOR-based credit and lending transactions and other LIBOR-based instruments "helps to drive one of the key sources of demand for hedging LIBOR in derivatives markets."[3] It follows that if an alternative reference rate were not suitable for use as the benchmark rate for commercial lending in all its guises, there would be less demand for hedging that rate in the derivatives markets.

Accordingly, the needs of borrowers, lenders and other participants in commercial credit and lending transactions should be considered in connection with both the development of any alternative reference rate and the measures taken to avoid disruption of the credit markets during the transition from one benchmark to another.

II. The Syndicated Loan Market

Syndicated loans are commercial loans that are not held by any one bank exclusively. These loans are made by multiple banks and non-bank lenders.[4] According to the Shared National Credit Review, in 2017, there were $4.3 trillion U.S. syndicated loan commitments outstanding[5], nearly all of which currently rely on LIBOR as a base rate.[6]

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2 *See, e.g.*, ARRC, Interim Report and Consultation, May 2016 ("ARRC Report"), p. 6-12, available at https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2016/arrc-interim-report-and-consultation.pdf.

3 *Id.* at p. 6.

4 Non-bank lenders include entities like Collateralized Loan Obligations ("CLOs"), mutual funds, insurance companies, hedge funds, pension plans, 401k retirement plans, 529 education plans, Health Savings Accounts and other institutional investors through separately managed or commingled accounts.

5 Shared National Credit Program, 3rd Quarter 2016 / 1st Quarter 2017 Examinations, Federal Reserve Board, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, August 2017, available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170802a1.pdf.

The syndicated loan market has a number of constituents that are stakeholders with respect to any transition from LIBOR to a new reference rate. All such market participants would want to ensure that such a transition does not result in a rate that changes the allocation of risk and rewards that was bargained for at the time the loan was executed, but they also have other concerns:

- *Corporate borrowers*. Collectively, corporate entities have borrowed $4.3 trillion through the syndicated loan market. In a transition from LIBOR to a new reference rate, corporate borrowers would want to ensure that: (1) they have confidence in the process by which the new rate is determined; (2) they still have the ability to easily hedge interest rate risk; and (3) the periodic rate for an interest period is reset at the start of the period, so that the borrower knows the amount of interest that it will be required to pay sufficiently in advance of each interest payment date to manage its liquidity and cash flow effectively – this facility may be lost, depending on how the alternative reference rate is reset.

  In addition, many corporate borrowers have multi-currency facilities, under which they can draw down amounts denominated in different currencies. If, as a result of the movement away from LIBOR, the reference rates used by different currencies are determined using significantly different methodologies, such facilities may either cease to be available, or may contain substantially different pricing depending on the currency.

- *Non-bank lenders*. Collectively, these entities have provided an estimated $1 trillion of U.S. syndicated loans.[7] Many of them rely on investors whose returns are based on the yield from their loan portfolios and depend on being able to attract future investment based on reasonable returns above a risk-free rate. Changes to the base rate that change the existing risk-reward profile could also change the willingness of investors to continue to support the non-bank lending market.

- *Banks acting as lenders*. These entities range from money center U.S. banks to regional and community banks, as well as foreign banking organizations. All have different specific needs and obtain their funding from a variety of sources. LIBOR is a component in calculating the cost of funds for certain of these banks. In general, banks would want any replacement rate to similarly reflect a cost of funds concept.

- *Banks acting as agents*. Banks frequently serve as agents for syndicated loans. In their capacity as agents, they typically calculate interest payment amounts and operate related payment systems. If a new reference rate is determined in a significantly different manner or at a significantly different time than LIBOR, these banks may be unable to use existing systems to calculate and effect payments. The transition to an

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[6] ARRC Report, p. 6. We note that data on size of the bilateral loan market are not available, but that bilateral loans are affected by the prospective transition away from LIBOR in many of the same ways as syndicated loans, with the exception that they may be easier to amend than widely syndicated loans.

[7] This estimate is based on S&P/LSTA Leveraged Loan Index outstandings of $938.32 billion as of Sept. 29, 2017.

alternate reference rate may require extensive investment by agent banks, which is likely to be passed on to borrowers. It is also possible that the new reference rate may extend the period between the end of an interest period and the time when each lending bank is paid its share of the accrued interest. That delay may cost the banks in terms of capital or liquidity, and that cost may also be passed on to borrowers.[8]

- *Investors in CLOs*. CLOs have exposure to approximately $470 billion of U.S. dollar LIBOR-based loans.[9] For the most part, interest payable on debt securities issued by U.S. CLOs is also based on U.S. dollar LIBOR. Thus, CLO investors would want to ensure that the reference rate on the loans remains correlated with the reference rate on the securities and is consistent among their existing investments at the time that LIBOR ceases to be published. In addition, they would want to ensure that the CLO debt securities they hold and the underlying loans that the CLOs hold all transition to the same replacement reference rate. Otherwise, there will be basis risk between the CLO assets and liabilities not accounted for in documentation or by investors.

In the process of transitioning from LIBOR to a new reference rate, any reduction of the underlying base rate referenced by syndicated loans could have a negative impact on yield of existing loans and could disrupt the secondary market for then outstanding syndicated loans. Any such disruption could result in a contraction of credit availability for U.S. businesses and consumers, thereby negatively affecting the U.S. economy. Accordingly, the LSTA requests that the concerns of all of these stakeholders be considered as any transition from LIBOR to a new reference rate progresses.

III. Are there any changes to one or more of these rates that would make them more useful? For what purposes?

The Request for Comment asked a number of questions, including, “Are there any changes to one or more of these rates that would make them more useful. For what purposes?” The LSTA appreciates the opportunity to discuss changes that would make the proposed reference rates more effective for the loan market or, at the least, should be considered during the transition process from LIBOR to a new reference rate.

Specifically, it is likely that many loans that will be outstanding when LIBOR is discontinued will not include a mechanism to allow for a simple transition from LIBOR to a new reference rate. To minimize disruption for these loans, the LSTA and its members ask that term fixings for SOFR and a bank credit risk spread (which is embedded in LIBOR, but not SOFR) be published when LIBOR is discontinued. We discuss why this is important below.

Syndicated loans are typically structured with LIBOR as a reference rate (which is meant to take into account banks' cost of funds) and a spread above LIBOR (which captures the credit risk of the borrower). Borrowers have the ability to select a LIBOR term (often one month or three months) that is suitable in light of their particular business cash flows.

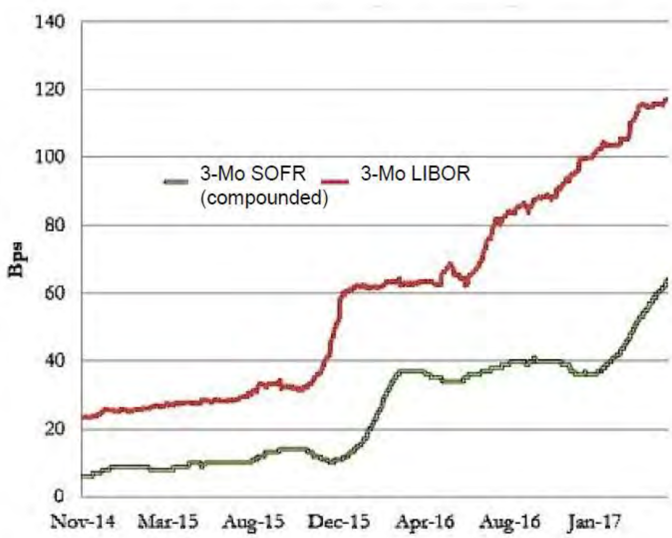
8 See also comments in the response of the Loan Market Association's to the Request for Information.

9 Leveraged Loan Monthly, Thompson Reuters LPC, September 2017, p. 5 ("Assets under management are now at $473 billion for U.S. CLOs").

However, SOFR, as proposed in the Request for Information, does not have either a term structure or a mechanism that would capture bank credit risk. Because SOFR is an overnight rate, it does not capture the term structure of LIBOR. Furthermore, because SOFR is a secured rate, bank credit risk, which is captured in LIBOR, is not captured in SOFR.

As a result of these factors, three-month U.S. dollar LIBOR – the most common reference rate used for loans – is expected to be higher than a three-month SOFR, irrespective whether it is determined on the basis of compounded historic rates or on the price of a term futures contract. While SOFR will not be published until 2018, provisional data provided by the New York Federal Reserve indicates that the three-month compounded SOFR has been below three-month LIBOR for the equivalent period. (See Figure 1 below.)

Figure 1: 3-Month LIBOR vs 3-Month Compounded SOFR



Source: FRBNY, St Louis Fed

We understand that ARRC expects to develop methodologies for term fixings for SOFR. The LSTA and its members reiterate that any permanent replacement rate should at least be suitable for the determination of robust term fixings for 1-week and 1-, 2-, 3-, 6- and 12-month maturities to capture the term structure and forward-looking nature of LIBOR. This would permit banks and borrowers to continue matching the term risk of loans with their corresponding interest cost.

In addition, the LSTA and its members believe that it would be helpful that any alternate reference rate for loans be accompanied by publication of a spread that accounts for bank credit risk, which is currently included in LIBOR but not in SOFR. There are several reasons why this is important for loan market stakeholders.

It has been customarily understood in the loan market that a loan's interest rate should reflect bank credit risk (as an element not subject to negotiation) and a spread (which incorporates borrower credit risk) that can fluctuate with market norms. Banks that extend credit in the syndicated loan market incur the cost of a liquidity term premium when they borrow funds from clients or institutional investors. This cost is made transparent and charged to borrowers through unsecured LIBOR settings across the money market term structure of interest rates. These banks are required to measure and manage to within risk appetite the quantity of basis risk that they are exposed to through the mismatch of volumes and tenors of various indices used in their asset and liability portfolios. If the cost to transform basis positions increases, this cost may be passed along to counterparties.

There has been discussion that it may be difficult to publish bank credit risk spreads for an extended period after LIBOR has been discontinued. Transition to a reference rate that excludes bank credit risk may be feasible after: (1) a new rate has been published for a sufficient period of time; and (2) the market has developed pricing methodologies that take into account bank credit risk spread and borrower credit risk spread.

Depending on how long an alternative rate has been published when LIBOR ceases to be available, market participants may not have had sufficient time to study the LIBOR-SOFR relationship. Consequently, stakeholders in legacy loans may seek to include some form of a credit spread that incorporates the LIBOR-SOFR differential when LIBOR is discontinued into their interest rate calculations. Although parties to a contract could theoretically individually negotiate a transfer fee based on their expectations of future LIBOR and future SOFR, this may not be a practical solution. Accordingly, the LSTA believes that it would be beneficial for these stakeholders to have access to a bank credit risk spread published when LIBOR is discontinued to ensure that there is no value transfer between a borrower and a lender as a result of the move away from LIBOR-based interest payments.

Finally, the LSTA is also concerned about fragmentation of reference rates by currency type. Many corporate borrowers have multi-currency facilities. Such arrangements are efficient and beneficial to the real world economy. The LSTA therefore encourages international coordination to encourage consistent approaches to alternative reference rates so that multi-currency loan facilities remain available and attractive to borrowers.

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The LSTA appreciates the Federal Reserve's consideration of these comments and would be pleased to provide additional information that might assist decision making. Please feel free to contact me at (212) 880-3019 if you have questions regarding these comments.

Sincerely,

Meredith Coffey
Executive Vice President, Research & Analysis