BMO IBOR Transition Office

September 9, 2019

Alternative Reference Rates Committee (“**ARRC**”)

Via email submission to: arrc@ny.frb.org

Re: Consultation Response – ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language For New Closed-End, Residential Adjustable Rate Mortgages

Bank of Montreal ("BMO") welcomes the opportunity to respond to the ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for New Closed-End, Residential Adjustable Rate Mortgages. BMO recognizes the need for establishing and adopting new industry standards in contract language for new Residential Adjustable Rate Mortgages that will assist in facilitating an orderly transition to a replacement Index. Our responses are as follows:

Questions about triggers

Question 1: Should fallback language for ARMs include either of the pre-cessation triggers (triggers 4(G)(ii) and 4(G)(iii))? If so, which ones?

Response: BMO believes it is appropriate to have both pre-cessation triggers included as part of the fallback language.

Question 2: 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.

Response: BMO does express some concern about the resulting time period for implementation of the fallback rate should either of these pre-cessation triggers be observed. BMO feels it would be beneficial to the industry to differentiate the implementation time periods between Pre-Cessation triggers 4(G) (ii) & 4 (G) (iii) versus 4(G) (i) Index being unavailable. The Index being unavailable (i) should still align with the 45 days following the Replacement event, however pre-cessation triggers should allow for a longer transition period as the nature of the pre-cessation events may not be widely anticipated and the Note Holders may require more time to action an orderly transition during which the original Index is still being published. 45 days is seen as Operationally aggressive time frame in which to execute an orderly transition.

Question 3: 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?

Response: BMO acknowledges that some loans have the ability for the issuer to substitute the Index but not the margins / spreads. However, without the addition of the Credit Spread (SOFR - LIBOR Basis), a value transfer would be expected.

As BMO sells a sizable portion of ARM product to Fannie Mae & Freddy Mac, BMO would require their consultation and guidance for any changes in the situation where pre-cessation triggers are not included, and a pre-cessation event has been observed for other interest rate products.

Question 4: The ARM language proposed uses simplified language in an effort to be more comprehensible for the consumer market. Is the simplified language appropriate or are there concerns with the language not matching ISDA or other cash product language precisely?

Response: BMO has no concerns with the language proposed and possible differences with ISDA and cash product language.

Replacement Index and Margin

Question 5: Is the replacement index determined by the Federal Reserve Board, the Federal Reserve Bank of New York, or a committee endorsed or convened by the Federal Reserve Board or the Federal Reserve Bank of New York the best choice as the first step of the waterfall? Why or why not?

Response: BMO agrees that this language is appropriate as it is specific in providing various sources from which to source the replacement rate while not being overly specific to only list a single fallback source.

It is considered the correct approach to expect that both the base replacement Index as well as a Spread value to be provided when the given industry body provides their replacement selection or recommendation.

BMO also sees appeal in language that would allow even more opportunity for more Note Holder selection, even if the proposed first step in the Replacement Index waterfall did produce a recommendation. This would allow for a similar rate to be selected for which the bank is operationally ready to support while still minimizing impact and price change to the customer.

Question 6: As noted in the narrative, the ARRC has committed to recommending spread adjustments for cash products that reflect the general difference between various tenors of LIBOR and SOFR. In addition, the ARRC has committed to seeing all-in, "spread-adjusted" rates published for use in cash products (e.g., a SOFR-based spread-adjusted replacement index for 1-year LIBOR). Should the ARRC recommend a spread adjustment for LIBOR ARMs and other consumer products, and should the corresponding spread-adjusted rate be the replacement index for the LIBOR ARMs?

Response: BMO agrees that there needs to be an adjustment to account for the difference between SOFR and LIBOR.

It is BMO's preference that the replacement SOFR based rates be kept in their components. IE, having SOFR rate plus a separate credit spread adjustment as the proposed replacement Index for LIBOR ARMs.

Question 7: As noted in the narrative, in addition to recommending SOFR, the ARRC may recommend forward-looking term SOFR rates if it is satisfied that a robust, IOSCO-compliant term rate that meets its criteria can be produced. If the ARRC recommends forward-looking term rates (e.g., 1-month, 3-month, 6-month, etc.) and a corresponding spread adjustment, should a spread-adjusted term rate be the replacement index for LIBOR ARMs, or would a spread-adjusted average (simple or compounded) of SOFR be more appropriate? Please provide support for your answer.

Response: BMO believes it would be appropriate to utilize a forward-looking term rate if they were available. Operationally, this would more closely mimic the LIBOR rate structure that is being replaced. From a customer experience perspective, this would outwardly have fewer elements of change in that the timing of events and rate components associated with a given mortgage would align with the LIBOR based mortgages.

Question 8: Should the Note Holder have the responsibility as the 2nd and last step of the waterfall? Why or why not?

Response: BMO agrees that the Note Holder should have responsibility if the first step does not result in a viable fallback.

However, the replacement rate selected needs to be comparable to where the interest rate is at time of cutover and reasonably be expected to behave similarly all the while still maintaining a reasonable and comparable margin for the Note Holder.

Question 9: Should the Note Holder have the ability to make adjustments (positive or negative) to the loan's margin to more closely approximate LIBOR at the time of replacement? Why or why not? If you do not believe the Note Holder should make adjustments to the loan's margin, and potential replacement indices diverge from the value of the current Index, what provision or step should be taken to preserve that consistency?

Response: BMO believes that the Note Holder should be able to maintain a comparable level of profit margin between LIBOR and the replacement Index.

The Note Holder should be able to implement and announce via notification to the customer of the replacement index and new margin without expectation to re-open and negotiate the contract.

The replacement all in rate, inclusive of margin, should be limited to those that are reasonably comparable in both the Note Holder's and customer's perspective. If the customer is in line or in a more favorable position, they are expected to be accepting of the revised rate.

Question 10: If the Note Holder is a trust (for example, as may occur in private label MBS), is there some entity other than the Note Holder that should be responsible for identifying the Replacement Index if Step 1 of the waterfall fails? Please provide sufficient rationale for your answer.

Response: BMO believes that a Trustee would be in best position to make this change. This would ensure that cashflow to bond holders would be comparable to prior expected flows.

A competitive pricing landscape would also have to be considered in making this selection.

Other Questions

Question 11: Will this language have unintended consequences not considered by the ARRC working group, such as title insurance restrictions, state law endorsement or filing restrictions, etc.? If so, please explain and provide information about why this language would present challenges. If there are concerns with this proposed language, please be sure to specify if concerns relate to this proposed language, or index replacement language in general.

Response:

BMO does foresee some possible consequences that should be given consideration. They are as follows:

a. As likelihood of transition nears without a clearly defined replacement, this could cause an influx of ARM pre-payments to switch over to the certainty of Fixed Rate products.

b. New originations on the Replacement Index would need to disclose APRs (Annual Percentage Rates), so a methodology for calculation would need to be understood depending on the announced replacement rate attributes.

c. Should there not be consistent and fair replacement rates assigned, the Consumer Finance Protection Bureau (CFPB) may need to step in and intervene.

d. The more flexibility and control that the Note Holders reserve and retain to themselves, the more legal risk that they open themselves up to.

General Feedback Questions

Question 12: Is there any provision in the proposal that would significantly impede ARM originations? If so, please provide a specific and detailed explanation.

Response: BMO anticipates no material impact in ARM originations as a result of these changes.

Question 13: Please provide any additional feedback on any aspect of the proposal.

Response:

BMO has two areas of additional feedback on this consultation:

a. BMO believes that there is an opportunity to more explicitly state in section 4.G that a primary objective in the selection of a replacement rate is one that minimizes value transfer and that is comparable to the LIBOR based rate on which it is replacing. This would alleviate customer concerns as well as provide guidance on expectations of those making the recommendation for replacement.

b. BMO poses the question of whether an Index Administrator need to be defined and referenced in the selection and communication of a replacement rate?