

ARRC CONSULTATION REGARDING MORE ROBUST LIBOR FALLBACK CONTRACT LANGUAGE FOR NEW ISSUANCES OF LIBOR FLOATING RATE NOTES

Bank of Nova Scotia -- RESPONSE

Question 1(a): Should fallback language for FRNs include any of the pre-cessation triggers (triggers 3, 4 and 5)? If so, which ones?

Answer to Question 1 (a). Our view is that the language used to describe the fallback triggers should be identical as between **floating rate notes** as it is for derivatives to ensure the cash and derivatives markets don't move asymmetrically. In addition, our view is that the triggers should be based on events that are objectively verifiable so as to avoid potential disputes when the language is invoked.

Question 1(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 to Question 1(b). As stated in response to question 1(a), our concerns about pre-cessation triggers pertain primarily to the possible misalignment between the terms of **floating rate note** documents and related hedge (derivatives) documents.

Question 1(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 to Question 1 (c). Most standard **floating rate notes** include clauses intended to address market disruption with respect to LIBOR, which could potentially be used in situations where there are no adequate and fair means to ascertain LIBOR for a given interest period.

If the market view is that these clauses are generally not adequate to address scenarios such as the examples presented, it is preferable to rely on pre-cessation triggers, *provided* there is a published replacement rate and the triggers (and language describing the triggers) are aligned with those in standard derivatives documentation (as mentioned in our answer to 1(a)).

Question 2: If the ARRC has recommended a forward-looking term rate, should that rate be the primary fallback for floating rate notes referencing LIBOR even though derivatives are expected to reference overnight versions of SOFR?

Answer to Question 2: Because a term SOFR would be akin to LIBOR, it would be more familiar to the market and may be simpler to operationalize. However, as indicated above, if the benchmark in the cash market documents (e.g. term SOFR) differs from the benchmark applicable to the related hedging instrument (e.g. compound or overnight SOFR), the ISDA documentation governing the derivative transaction will have to be amended.

Our view is that if the cash markets prefer a term SOFR, ISDA should take steps to ensure the derivatives documentation is aligned.

Question 3(a): Should Compounded SOFR be the second step in the waterfall? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR?

Answer to Question 3(a): Floating rate notes are currently priced using either a compounding or spot overnight rates. This differs from derivatives products which use a compounding approach. Depending on which approach is used in the **floating rate note** contract, the same approach applies in the case of fallback to an alternative rate.

For example, if the **floating rate note** uses a spot approach, a spot approach would be used if and when a fallback rate is applied. Consistency in methodology between the primary and fallback rates should dictate the order of the waterfall. Should the derivatives market reference either a compounded SOFR or overnight SOFR, misalignment will occur between the derivative product and those FRNs that reference the opposite.

It is our view that it isn't yet possible to ascertain or predict whether the market will align to a single approach (either spot or compounding) for **floating rate note** issuances.

Question 3(b): 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 to Question 3(b). Should Compounded SOFR be included in the waterfall, our preference is for a compounding period "in arrears". We don't support an "in advance" compounding period.

Question 4(a): Would an overnight rate that remains in effect for the entire interest period be an acceptable option for investors, issuers and agents?

Answer to Question 4(a): An overnight rate that remains in effect for the entire interest period is acceptable, as long as it corresponds with the relevant tenor, and it is published, transparent and accepted by the industry. In addition, it should include a spread adjustment where necessary.

Question 4(b): Should the waterfall include Compounded SOFR (step 2) and spot SOFR (step 3) and/or a simple average of SOFR (not in the waterfall at this time)? If only one of these options is included, which is preferable? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR?

Answer to Question 4(b): As mentioned in our response to 3(a), **floating rate notes** are currently priced using either a compounded rate or a spot rate. The fallback rate should operate the same way as the primary (LIBOR) rate; that is, the fallback rate should be either compounded or spot depending on how the primary rate was calculated. Depending on whether the **floating rate note** market moves towards either compounded or spot, the waterfall should allow for consistency between methodologies between the primary and fallback rates.

Question 5: In the future circumstance where there is no SOFR-based fallback rate, is the replacement rate determined by the Relevant Governmental Body the best alternative at this level of the waterfall?

Answer to Question 5: In this stage of the waterfall, the alternative replacement rate should be a managed, central bank rate, or another rate which is published, transparent, and accepted by the industry.

Question 6(a): In the future circumstance where there is no SOFR-based fallback rate and the Relevant Governmental Body has not recommended a replacement rate for FRNs, is the fallback for SOFR-linked derivatives set forth in the ISDA definitions the best alternative at this level of the waterfall?

Answer to Question 6(a): Yes.

Question 6(b): Should this step in the waterfall refer expressly to OBFR and then the FOMC Target Rate rather than refer to the fallback rate for SOFR-linked derivatives in the ISDA definitions (which could change in the future)?

Answer to Question 6(b): Yes, this is acceptable. We agree that the ISDA definitions would be the best alternative in the absence of other rates, but we cannot fully comment until we have seen the outcome of the ISDA consultation.

Question 7: Should the issuer or its designee have the ability to over-ride the ISDA fallback for SOFR-linked derivatives in the ISDA definitions at this level of the waterfall if it determines that another rate that is an industry-accepted successor rate for FRNs exists at such time?

Answer to Question 7: We do not support the ability of the issuer or its designee having the ability to over-ride the ISDA fallback for SOFR-linked derivatives.

Question 8: Do you believe that the ARRC should consider recommending a spread adjustment that could apply to cash products, including FRNs?

Answer to Question 8: Yes, we request that the ARRC recommend and publish a spread adjustment that would apply to cash products, including **floating rate notes**.

Question 9: Is a spread adjustment applicable to fallbacks for derivatives under the ISDA definitions appropriate as the second priority in the spread waterfall when the Unadjusted Replacement Rate is equivalent to the ISDA fallback rate?

Answer to Question 9: If the **floating rate note** fallback is to a different rate than the rate adopted by ISDA, it is not appropriate to look to the ISDA spread adjustment. If the spread adjustment selected by ISDA is included in the waterfall, it should only apply if it relates to the same benchmark (e.g. Compounded SOFR).

Question 10: If the ARRC does not recommend a spread adjustment, should the issuer (or its designee) have the ability to determine the spread adjustment (or, if step 2 is applicable, over-ride the spread adjustment for derivatives fallbacks in the ISDA definitions) and select a spread adjustment that would result in a rate that is an industry-accepted successor rate in floating rate notes at such time?

Answer to Question 10: If the ARRC does not recommend a spread adjustment, the spread adjustment should be determined by the calculation agent.

Question 11: Whether as issuer or as calculation agent, would your institution be willing to (i) determine whether the proposed triggers have occurred, (ii) select screens where reference rates or spreads are to be found, (iii) make calculations of a rate or spread in the absence of published screen rates, (iv) interpolate term SOFR if there is a missing middle maturity and (v) make the decisions in step 6 of the Replacement Benchmark waterfall and step 3 of the Replacement Benchmark Spread waterfall?

Answer to Question 11: In our capacity as issuers, we would prefer not to be in the position of having to determine whether a trigger has occurred, or make any other determination as outlined above. In cases where a calculation agent is appointed, and provided the calculation agent has broad discretion to make decisions in a commercially reasonable manner, we are not opposed to the calculation agent making those determinations.

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

Answer to Question 12: In respect of floating rate *structured* notes, a derivative product is typically used to hedge the structured pay off, and that derivative references the same floating rate as the FRN. Where there is misalignment between the reference rates (and their underlying methodologies) used between floating rate structured note and the hedging instrument, there is a potential for basis risk between the note and its hedge. This could impede the issuance of floating rate structured notes.

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

Answer to Question 13: As we have explained throughout, it is very important that fallback rates for **floating rate notes** operate in the same manner as the derivatives used to hedge the risk associated with the floating rate note.

However, it is also important to note that in the case of **floating rate notes**, the market currently uses both (or rather, either) the compounded or the spot approach, depending on pricing. To ensure the integrity of the instrument in the case of fallback is invoked, the same approach should be used between primary and alternative rates. Since there is no way to know whether the **floating rate notes** market will adopt a singular approach (either spot or compounded), it is not possible to determine how those approaches should be ranked in the waterfall.

Should the ISDA consultation make clear that either a compounded or a spot rate will be used, this may influence the way in which **floating rate notes** are priced (assuming the **floating rate notes** market

follows the derivatives market), and therefore create better alignment between the cash and derivatives market.

We therefore urge the ARRC to consider the results of the ISDA consultation before concluding the order of the waterfall.