Alternative Reference Rates Committee

Via email: arrc@ny.frb.org

5 February 2019

RE: Consultation regarding new issuances of LIBOR securitizations

Our firm welcomes the opportunity to respond to the Alternative Reference Rates Committee (ARRC) consultation in relation to U.S.dollar (USD) LIBOR fallback contract language for new securitizations. Our firm has set out the responses to the questions contained in the consultation paper released on 7 December 2018 below.

Our firm requests that its response please be posted anonymously.

Question 1: Which securitization asset classes are you referring to in your response to this consultation if limited to only certain asset classes? If there are any particular features of these asset classes that shape your responses to the question sin this survey, please describe them to the extent possible.

The responses provided here refer primarily to Residential Mortgage-Backed Securities (RMBS), although our view is that they would also be relevant for auto loans, Collateralized Loan Obligations (CLO) and personal loan securitizations.

Neither the underlying assets nor the notes issued under any of the outstanding RMBS transactions our firm has issued are priced as a margin to LIBOR. The underlying mortgages are discretionary priced while the notes are priced at a margin to BBSW.

Question 2: The ISDA triggers contemplate a permanent cessation of LIBOR as of a date certain which may be announced in advance (the "Cessation Date"), at which point the transition from LIBOR to SOFR would occur. As there may be operational challenges for securitizations as both assets and liabilities will have to be transitioned, some have asked for the ability to transition in advance of the Cessation Date in order to address any operational issues that may arise. Specifically, the Designated Transaction Representative (as defined in Appendix 1) will have the ability to pick one date within a 30-day period prior to the Cessation Date to facilitate an orderly transition. Do you feel the inclusion of this ability to transfer prior to the Cessation Date is needed? If so, please explain the specific, critical and tangible needs that support its inclusion.

Yes, there is value in having the ability to transfer from LIBOR to SOFR in advance of the Cessation Date as the Cessation Date may not coincide with a repricing rollover date for the underlying securitization transactions. It would be operationally most efficient for the Pre Cessation Date change to take effect from the next coupon payment date and for both the assets and liabilities to reprice on the same date and to the identical new index (i.e. as per ISDA) to minimise any basis risk.

Question 3(a): Should fallback language for Securitizations include any pre-cessation triggers (clauses (3), (4), (5) and (6) of the Benchmark Discontinuation Event definition)? If so, which ones? Also, please identify any pre-cessation triggers that you do not believe should be utilized for a particular securitization product and explain why.

Trigger 3 – Other than as a consequence of a systems glitch/market disruption, our firm would expect any failure to publish a LIBOR rate for 5 consecutive days would be a consequence of triggers 4 or 5.

Triggers 4 and 5 – Yes. If pre-cessation triggers are not included, there is an increased risk of litigation if the noteholders consider that the LIBOR rates used are not representative of what the real LIBOR rate should be.

Trigger 6 – Potentially, although the response to this question will be driven by ratings agencies criteria specifying the minimum percentage of assets that are required to be priced off the same base rate as the notes.

Question 3(b): Please indicate whether any concerns you have about these pre-cessation triggers relate to the difference between these securitization triggers and those for standard derivatives or whether your concerns relate specifically to the pre-cessation triggers themselves.

Our concerns have to do with the difference between the securitization triggers and those for standard derivatives. To minimise any basis risk between the pricing of the assets and the notes, the pre-cessation triggers need to be triggered for both at the same time. If the pre-cessation triggers are not aligned, the resulting mismatch could lead to securitization rating downgrades.

Question 3(c): If you believe that the pre-cessation trigger in clause (6) (Asset Replacement Percentage) should not be retained, please note any specific concerns leading to this conclusion. If you believe it should be retained, are there any changes you believe should be made to this trigger? Please explain.

The pre-cessation trigger in clause (6) should be retained. As noted above, the driver in determining whether or not this trigger has been triggered should be the note ratings criteria set by the ratings agencies.

Question 3(d): If you believe the pre-cessation trigger in clause (6) (Asset Replacement Percentage) should be retained, how would you address concerns that it could result in a transfer of value in a transaction where the Designated Transaction Representative has the ability to change the benchmark used on the underlying asset and, as a result, determine the timing of the pre-cessation trigger? Are there other changes that should be made to the Asset Replacement Percentage trigger? Note that this trigger relates to a mismatch between the securities and the Securitization assets that result from changes in the assets. A mismatch may also arise from a change in the securities due to a trigger event under these fallback provisions. Any concerns with the latter scenario can be addressed in responses to question 16.

As noted above, the risk of value transfer would be minimised by ensuring the underlying assets and notes both reprice to the new benchmark at the same time. Changes to the Asset Replacement Trigger should be discussed and agreed with the relevant ratings agencies, as their criteria will determine what the trigger level should be.

Question 3(e): If pre-cessation triggers are not included, are there options available to market participants to manage the potential risks involved in continuing to reference a Benchmark in the circumstances contemplated by each of these pre-cessation triggers?

One possibility would be to seek investor consent to change the pricing benchmark terms. However, 100% investor consent may be difficult to achieve and, in the absence, lead to litigation.

Fortunately, as noted above, as an issuer, the firm does not have any securitization exposure to assets or liabilities priced off LIBOR.

Question 4: Should the proposed securitization fallback language permit the Designated Transaction Representative to transition the securities after a trigger has occurred but before the Benchmark Replacement Date? Should any limitations be placed on its use? Should there be a limited date range (e.g., 60 days) prior to the Benchmark Replacement Date in which this could be used? Should the Designated Transaction Representative be limited in the circumstances under which it could elect to utilize the additional time? If so, what standard should be utilized to assess whether the additional time is necessary? In each case, explain why.

Yes, the fallback language should permit the Designated Transaction Representative to transition the securities after a trigger has occurred but before the Benchmark Replacement Date. This discretion should only be available for exercise within a relatively short period before the Benchmark Replacement Date, say 90 days to ensure there is sufficient liquidity available in the alternative benchmark. Any change in benchmark should occur on a coupon repricing date and should apply to both the assets and liabilities. Preferably, the issuer would not make the call, but there would be industry wide agreement to transition securitization transactions on their next rollover dates within the 90 day window.

Question 5(a): If the ARRC has recommended a forward-looking term rate, should that rate be the primary fallback for the securities referencing LIBOR even though derivatives are expected to reference overnight versions of SOFR? Please explain why.

Yes, provided it reflects investor demand and only on the condition that an effective derivative hedge can be executed on the same basis. Securitization investors have a strong preference to know what their future interest and cashflows will be at the start of each interest period and require the ability to hedge these exposures. Development of deep and liquid derivatives markets (in SOFR) will be a precondition to allow the calculation of accurate forward rate curves/rates.

Question 5(b): Is there a specific reason that the securitization market should first fall back to forward-looking term SOFR instead of another rate? Please explain why.

Yes, as stated above, investors have a preference to know in advance what their interest rate and cashflows will be rather than waiting till the end of the interest period. Also, as explained in the response to question 17, there are practical reasons why having a forward-looking SOFR rate would be the preferred first fall back rate.

Question 5(c): Is the use of an Interpolated Period appropriate in the securitization markets? Please explain any limitations that should be applied to the use of an Interpolated Period.

Yes, it should be readily able to be calculated by investors and calculation agents.

Question 5(d): In the event a Replacement Benchmark is determined other than under Step 1 of the waterfall, should the waterfall provide that the Replacement Benchmark be changed in the future as soon as a rate can be established under Step 1 of the waterfall?

Yes, subject to the not being inconsistent with the ratings criteria set by the ratings agencies, allowing the Replacement Benchmark to be changed will increase the probability it will be the benchmark which best meets the needs of investors (i.e. a term SOFA rate) and their desire to have a rate that enables them to know what their future interest rate and cashflows will be at the start of each interest period. Any change to a Replacement Benchmark needs allow sufficient time for operational reasons for the change to be implemented.

Question 6(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?

Yes, and ideally compounded SOFA will apply under both the ARRC and ISDA recommendations.

Question 6(b): If you believe that Compounded SOFR should be included, which compounding period is preferable ("in arrears" or "in advance")? Please explain why. Would this preference be influenced by whether ISDA implements fallbacks referencing Compound SOFR "in arrears" or "in advance"? Please explain whether your preference is based on operational concerns in implementing a particular approach or on economic concerns.

"In arrears" compounding is preferred to ensure consistency with the recommended ISDA approach. This preference is based on economic concerns as any rate determined "in advance" may not be representative of interest rates over the actual period against which it is applied.

Question 6(c): If it was necessary to calculate Compounded SOFR and a third party was not available to perform these calculations, are there parties to the Securitization transactions with sufficient resources to perform those calculations accurately and efficiently? Are there other considerations relating to the calculation of Compound SOFR that would make it an undesirable Replacement Benchmark without the availability of a third party provider?

Yes, the calculation agent, or as a last resort, the issuer, should be able to perform the calculation.

No other considerations come to mind as the compounding calculation would be one consistent with an industry standard. It is not unreasonable to assume a third party would always be available to calculate the rate, and this would be no different if the underlying transaction was an FRN, swap or securitization transaction.

Question 7: As noted, this consultation does not include Spot SOFR as a third step in the waterfall. Do you believe that Spot SOFR is an appropriate fallback reference rate for Securitization contracts or should the second step in the replacement rate waterfall be Compounded SOFR, after which the replacement rate would be, first, recommended by the Relevant Governmental Body, second, default to the then-current ISDA Definitions, and third, proposed by the Designated Transaction Representative?

No, Spot SOFR is not an appropriate fallback rate. It is subject to volatility, especially over month/quarter end dates, and may not be representative of rates over the longer interest period. The sequence for fallback calculations should be as set out above.

Question 8: In the future circumstance where there is no SOFR-based fallback rate, is the replacement rate determined by the Relevant Government Body the best alternative at this level of the waterfall? Please explain why.

Yes, an officially sanctioned industry standard determined by a Relevant Government Body would be the best alternative.

Question 9: In the future circumstance where there is no SOFR-based fallback rate and the Relevant Government Body has not recommended a replacement rate for Securitizations, is the fallback for SOFR-linked derivatives set forth in the ISDA definitions at the time of cessation the best alternative at this level of the waterfall? Is this fallback appropriate if ISDA Definitions only include overnight fallback rates? Please explain why.

Yes, this would minimise the likelihood/extent of basis risk between the securitization and any underlying derivative hedge.

Question 10(a): Since it is unlikely that there will be no ISDA fallback clause (clause (a) above), this provision is more likely to occur (if at all) when the ISDA fallback is deemed not appropriate for securitization securities (clause (b) above). In that scenario, is this provision appropriate as the final step in the Replacement Benchmark waterfall? Please explain why.

There should be sufficient fallbacks higher up the waterfall such that this additional fallback is unnecessary. If it did occur, it would be highly unlikely any Designated Transaction Representative would be prepared to determine a Replacement Benchmark rate as doing so would open them up to the significant risk of litigation.

Question 10(b): Should the provision allow for "re-testing" the waterfall to determine whether another Replacement Benchmark has become available in the scenario where investors have rejected the Proposed Replacement Benchmark? Should the waterfall be re-tested in any other circumstances (e.g., any time the Replacement benchmark has been determined under a "less-desirable" clause)? How often? Please explain why.

There should be sufficient fallbacks higher up the waterfall such that this additional fallback is unnecessary.

Question 11: Are there any concerns if a spread adjustment was utilized with cash products that was calculated by a spot rate comparison of the difference between LIBOR and the Replacement Base Rate at the time of conversion? Should this option be included in the spread waterfall? If so, where?

No, the risk here is that a spot rate determined spread may be volatile and not be representative of what the spread has been over a longer period and should therefore not be used in the waterfall. The overwhelming recommendation from the recent ISDA consultation paper is that the historical mean/median spread should be used to determine the spread adjustment.

Question 12: Do you believe that the ARRC should consider recommending a spread adjustment that could apply to cash products, including Securitizations?

Yes, it would be preferable to have an industry agreed spread adjustment, and ideally this would be consistent with the ISDA recommended spread.

Question 13(a): Is a spread adjustment applicable to fallbacks for derivatives under the ISDA definitions appropriate as the second priority in the spread waterfall? Please explain why.

Yes, it would then be consistent with the ISDA adjustment and minimise any basis risk between securitization transactions and swaps

Question 13(b): If the ARRC has recommended a forward-looking term SOFR but has not recommended a corresponding spread adjustment under Step 1 above, do you believe that the ISDA spread adjustment described in Step 2 (which may be intended to apply to a different Replacement Base Rate) should apply to Securitizations? Please explain why.

No, the two rates (compound in arrears overnight SOFR under ISDA and the forward-looking SOFR under ARRC) are potentially very different rates with the forward looking rate incorporating a term premium. Therefore the spread adjustments applied to each needs to be different.

Question 13(c): Given that ISDA has not yet decided upon the spread calculation methodology, should Step 2 be excluded from the waterfall? Please explain why.

No, a spread adjustment is necessary to minimise the extent of any value transfer given the change in benchmark rates from a forward looking LIBOR rate to an overnight based SOFR.

Question 14(a): What type of institution can and should take on the responsibility 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/or (v) elect to cause an early transition under the proviso to the definition of Benchmark Replacement Date?

Type of institution for each alternative should be:

(i) Regulatory supervisor for the benchmark administrator, central bank for the currency of the benchmark, insolvency official or resolution authority with jurisdiction over the benchmark administrator
(ii) Issuer subject to an industry body announcing what are the appropriate pages
(iii) Issuing and Paying Agent (IPA)/calculation agent
(iv) Issuer
(v) Unsure at this stage – preferably a central bank or relevant industry body

Question 14(b): Whether as issuer, sponsor, servicer or calculation agent, will your institution be willing to (i) determine whether the proposed triggers have occurred, (ii) select screen 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/or (v) elect to cause an early transition under the proviso to the definition of Benchmark Replacement Date?

This institution would be:

(i) Willing to determine a trigger has occurred, but only if they are able to refer to an industry announcement that clearly signals a trigger has occurred
(ii) Willing to select screen but subject to an industry body announcing what the appropriate pages are
(iii) Not willing to calculate a rate or spread in the absence of published screens
(iv) Willing to interpolate SOFR where there are missing/middle maturities
(v) Not elect an early transition under the Benchmark Replacement Date proviso

Question 15: Is there any provision in the proposal that would significantly impede Securitization issuances? If so, please provide a specific and detailed explanation.

No.

Question 16: Given the fallback language for the Securitization and the underlying assets may operate independently, please identify any sources of misalignment between those components that are not addressed in the consultation.

Other than the basis risk identified above, there is nothing additional to add.

Question 17: Are there specific operational challenges that implementing the proposed fallback language might create for securitizations? If so, what are those challenges and under what circumstances might they occur? How might they be mitigated?

For legacy transactions, if the alternative reference rate chosen to replace LIBOR is compounded SOFR which uses a look back period or a lock out period, this will cause operational challenges for legacy transactions. The operational challenge is caused where there's a mismatch between the time frame for collecting payments on underlying securitized assets and the payments on the notes. In a typical securitization transaction, the cashflows on the underlying securitized assets pay returns from the first to the last day of the month – this is known as the Collection Period. The note coupons are due during the month *after* the collection period. If Libor is used as the reference rate for coupon payments, the Libor rate is know in advance during the Collection Period and can be used to calculate all the trust receipts from the assets and payment on the notes. If compounded SOFR is used, the note coupons will be unknown until a few days before coupons are due which practically doesn't provide sufficient time to calculate payments due to investors.

This can be mitigated by using a forward looking SOFR rate as the fall back rate to replace LIBOR. The forward looking SOFR rate will be known during the collection period in advance of the coupon payment dates.

Question 18: Please provide any additional feedback on any aspect of the proposal.

Nothing further to add.