ARRC CONSULTATION REGARDING MORE ROBUST LIBOR FALLBACK CONTRACT LANGUAGE FOR NEW ORIGINATIONS OF LIBOR SYNDICATED BUSINESS LOANS

The Bank of Nova Scotia -- Response

Question 1. If the ARRC were to adopt one or more sets of business loan fallback language, which one or both of the recommended provisions (i.e., amendment approach and/or hardwired approach), in your view, is an appropriate policy? If you believe the amendment approach is more appropriate at present, what specific information (for instance, existence of term SOFR) would you need in order to get comfortable eventually adopting a hard-wired approach? Why?

Answer to Question 1. In theory, a "hard-wired" approach is preferable as it would provide greater clarity to all parties, lessen administrative burden, and reduce operational risk and market risk. However, before adopting a hard-wired approach, and thereby including specific language into our documentation, we need to see a more developed market understanding of the proposed fall back rates and the spread adjustment. This is critical if we are asking borrowers to accept hard-wired terms. For example, ARRC has proposed that forward-looking term SOFR be the primary fallback in the waterfall of replacement benchmarks, although this benchmark has not yet been developed.

As emphasized below, we believe there should be consistency across the loan and derivatives markets, given that many borrowers with LIBOR-based corporate loans will have related interest rate hedges.

Question 2. (a) Should fallback language for business loans include any of the pre-cessation triggers (triggers 3, 4 or 5)? If so, which ones?

Answer to Question 2 (a). Our view is that the language used to describe the fallback triggers should be identical as between **syndicated loans** 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.

(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 2(b). As stated in response to 2(a), our concerns relating to pre-cessation triggers pertain primarily to the possible misalignment between the terms of the loan agreements and related hedge documents.

(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 2(c). Most standard **syndicated loan** agreements include clauses intended to address market disruption respecting LIBOR loans, which could potentially be used in situations where there are no adequate and fair means to ascertain LIBOR for a given interest period.

If, however, 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 triggers (and the language describing those triggers) are aligned with those in standard derivatives documentation (as mentioned in our answer to Question 2(a)).

Question 3. (a) Is an "opt-in" trigger appropriate to include? Why or why not? (b) If you do believe an "opt-in" trigger should be included, do you prefer the approach in the hardwired proposal or the amendment proposal? Please explain.

Answer to Question 3 (a) and (b). We acknowledge there will be some period of time prior to the formal discontinuation of LIBOR, or a formal notice from the regulator of a cessation date, when both LIBOR and SOFR based loans will be offered.

While we see the value of parties being able to "opt-in" to the new rate prior to the occurrence of one of the pre-cessation triggers - in so far that it would allow for a more gradual and earlier transition to a new benchmark than if only objective and external triggers are available – we are concerned that not all banks will be operationally ready. There is a risk of calculation misalignment between syndicate members. Accordingly, consideration should be given as to how to mitigate risk of operational readiness if an early opt-in is permitted. For example, unanimous lender consent would assist, but may be resisted by borrowers.

Question 4. Are there any other trigger events that you believe should be included for consideration? If yes, please explain.

Answer to Question 4. No, not at this time.

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

Answer to Question 5. Because a term SOFR would be akin to LIBOR, it would be more familiar to borrowers and may be simpler to operationalize. However, as indicated above, if the benchmark in the loan documentation (e.g. term SOFR) differs from the benchmark applicable to the related interest rate swap (e.g. compound or overnight SOFR), it will be necessary to amend the ISDA documentation governing the swap. Lenders and banks will be left trying to manage numerous ISDA amendments.

Our view is that if the loan market prefers a term SOFR, then ISDA should take steps to accommodate corporate borrowers with interest rate hedges.

Question 6. Should the administrative agent (by itself or with some other party) be able to eliminate certain interest period options if there are no equivalent SOFR terms available? If so, consider the following options: (i) the administrative agent (and/or some other party) may remove all interest periods for which there is not a published term rate or (ii) the administrative agent (and/or some other party) may remove only the interest periods for which there is not a published term rate and a term rate cannot be interpolated. Which of the options do you support? Why?

Answer to Question 6. If term SOFR is the primary fallback in the waterfall, only publicly quoted tenors should be available to borrowers. We support the Agent being able to amend the agreement, but amendments should be limited to existing or future quoted tenors; in other words, the option outlined in (i) of Question 6.Since term SOFR is still not established, the language should allow for the possibility that new terms may emerge after a Benchmark Discontinuation Event.

We would consider the feasibility of using interpolated rates, should a use case be provided and the market agrees to a standard mechanism (with an assumption that SOFR moves in a linear fashion between quoted tenors).

Question 7. Should "Compounded SOFR" be included as the second step in the waterfall? Why or why not? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR?

Answer to Question 7. For the reasons stated above, consistency between the cash and derivatives market is preferred. We support Compounded SOFR if this aligns with the approach taken in the derivatives market.

Question 8. If you believe that Compounded SOFR should be included, would a Compounded SOFR in advance or Compounded SOFR in arrears be preferable for syndicated loans? Please explain.

Answer to Question 8. If Compounded SOFR is included in the waterfall, our preference is for Compounded SOFR in arrears. However, we also request that the ARRC publish a use case which would clearly show how interest would be calculated in a lending scenario; that is, how daily interest accruals would be generated. It is critical that all market participants adopt the same methodology for Compounded SOFR and the calculation is clear and transparent to borrowers.

Question 9. Is Overnight SOFR an appropriate fallback reference rate for syndicated loans or should the final step in the replacement rate waterfall be Compounded SOFR (after which the hardwired approach defaults to a streamlined amendment process)? Would this preference be influenced by whether ISDA implements fallbacks referencing compounded SOFR or overnight SOFR? Please explain.

Answer to Question 9. For the reasons stated above, our response to this question depends on the approach ultimately adopted by ISDA, as well as an assessment of the use case demonstrating how interest would be calculated in each case.

Question 10. Is it acceptable to fix one observation of Overnight SOFR as the reference rate for a loan lasting three months (or longer)? Would lenders refuse to offer longer-duration loans if they were priced over one Overnight SOFR observation? Please explain.

Answer to Question 10. This is not acceptable as, in our view, it would expose borrowers and lenders to excessive market risk. In this regard, we note that SOFR moved almost 30 bps in the month of September.

Question 11. Is there any another replacement rate that should be added to the hardwired approach waterfall before parties move to the streamlined amendment process? If so, what is the appropriate rate or rates and at which stage in the waterfall should they be applied?

Answer to Question 11. No, none at this time.

Question 12. Do you believe that the ARRC should consider recommending a spread adjustment that could apply to cash products, including syndicated business loans?

Answer to Question 12. Yes, we would request that the ARRC recommend and publish spread adjustments that would apply to corporate loans. We expect there would be different spread adjustments for different tenors, if required.

Question 13. Is a spread adjustment applicable to fallbacks for derivatives under the ISDA definitions appropriate as the second priority in the spread waterfall even if syndicated business loans may fall back at a different time or to a different rate from derivatives? Please explain.

Answer to Question 13. The spread adjustment must specifically relate to the benchmark rate being used. If this isn't possible, the next fallback should be the amendment process. In other words, if syndicated business loans fall back to a rate different from that 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 14. Is there any another spread adjustment that should be added to the hardwired approach spread waterfall before parties move to the streamlined amendment process? If so, what is the appropriate spread and at which stage in the waterfall should it be applied?

Answer to Question 14. Any spread adjustment should be specific to the replacement benchmark, publicly available and its calculation transparent.

Question 15. (a) Under the amendment approach proposal, if parties are selecting a replacement rate through the amendment process, should the objection of the Required Lenders be by class (if applicable) (see clause (b) of the section titled "Effect of Benchmark Discontinuance Event" in Appendix I)? Why or why not?
(b) Under the amendment approach proposal, if parties choose to select a replacement rate through the "opt-in" amendment process, should the affirmative consent of the Required Lenders be by class (if applicable) (see clause (b) of the section titled "Effect of Benchmark Discontinuance Event" in Appendix I)? Is affirmative consent appropriate or should negative consent be considered instead? Please explain.

Answer to Question 15. Generally, we are supportive of a hard-wired approach versus an amendment approach. If the market did adopt an amendment approach, our view is that class voting should apply and that negative consent may be more practical.

Question 16. (a) Under the hardwired approach proposal, if parties must fallback to selecting a replacement rate through the amendment process because none of the options in the replacement rate waterfall are available, is the objection of the Required Lenders by a class appropriate (if applicable) (see clause (d) of the section titled "Effect of Benchmark Discontinuance Event" in Appendix II)? Why or why not?

Answer to Question 16 (a). In the above scenario, our view is that the objection of the Required Lenders by class is appropriate.

(b) The hardwired approach proposal provides two bracketed options for a successful declaration of the "opt-in" amendment process - Required Lenders (typically a majority) vs. supermajority (2/3) of lenders (see clause (B) of the definition of "Benchmark Transition Determination" in Appendix II). What should be the standard affirmative lender voting threshold for consenting to the "opt-in"? Please explain.

Answer to Question 16(b). Our preference is that supermajority consent should be required, given the novelty and lack of certainty surrounding this issue. That said, we could also accept these decisions being made at a majority level.

Question 17. For respondents that act as administrative agents in the syndicated business loan market, would your institution be willing to (i) work with the borrower to identify a new reference rate or spread adjustment, (ii) determine whether triggers have occurred, (iii) select screen rates where reference rates are to be found, (iv) interpolate term SOFR if there is a missing middle maturity and, (v) execute one-time or periodic technical or operational amendments to allow the administrative agent to appropriately administer the replacement benchmark? Please respond to each and explain.

Answer to Question 17. While the Administrative Agent typically serves as the primary point of contact with a borrower, and will initially work with a borrower on requested amendments, these amendments are submitted to the syndicate for their consent, either on a unanimous, super-majority or majority basis. Generally, Administrative Agents avoid having to use their discretion and will act at the direction of the lenders (at applicable consent levels).

While it is acknowledged that a lower lender consent threshold is likely appropriate in this context - to ease administrative burden if numerous amendments need to be negotiated at the same time – our expectation is that all changes and decisions would be subject to some level of lender consent (affirmative or negative).

To the extent the discretion of the Administrative Agent is broadened, the related indemnification language would need to expressly address this increased exposure.

Question 18. Is it necessary that any replacement rate and/or applicable spread adjustment be published on a screen by a third party? Why or why not?

Answer to Question 18. Yes, we are of the view that both should be published. This is critical for transparency for both lenders and borrowers. In addition, greater transparency supports operational accuracy and automation.

Question 19. Given that market practices and conventions may change over time, should the administrative agent's limited ability to make conforming changes be available only at the point of transition or on a periodic, ongoing basis? Why or why not?

Answer to Question 19. Provided the scope of the Administrative Agent's discretion is clearly defined and supported by appropriate indemnities, we support the idea of an Administrative Agent being able to make conforming changes on a periodic, ongoing basis to adapt to ongoing developments in the market.

Question 20. How important is it for the fallback rate to be available prior to making a borrowing/advancing funds? For instance, if the rate was a compounded three-month rate calculated at the **end** of the interest period, would that be problematic? Please explain.

Answer to Question 20. As indicated in our answer to Question #8, we request the publication of a use-case demonstrating how interest would be calculated using Compounded SOFR in arrears. It is critical that the methodology be consistently applied by all market participants.

Provided a market-accepted methodology is available with sufficient lead time in advance of the transition, it should be operationally feasible to administer corporate loans accruing interest at Compounded SOFR in arrears.

Question 21. Are there operational concerns about having the ability to convert many loans over a very short period of time? Please explain.

Answer to Question 21. This largely depends on what alternate benchmark(s) are ultimately chosen by the market. For example, we anticipate that a term SOFR would, operationally, be very similar to LIBOR. However, developing systems to accommodate a Compounded SOFR in arrears, or an overnight rate, will be more time consuming. Again, we emphasize that the publication of a use case would be of considerable assistance.

Question 22. Do you see other operational challenges that fallback language should acknowledge or of which the ARRC should be aware? Please explain.

Answer to Question 22. No, not at this time.

Question 23. What modifications to the syndicated loan consultative language may be helpful to market participants as they consider more robust fallback language in a bilateral or single-bank business loan context, if any? Please explain. Specifically, what modifications to the language may be appropriate in instances in which the bilateral loan is fully or partially hedged? Please explain.

Answer to Question 23. We expect that the language and mechanics related to the replacement of LIBOR in bi-lateral agreements will align with the approach ultimately adopted by the syndicated market.

Question 24. Are there any provisions in the fallback language proposals that would significantly impede syndicated loan originations? If so, please provide a specific and detailed explanation.

Answer to Question 24. We re-iterate our concern regarding potential lack of alignment between the approaches to LIBOR replacement in the cash markets and the derivatives markets. As noted, a number of corporate borrowers with LIBOR-based facilities enter into related interest rate swaps. Accordingly, we would expect the fallback rate applicable to the loans to be the same as that available for the hedge. If not, there is a risk for the borrower, which could complicate the origination of new loans.

Question 25. Please provide any additional feedback on any aspect of the proposals.

Answer to Question 25. As stated in response to Question 1, we support a hard-wired approach, in principle. Such an approach would provide all parties with greater certainty, reduce administrative burden and lessen exposure to market risk at the time of transition. Given the number of unknowns at this stage, however, we cannot fully endorse the approach. Borrower education will be critical if lenders seek to have them agree to terms that are not yet defined or known.

We also emphasize the need for consistency across cash (bonds and loans) and derivative products, given that corporate loans will often have corresponding interest rate hedges. We can foresee a number of issues if different products adopt different triggers, rates or spread adjustments.