March 25, 2020

ARRC Secretariat
Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045
Via email: arrc@ny.frb.org

RE: ARRC Consultation on Spread Adjustment Methodologies for Fallbacks in Cash Products Referencing USD LIBOR

ARRC Secretariat:

BAFT (The Bankers Association for Finance and Trade) appreciates the opportunity to comment on the ARRC Consultation on Spread Adjustment Methodologies for Fallbacks in Cash Products Referencing USD LIBOR.

BAFT is an international financial services industry association whose membership includes a broad range of financial institutions throughout the global community. As a worldwide forum for analysis, discussion, and advocacy in international financial services, BAFT's nearly 300 members provide leadership to build consensus in preserving the safe and efficient conduct of the financial system worldwide. BAFT closely monitors the impact that new policy initiatives could have on the provision of trade financing and payment services that support the real economy. To that end, BAFT's comments are primarily focused on issues for these particular sectors of the banking industry.

Global trade relies upon accessible financing for trade transactions. Trade financing assists customers with their import and export requirements, by providing import/export financing and trade risk mitigation. Trade finance exposures[1] are diverse in nature, smaller in value, shorter in tenor, self-liquidating and exhibit different behavior and payment patterns from other corporate banking products.

[1]See Appendix A for a summary trade finance definitions.

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Since 2000, global trade flows have swelled from USD 6.2 trillion to a new peak of USD 18.5 trillion in 2018.[2] Bank-intermediated transactions now represent more than a third of world trade. LIBOR, in the various currencies, has long been the default benchmark interest rate for trade finance. Trade finance references LIBOR because it has historically used forward looking term rates that manufacturers/traders/importers and exporters utilize to price their product margins against. In discussions with BAFT members across different geographies, it became clear that the transition from LIBOR to SOFR would have a deep impact across a variety of products.

Table 1 below lists trade finance products that have historically used forward looking term rates, either through discounted interest taken at date of financing or interest in arrears, but set at loan inception.

Table 1: Trade finance products that have historically used forward looking term rates

Discounted Trade Finance Products:	
Products include: • Deferred Payments under LCs Drafts under LCs • Avalized Drafts • Promissory Notes • Supply Chain Finance Products (Invoice Financing, Receivables Discounting and Payables Finance, etc.)	*Characteristics:* • Principle amount payable on a fixed maturity date; no stated interest component • Interest is deducted in advance, i.e. Net Proceeds payable on financing date = Principle Amount minus Discount Calculation (can be Straight Discount basis or Discount to Yield basis) • Discount calculation has to be done at the outset based on a forward-looking rate
Loan-type Trade Finance Products:	
Products include: • Trade Loans • Bankers Acceptances • Import Loans • Asset- or Receivables-backed Loans	*Characteristics:* • Principle and interest payable on stated dates; interest component is clearly stated • Interest is payable in arrears (can be either at maturity or also at predetermined refix dates) • Interest can be calculated on a backward-looking basis, but removes certainty for borrowers at the outset of the financing regarding how much interest they will be paying

The ARRC's April 2019 publication of a User's Guide helped explain how market participants can use SOFR in cash products, urging participants not to wait for forward-looking term rates in order to transition. The following key observations have been derived by the industry:

1. SOFR averages will smooth out day-to-day fluctuations and accurately reflect interest rates over any given period of time.
2. Choices can be made between simple or compound averages – simplicity versus accuracy.

[2] ICC 2018 Trade Register Report

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3. Choices need to be made between in advance or in arrears averages, with the latter reflecting what actually happens over the current period.
4. SOFR in arrears provides very little notice before payment is due, but can be overlaid with delays, look-backs or lockouts.

We understand that while it is the intention of the ARRC to derive a forward-looking term reference rate, it is not guaranteed before the end of 2021. The lack of a forward looking term reference rate presents operational challenges for this business line, as the exact cash flow due to be paid is only known one business day before the payment date. In comparison, three month LIBOR is set 3 months in advance and so cash flows under loans referencing three month LIBOR are known three months before the payment is due. Table 2 below summarizes the expected impact on transaction banking products.

Table 2: Assessment of impact to transaction banking products

Product	Sub-Product	Impact	Scope
Traditional Trade	Documentary LC, Collections, Bonds, SBLC	Not expected	N / A
	Guarantees	Potential impact	IBOR referenced in payment clauses
	Discounted products (e.g. deferred payment under LC, Promissory Notes, Avalized Drafts, etc.)	Likely impact	IBOR used to determine rate
Open Account	Supplier / Receivables Finance		
Trade Lending	ECA / Structured Export Finance, Trade Loans		
Secondary market for trade finance	All funded trade finance products	Likely impact	IBOR used to determine rate
Cash Management / Payments	Cash / Payments / Deposits / Overdrafts	Light impact	IBOR used in overdraft rate

We have a particular concern with trade finance transactions that are offered on a discount (interest deducted upfront) basis e.g. supply chain finance, where the lender "buys" the receivable, less the interest cost. These businesses do not have access to market curves and clients are typically price sensitive and thus less suited to the compound in advance approach. As called out by a recent paper from the Working Group on Sterling Risk Free Rates[3], for the lenders to be able to continue to offer this funding solution widely relied on by many corporates globally, forward looking term rates are essential (interest cannot be deducted upfront if it is not known at the time of funding and fixed through to the maturity).

[3] Sterling Use Cases of Benchmark Rates, Compound in Arrears, Term Rates and further alternatives. January 2020. https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/use-cases-of-benchmark-rates-compounded-in-arrears-term-rate-and-further-alternatives.pdf?la=en&hash=22BA20A8728D9844E5A036C837874CA3E70FEAE1.

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In addition, there is an active secondary market for trade finance assets which mostly replicates the methodology of the underlying asset that is being sold. Therefore, if the underlying transaction is discounted, the sale between the existing financing party and the new party will also be discounted. In order for the secondary market to continue to function efficiently, the two parties (often both financial institutions) need to be able to determine a mutually agreeable third party rate to apply to the discount.

BAFT looks forward to the publication of a term rate ahead of the 2022 deadline and, in the meantime, would encourage the ARRC to develop a working group focused on trade finance to address issues specific to this subset of the industry.

We appreciate you taking into account our responses to the consultation. Should further information regarding or discussion of any of these matters be desired, please do not hesitate to contact Diana Rodriguez, Senior Director, International Policy at drodriguez@baft.org or 202-663-5514.

Very truly yours,

Tod R. Burwell
President and Chief Executive Officer

Consultation Responses

***Question 1**. Do you agree that using the ISDA methodology of a 5-year median of the historical difference between LIBOR and the SOFR fallback rate is the best choice for the following cash products, or would you prefer an alternative method?*

Floating Rate Notes	✓ *5-year median is preferred*	☐ *Other method is preferred*
Securitizations	✓ *5-year median is preferred*	☐ *Other method is preferred*
Syndicated Loans	✓ *5-year median is preferred*	☐ *Other method is preferred*
Bilateral Business Loans	✓ *5-year median is preferred*	☐ *Other method is preferred*

BAFT and its members generally support consistency between asset classes in alignment with ISDA's methodologies. While we find that this consistency will minimize any basis in hedges, reduce operational challenges, and minimize customer confusion, our preference is for a dynamic credit spread in association with a term rate once one has been established.

Given the short-term nature of our products (less than 1 year), 5-year median of the historical difference may work better for longer term products given any larger errors are most likely to "average out". However, we may be more prone to being exposed to short term volatilities in the market which does not allow us enough time to "average out" the peaks and troughs.

***Question 2.** If "Other Method" was specified for any product, please provide additional feedback on your institution's preferences, noting whether your alternative is strongly or mildly preferred and why you prefer the alternative method:*

a. 5-year trimmed mean	*f. 3.5-year median*
b. 5-year average	*g. 3.5-year trimmed mean*
c. 10-year median	*h. 3.5 year average*
d. 10-year trimmed mean	*i. Other (please specify)*
e. 10-year average	

N/A

***Question 3**. If there are fewer than 5 years of available data to use in calculating a spread adjustment for a forward-looking term rate, which method would you prefer to calculate the associated spread adjustment:*

a. Use the longest span of indicative term rate data available
b. Use the spread adjustment associated with the difference between LIBOR and a compound average of SOFR in arrears as an appropriate spread adjustment for the forward-looking term rate.
c. Use the spread between LIBOR and EFFR OIS rates, adjusted for the mean difference between compound averages of EFFR and SOFR

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Given the short-term nature of products common in our industry, we support the use of the spread adjustment associated with the difference between LIBOR and a compound average of SOFR in arrears as an appropriate spread adjustment for the forward-looking term rate.

Question 4. *Do you believe that a 1-year transition period should be included for any of these cash products? If yes, please specify which products. (If you believe that a transition period should be included, but that it should be longer or shorter than 1 year, please note this and explain why.)*

We support a 1-year transition period for trade finance products.

Question 5*. Should the ARRC recommend spread adjustments for 1-week or overnight LIBOR?*

N/A

Question 6. *Should the ARRC recommend spread adjustments based on the differences between LIBOR simple averages of SOFR in addition to compound averages?*

N/A

Question 7. *Would it be problematic to use different approaches to calculate the spread adjustment across products and currencies? Please comment specifically on the implications of any differences in the recommended spread adjustment methodologies.*

As noted in question 1, BAFT supports a consistent spread across products and currencies. Given the multi-currency nature of trade finance products, consistency in the spread adjustment calculation would facilitate the transition to SOFR.

Question 8. *Do you agree that using the ISDA methodology of a 5-year median of the historical difference between LIBOR and the SOFR fallback rate is an acceptable choice for consumer products, or would you prefer an alternative method? (If another method is preferred, please specify which and note whether your alternative is strongly or mildly preferred and why you prefer the alternative method).*

As noted in question 1, we support the ISDA methodology of a 5-year median of the historical difference between LIBOR and SOFR fallback rate.

Question 9. *Do you believe that a 1-year transition period should be included for consumer products? (If you believe that a transition period should be included, but that it should be longer or shorter than 1 year, please note this and explain why).*

We understand that a 1-year transition period refers to the window of time for legal documentation to transition and repapering to take place, which BAFT is supportive of. We do not support a 1-year transition period for the application of the fall back methodology to determine the credit spread fixing (conversion spread from LIBOR to RFR).

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Question 10. *If a 1-year or 6-month term rate has not been recommended by the ARRC, would you prefer that a consumer ARM referencing 1-year or 6-month LIBOR fall back to a spread adjusted rate based on:*

a. the next longest tenor of term rate recommended by the ARRC
b. a compound average of SOFR in advance

(Note that in these instances, the rate would still reset annually or semiannually and spreads would be calculated relative to 1-year or 6-month LIBOR).

N/A

Question 11. *If there is less than 5 years of available data to use in calculating a spread adjustment for a forward-looking term rate, which method would you prefer to calculate the associated spread adjustment:*
a. Use the longest span of indicative term rate data available
b. Use the spread adjustment associated with the difference between LIBOR and a compound average of SOFR in arrears as an appropriate spread adjustment for the forward-looking term rate
c. Use the spread between LIBOR and EFFR OIS rates, adjusted for the mean difference between compound averages of EFFR and SOFR

N/A

Question 12. *Please provide any additional feedback on any aspect of the proposals.*

As an industry engaged in trade finance, our preference is for a dynamic credit spread in association with a term rate. The reason for this preference are described in the letter that precedes the response to the questionnaire. Over the ensuing weeks and months the working group the BAFT has assembled will follow on in greater detail.

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Appendix A: Definitions of trade finance products

Trade Finance Products	Definition
Documentary Letters of Credit(L/Cs)	An irrevocable undertaking issued by a Bank at the request of the Applicant (Buyer), to make payment to the Beneficiary (Seller) upon presentation of specified documents that comply with all terms and conditions that are stipulated in the L/C.
Trade Finance Loans (TFLs)	An advance that enables both buyers and sellers to benefit by financing their genuine trade commitments on a transactional basis. Trade Finance Loans must only be used to finance genuine trade transactions, evidenced by appropriate transaction documentation /information.
Supply Chain Finance - Payables Finance	A financing structure which allows a Buyer (the lenders Customer) to arrange early payment (less the interest) to their Suppliers against invoices “approved for payment” by the Buyer and “elected for early payment” by the Supplier.
Supply Chain Finance – Receivables Finance	The Seller (the lenders customer) sells to the lender the trade receivable due from its Buyer, with interest deducted upfront. The lender has the right to receive payment from the Buyer and in the event of non-payment the lender should have the ability to enforce this right against the Buyer.

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