MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

July 15, 2016

Via Electronic Mail: arrc@ny.frb.org

Alternative Reference Rates Committee
Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Interim Report and Consultation of the Alternative Reference Rates Committee

Dear Alternative Reference Rates Committee Members:

Managed Funds Association ("**MFA**")[1] welcomes the opportunity to comment on the Alternative Reference Rates Committee's ("**ARRC**") interim report and consultation dated May 2016 ("**Consultation**").[2] MFA supports the Board of Governors of the Federal Reserve ("**Board**") for its examination of the London Interbank Offered Rate ("**LIBOR**"), and the issues that previously lead to the attempted manipulation of the rate-setting process.[3] We also support the Board's creation of the ARRC. MFA strongly believes that having a liquid, reliable, and well-regulated reference rate is important for the proper functioning of the financial markets.

MFA also applauds the Board and the ARRC for consulting with end-users on their current thinking on potential alternative reference rates to U.S. dollar ("**USD**") LIBOR.[4] As noted in the Consultation, end-users are key participants in the financial markets.[5] Thus, we hope that our

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[1] Managed Funds Association represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policymakers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[2] Available at: https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2016/arrc-interim-report-and-consultation.pdf?la=en.

[3] *See* David Hou and David Skeie, LIBOR: Origins, Economics, Crisis, Scandal, and Reform, Staff of Federal Reserve Bank of New York, Staff Report No. 667 (Mar. 2014), available at: https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr667.pdf.

[4] MFA notes that the ARRC held a roundtable on June 21, 2016, which included various end-users to discuss the matters set forth in the Consultation. The meeting agenda is available at: https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2016/Jun-21-2016-ARRC-Agenda.pdf.

[5] *See* Consultation at 1.

views on this important matter are constructive and instructive. We look forward to our continued engagement with the Board and ARRC as this initiative proceeds.

I. Executive Summary

In the Consultation, the ARRC discusses that it is preliminarily considering either the Overnight Bank Funding Rate ("**OBFR**") or an overnight Treasury general collateral repurchase agreement rate ("**GC Repo Rate**") as the two strongest alternatives to USD LIBOR.[6] The ARRC also provides an initial transition strategy to assist with providing a threshold level of liquidity for the new reference rate.[7] As between the two proposed rates, MFA expresses no preference.

MFA recognizes that the Board and the ARRC appreciate that transitioning away from USD LIBOR represents a fundamental shift to the market that requires thoughtful consideration and thorough planning.[8] However, after reviewing the Consultation, MFA respectfully requests that the Board be cautious as it transitions the market from USD LIBOR to a different reference rate. In particular, as the ARRC considers what recommendations it will make to the Board, and as the Board determines how it will proceed, MFA notes the following issues, which we discuss in greater detail below:

(1) The Board and the ARRC should consult not only with end-users, but also clients and investors of end-users on the proposed alternative reference rates; and

(2) The transition strategy needs further refinement because we remain concerned that the transition to a new reference rate could lead to market disruptions and/or illiquidity.

II. Consulting with Clients and Investors

As mentioned, MFA greatly appreciates the Board and the ARRC consulting with end-users on the new reference rates and the other matters contained in the Consultation. We also strongly recommend that the Board and the ARRC consult "widely and closely" with the clients and investors of end-users on these issues, such as large corporate and pension plan investors.

In the Consultation, a core component of the ARRC's plan for transitioning the market to a new reference rate is the "voluntary trading by ARRC member banks and other market participants sufficient to achieve a critical mass of liquidity in futures contracts and/or OTC derivative contracts that reference the new rate".[9] Because the ARRC recognizes that the "demand for interest rate derivatives is ultimately driven by end users",[10] in the Consultation, the ARRC

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[6] *See id*. at 1, 15-18.

[7] *See id*. at 21-24.

[8] *See id*. at 21-22, Section V.

[9] *Id*. at 21.

[10] *Id*. at 1. *See also id*. at 12, discussing that "[p]rominent end users include hedge funds, asset managers, insurance companies, and non-financial corporations".

discusses consulting with and involving end-users throughout its process to ensure that both the buy-side and sell-side are supportive of the ARRC's ultimate recommendations.

While MFA agrees that end-users are critical users of interest rate derivatives and other products such that our views are an important component of the Board's process, we note that asset managers and other investment managers may not necessarily determine which reference rates or benchmarks they will use. Rather, in some cases, the investment management arrangements that asset and investment managers have with their clients and investors will specify that the client or investor have the authority to choose the reference rate.

In particular, large corporate or pension plan investors are very sophisticated investors that frequently have sizable in-house management teams and engage asset or investment managers to help them implement their investment strategies. Thus, these investors often maintain substantial (if not exclusive) control over their accounts as well as the exposures and the products within their accounts. In such cases, it is the large corporate or pension plan investor that will dictate to the asset or investment manager which reference rate or benchmark must be used.

Therefore, MFA emphasizes that, if the Board and ARRC expect to develop sufficient liquidity in the new reference rate, in part, by voluntary market migration, it is important for the Board and ARRC to consult with, and obtain the support of, the clients and investors of end-users.

III. Concerns with Transition Strategy

MFA agrees with the ARRC that transitioning to a new reference rate will be challenging given the pervasiveness of USD LIBOR.[11] Therefore, we express the need for the Board and ARRC to proceed cautiously to ensure a smooth transition and prevent any market disruptions or illiquidity. In particular, because of the impact that transition to a new reference rate could have on the markets, below we discuss a few of our key areas of concern for consideration as the Board and the ARRC refine the proposed transition strategy.

A. Developing Liquidity in the New Reference Rate

While MFA expresses no view as to whether the OBFR or GC Repo Rate is preferable, we note some concern that, while the underlying markets for both are relatively liquid, there is volatility in both indices. Specifically, data available on Bloomberg demonstrates that the GC Repo Rate has some volatility both on a seasonal basis (*i.e.*, that coincides with each month-, quarter- and year-end) as well as intra-month. In addition, in the Consultation, the ARRC notes similar seasonal quarter- and year-end volatility with respect to the OBFR.[12] If the seasonality of fixings is stable and predictable, then its presence should not reduce the attractiveness of a particular rate. However, if such stability and predictability is not present, and the fixings do have some inherent volatility, then this volatility may make the rates unattractive to market participants. Moreover, such volatility may lead to uncertainty as to how either of these rates will perform during stressed

[11] *See id*. at 21.

[12] *See id*. at 15 (noting that activity has tended to decline around quarter- and year-ends).

market conditions.[13] This uncertainty, in turn, may further affect the market's willingness to transition to and adopt either of these rates.

We appreciate that the ARRC's transition strategy includes various mechanisms intended to build liquidity in contracts referencing these rates, such as voluntary trading in the new rate by market participants.[14] However, because the ARRC's proposed transition strategy is essentially market driven, to achieve the desired liquidity, some market participants will need to be the first movers to contracts with the new rate. Based on the composition of the ARRC, we assume that its dealer members will be the first movers for beginning the transition. Nevertheless, ensuring a smooth and successful transition will require substantial cooperation from all market participants across all affected products. Because differences in these groups of market participants and products may present different transitional difficulties, it will be important that there continue to be robust liquidity for USD LIBOR contracts during the transition period.

For example, in the Consultation, the ARRC seems focused on the transition of interest rate derivatives ("**IRDs**") from USD LIBOR to the new reference rate. However, as the ARRC also acknowledges, market participants use USD LIBOR as a benchmark for a number of other products, such as mortgage and retail products.[15] There is lower liquidity in the markets for these products than in the IRD market. In addition, for these products, there typically is no provision in the contracts that allows for automatic substitution of a new reference rate if USD LIBOR cannot be determined. Therefore, given the size of the markets for these other products and their reliance on USD LIBOR, if liquidity for USD LIBOR disappears too quickly or the transition of these products to the new rate is too fragmented, it could make it difficult to price and mark these products, and thus, disrupt these markets entirely.

Given that there is likely to be a lack of market confidence in the new reference rate initially, achieving sufficient liquidity in that rate may be a slow process that takes a substantial amount of time. Therefore, until there is robust liquidity in a new reference rate, the Board needs to preserve liquidity in USD LIBOR and not drive the market to become reliant on a new reference rate too quickly so that the market can continue to function efficiently and without disruption during the transition.

B. Treatment of Long-Dated Legacy Contracts

Another issue with the proposed transition strategy is treatment of legacy contracts. We recognize that, in the Consultation, the ARRC indicates that its proposed transition strategy "has been crafted to avoid any changes in existing contracts".[16] While MFA agrees in principal that the transition to any new reference rate should be only a prospective matter, we are not certain how that works as a practical matter. As the ARRC knows, USD LIBOR is derived from daily information provided by major banks about the estimated rate at which they can borrow funds from other banks. As a

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[13] MFA notes that, despite discussion about transitioning to one of these two new rates, we have not seen liquidity in these rates increase.

[14] *See supra* note 9.

[15] *See* Consultation at 6-7.

[16] *Id*. at 21.

result, if ARRC members and other major banks decide to transition to the new reference rate, and cease providing the daily information necessary to set USD LIBOR, then consequently, legacy trades would be affected.

In particular, MFA is concerned about of the long-dated nature of some legacy products and trading arrangements. Because some legacy contracts that reference USD LIBOR have lengthy durations (*e.g.*, a 30-year swap), it would be a lengthy process to wait for these products to mature or close out to complete transition to the new reference rate. In recognition of this issue, in the Consultation, the ARRC discusses that some ARRC members are "exploring mechanisms to accelerate the closing of legacy contracts", but acknowledges that the feasibility of such mechanisms remains uncertain.[17] We echo this concern because we believe that the options for addressing legacy contracts, especially contracts of lengthy duration, are undesirable.

For example, one alternative would be for market participants to transition these contracts to a new reference rate prior to maturity. However, as mentioned, such a transition is not a simple matter because many of these contracts do not have provisions that allow for the substitution of a new rate. Another alternative would be for market participants to accelerate close out of existing contracts and replace them with new contracts referencing the new rate for the remaining maturity of the original contracts. However, with either of the foregoing options, market participants would need to re-negotiate their contracts. Given the costs and burdens that would come with any such re-negotiation, MFA believes that there will be little market appetite to undertake such re-negotiations.

Therefore, MFA is concerned that, despite the ARRC's intentions, long-dated contracts may be adversely affected by the transition to the new reference rate without their being cost-effective and desirable solutions for the market participants that are parties to them.

C. Transition of the Price Alignment Interest

Lastly, MFA has concerns with the ARRC's proposed transition for cleared trades. In the Consultation, the ARRC suggests that central counterparties ("**CCPs**") would cease to accept new trades for clearing that reference the effective federal funds rate ("**EFFR**") as the price alignment interest ("**PAI**"), and then at a later time, would expect CCPs to begin using the new rate to calculate discounts.[18] MFA disagrees with this proposed approach. We believe that it is important that liquidity for the new reference rate be well established before CCPs begin accepting only trades where the PAI references the new rate.

As noted in the Consultation, PAI is an amount used to adjust the variation margin ("**VM**") owed on cleared IRDs to align that the economics of the cleared trade with the economics of uncleared trades.[19] Typically, the PAI reference rate used to calculate the VM for IRDs is the same as the reference rate used to calculate the discount on the underlying IRD. At present, EFFR is the rate

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[17] *Id*. at 24.

[18] *See id*. at 23, steps 6 and 7.

[19] *See id*. at 10-11.

that CCPs use both for discounting and as the PAI for IRDs.[20] Because of the alignment between the discount rate and the PAI used for cleared IRDs, it is important that there be enough liquidity in the reference rate that CCPs use for the PAI so that CCPs can use the same rate for discounting purposes.

Because of the ARRC's proposal, we are concerned that, by having CCP's cease accepting IRDs referencing EFFR as PAI before the related IRDs discount also transition to the new rate, the market will find it difficult to value and discount cleared IRDs. Therefore, we recommend that the ARRC revise its proposed transition strategy such that CCPs' continue to accept IRDs that reference EFFR until there is robust liquidity in the new reference rate.

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MFA thanks the ARRC for considering our views on the Consultation. We welcome the opportunity to discuss our views with you in greater detail. Please do not hesitate to contact Carlotta King or the undersigned at (202) 730-2600 with any questions the ARRC or its members might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
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[20] *See id*.