Charges to FRAC for July 2019 Meeting

1. **How should the challenges associated with the transition from LIBOR to SOFR be addressed?**

2. **Does leveraged lending pose a risk to financial stability?**

Topic: Transitioning from LIBOR to SOFR

Summary
The Office of Financial Research (OFR) is requesting the Financial Research Advisory Committee (FRAC) to consider challenges in building volumes in the industry-identified alternative reference rate, SOFR.

Background
Low underlying transaction volumes threaten the long-term stability of the U.S. dollar London Interbank Offered Rate (LIBOR). This situation prompted the Alternative Reference Rates Committee (ARRC), an industry group convened by the Federal Reserve, to identify an alternative reference rate. The rate selected by the ARRC is the Secured Overnight Financing Rate (SOFR), an index reflecting the cost of overnight funding secured by Treasury securities. The SOFR is produced by the Federal Reserve Bank of New York in cooperation with the OFR.

The SOFR has been in production for almost a year, and is used in both cash and derivatives contracts. However, contract volumes need to increase significantly before discontinuing LIBOR if a disruptive transition is to be avoided. To provide additional benchmark options reflecting the cost of SOFR funding over a term, the Federal Reserve Bank of New York is considering the publication of backward-looking term average SOFR rates.

Questions

1. What are the major impediments to building volume in SOFR-linked contracts?
2. What measures, if any, should the official sector consider to encourage adoption of the SOFR?

Topic: leveraged lending

Summary

The Office of Financial Research (OFR) is requesting the Financial Research Advisory Committee (FRAC) to consider questions regarding potential systemic vulnerabilities related to the U.S. leveraged loan market, and associated markets such as the market for collateralized loan obligations (CLOs). Further, the OFR seeks input on data gaps that affect monitoring of these markets.

Background

Investor demand for leveraged loans has increased significantly in recent years, in part, due to expectations for higher interest rates. Most leveraged loans are floating-rate instruments. These loans are structured and syndicated to accommodate two primary types of lenders: banks and institutional investors. Institutional loans comprise the majority of new issuance. The share of covenant-lite loans has grown along with institutional loan issuance. The OFR has access to data on institutional loans (issuance and outstanding) via Standard & Poor's Leveraged Commentary & Data, but not bank loans. Data on investor exposures to leveraged loans is also incomplete.

Questions

1. How should the OFR evaluate and monitor risks related to leveraged lending?
2. Does leveraged lending pose any threat to financial stability? If not, what are the mitigants?
3. How are the risks different for bank versus institutional leveraged loans?
4. How do the above risks and mitigants vary and interact with specific risks associated with different types of institutional investors (e.g., liquidity mismatch for loan mutual funds)? Please include comments on CLO managers, hedge funds (including distressed funds), mutual funds, exchange-traded funds, pension funds, and insurers.
5. Are there risks from the securitization of leveraged loans into CLOs? How can the OFR effectively monitor these risks?
6. What are the similarities and differences between leveraged loan markets today versus those pre-crisis? With respect to CLOs, how are these similar or different from subprime mortgage securities in the pre-crisis era?
7. What other sources of data would enhance the OFR's market monitoring efforts?
8. What are the risks from covenant-lite loans? What are the risks from earnings before interest, taxes, depreciation, and amortization adjustments, and other loan document modifications?