



Deloitteⁱ US LIBOR Transition Newsletter

A summary of US regulatory and market updates related to the transition from LIBOR



Executive Summary

On December 23, 2019, the New York State Department of Financial Services (NYDFS) released a letter requesting New York-regulated depository and non-depository institutions, insurers, and pension funds to submit their risk management plans related to the cessation of LIBOR by February 7, 2020. According to the letter, information on five aspects of transition planning is requested and “prudent risk management requires that all regulated institutions with exposure to LIBOR fully understand its cessation and transition risks, and the implications for them and their customers and counterparties.”

The Commodity Futures Trading Commission (CFTC) made an announcement that it will be the first of the regulatory bodies to provide no-action relief requested by the Alternative Reference Rate Committee (ARRC). The relief aims to treat amended swaps converting from LIBOR to Secured Overnight Financing Rate (SOFR) similarly to the original swap. They also aim to incorporate pre-cessation and fallback languages into the swaps. The CFTC published three letters that detail the no-action relief regarding the LIBOR transition and further warned the risk of “zombie” LIBOR continuing after it is no longer representative.

Multiple new SOFR-linked financial instruments were recently developed and issued. Freddie Mac priced a new offering of Structured Pass-Through Certificates (K-Certificates), which includes a class of floating rate bonds indexed to SOFR; and the Chicago Mercantile Exchange (CME) launched SOFR options on January 6, 2020 representing the first listed non-linear product on the SOFR benchmark.



Regulatory Updates

US Regulatory Highlights

- On December 23, 2019 NYDFS sent a letter to regulated entities requesting LIBOR transition plans by February 7, 2020. The letter is available [here](#). The plan should describe:
 1. Programs that would identify, measure, monitor and manage all financial and non-financial risks of transition.
 2. Processes for analyzing and assessing alternative rates, and the potential associated benefits and risks of such rates both for the institution and its customers and counterparties.
 3. Processes for communications with customers and counterparties.
 4. A process and plan for operational readiness, including related accounting, tax and reporting aspects of such transition.
 5. The governance framework including oversight by the board of directors, or the equivalent governing authority, of the regulated institutions.
- Three divisions of the CFTC issued no-action letters providing relief to swap dealers and other market participants relating to the transition away from LIBOR. The letters are available [here](#).
- Freddie Mac Prices First K-Deal with bonds indexed to SOFR. The article is available [here](#).

Summary of ARRC Office Hours Q&A with David Bowman (The Federal Reserve Board (FRB))

This section represents a summary of the ARRC office hours Q&A with David Bowman from December 4, 2019 until December 31, 2019. Weekly office hour information can be found [here](#). The information below does not represent the view of the Federal Reserve but represents the personal views of David Bowman outside of his official capacity. Below are some of the specific topics discussed:

ARRC Conforming Changes Provision in Fallback Language

- The ARRC fallback language may likely be used for a new issuance or a re-negotiated issuance. If the ARRC language is used, the provisions may likely be embedded into the contract and specifically reference compound SOFR. However, the conforming changes provision is not meant to move from simple to compound average. The conforming changes provision is meant to adjust the contract to switch from LIBOR to SOFR to make compound work, but not move from simple to compound.

Transition Alternatives for Debt Instruments

- Legacy debt instruments that require unanimous consent will convert to a fixed rate unless there is regulatory relief. Financial issuers did not anticipate the cessation of LIBOR when many of these instruments were written. In the past year, some financial issuers started putting in fallback language that allowed them to change the rate. Newer instruments have started to incorporate the ARRC fallback language. The ARRC is also pursuing legislative relief in New York. The ARRC proposal may likely address the relief for floating rate notes (FRNs) that fall under NY jurisdiction.

ARRC Consultation on SOFR Spread Adjustment

- The International Swaps and Derivatives Association (ISDA) is still debating inclusion of pre-cessation triggers, however there has been wide spread consensus on the fallback itself. There was a clear preference for falling back to a compound average of SOFR in arrears for USD LIBOR and to include a spread adjustment with a five-year median based on the difference of LIBOR with a specific tenor and the compound average SOFR for the same tenor over the five years before the trigger event. There is also no transition period; just a single static spread number. ARRC will have a consultation out sometime in January 2020. The consultation will be similar to ISDA with the recommendation of a static spread but may include a transition period. The decisions will be open to discussion and recommendations.

Perspectives on 2019 and Areas for Improvement

- The pace of transition picked up especially the second half of the year. The release of the white paper on using SOFR and consultation on fallbacks for mortgages were extremely important. There were some non-ARRC accomplishments that are also very important such as FASB providing guidance about implementation goals next year and proposed tax relief:
 - There are some areas that could use improvement such as less dependence on LIBOR and an increase in SOFR loans and more SOFR securitization.
 - In 2020, the ARRC is going to release the final spread adjustment (aiming for Q1) and expand to different groups such as asset managers, investment managers, and smaller banks.

SOFR Loan Conventions

- Loan Working Group had multiple working sessions with vendors in the Fall of 2019. A paper will be released in Q1 2020 on those sessions and will include details on conventions on a SOFR loan. A spreadsheet with examples may be shared along with the paper.

ARRC Working Group

- Tom Wipf, ARRC Chairman, authored a "Bloomberg opinion-editorial" article about the transition to SOFR. The article is available [here](#).
- The ARRC released a comment letter on the notice of proposed rulemaking regarding margin and capital requirements for covered swap entities. The letter is available [here](#).

ISDA Updates

- A letter from ISDA was sent to the Financial Conduct Authority (FCA) and the FRB informing them of the ISDA's intention to reopen the pre-cessation consultation. The letter is available [here](#).
- ISDA released the December 2019 publication of "In Review". The report is available [here](#).

Accounting & Tax Updates

- The chair of the ARRC's Tax Subgroup released a letter requesting IRS and Treasury guidance regarding the predicted ISDA Protocol relating to Interbank Offered Rate (IBOR) fallback provisions. The letter is available [here](#).
- A letter from the chair of the ARRC's Accounting and Tax Working Group was written to the SEC describing ARRC's understanding that the SEC staff does not object to the conclusions that "certain amendments to preferred shares would be accounted for as a modification, rather than an extinguishment, and that such a modification would not result in the recognition of an exchange of value." The letter is available [here](#).

Other News / Useful Reading

- CME's SOFR discounting & price alignment transition plan for cleared USD interest rate swaps. The article is available [here](#).
- The London Clearing House (LCH) plans to migrate to SOFR discounting on USD denominated SwapClear contracts in the second half of 2020. The report is available [here](#).
- The CFTC public speech on the LIBOR transition. The statement is available [here](#).
- Big banks making significant progress in LIBOR transition. The article is available [here](#).
- Intercontinental Exchange (ICE) interest rate report for November 2019 is available [here](#).
- LIBOR's demise and a \$200 trillion question. The article is available [here](#).
- Office of the comptroller of the currency's semiannual risk perspective for fall 2019 publication which highlights LIBOR's cessation in 2021. The report is available [here](#).

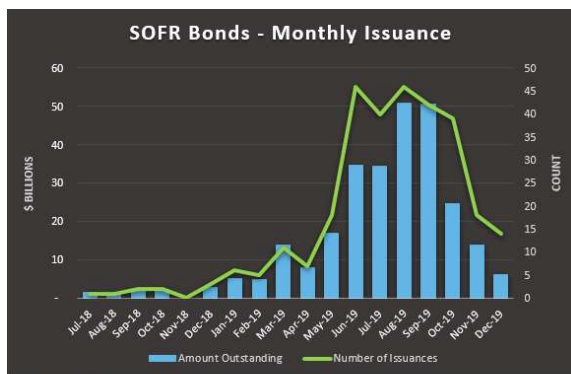


Decrease in Debt Issuance Referenced to SOFR

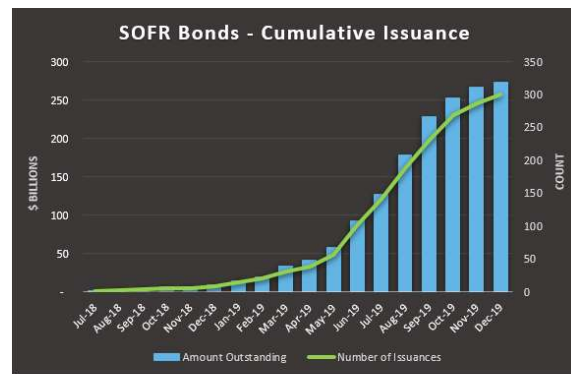
The issuance of floating-rate debt linked to SOFR continued with the declining trend observed in the prior months of October and November 2019. The issuance decreased to \$6.1 billion in the month of December 2019 which is down from \$13.9 billion in November 2019 and \$24.6 billion in October 2019. Comparing this to the issuances in August 2019, which represented the largest monthly issuance for 2019, this is approximately ~12% of the \$50.9 billion issuances in August 2019. Some analysts believe the decline is impacted by the recent interest rate cuts and the decision of the Federal Home Loan Bank to scale back SOFR debt issuances (the article is available [here](#)) by the FRB. The graphs below represent data through December 31, 2019.

The cumulative issue size of SOFR bonds outstanding currently stands at \$274.3 billion with 302 bonds (this excludes the matured bonds) through December 6, 2019. There were 14 new issuances in the month of December 2019 compared to 18 and 39 issuances in November and October respectively.

In the month of December 2019, federal agencies issued SOFR referenced float rate notes worth \$2.8 billion.



Source: Bloomberg, compiled by Deloitte
*Data as of Dec 31, 2019

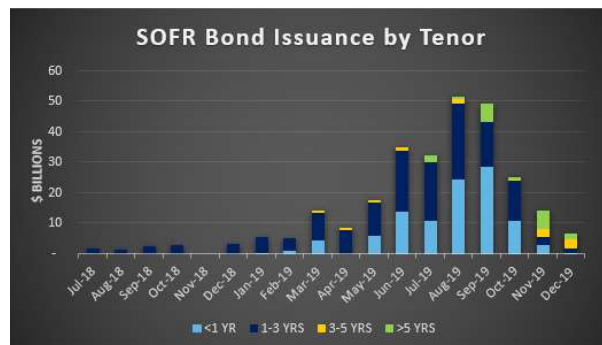


Source: Bloomberg, compiled by Deloitte
*Data as of Dec 31, 2019

Increase in Longer Dated Debt Issuance Referenced to SOFR

Majority of the SOFR bonds issued have a maturity of less than five years. During the month of December 2019, bonds worth \$1.3 billion, which have a maturity greater than or equal to five years, were issued. It is significant as this comprises approximately ~20% of the total issuance of \$6.1 billion in December 2019. For the month of November 2019, bonds worth \$5.9 billion, with a maturity greater than or equal to five years were issued.

There were 31 issuances worth \$15.5 billion, with a maturity greater than or equal to five years, through January 6, 2020. Included in this are 24 issuances worth \$7.5 billion with a term greater than or equal to 10 years.

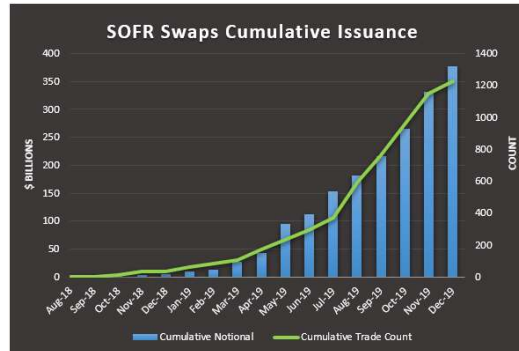


Source: Bloomberg, compiled by Deloitte
*Data as of Dec 31, 2019

Cumulative SOFR Interest Rate Derivatives

SOFR Swaps

- SOFR swaps have shown a steady increase; the notional volume of SOFR-based interest rate and basis swaps totaled \$45.0 billion through December 13, 2019.
- At the end of December 2019, the notional volume of SOFR-based interest rate and basis swaps totaled \$45.0 billion compared to the \$65.8 billion in November 2019, and \$49.2 billion in October 2019.



Source: <http://swapsinfo.org/>, compiled by Deloitte
*Data as of Jan 3, 2020

SOFR Options

- CME Group Inc. launched SOFR options on January 6, 2020. This is the first listed non-linear product on the SOFR benchmark. The underlying is the three-month SOFR futures contract. The article is available [here](#).
- As per Bloomberg, 10 contracts changed hands—five lots of a straddle—in which a put and a call with the same strike were bought, anticipating an increase in volatility. The article is available [here](#).
- The trade involved the 98.625 strike in December 2020 options on three-month SOFR futures, according to open-interest data released by CME Group Inc. The article is available [here](#).



Global Highlights

United Kingdom

- Challenges are currently being faced with the LIBOR transition for bond markets and "it remains to be seen whether or not corporates will widely adopt RFRs in their financing arrangements (in bonds or loan facilities), or if they will avoid any backward-looking RFRs." The article is available [here](#).

European Union

- The European Money Markets Institute (EMMI) confirmed the effective completion of the phase-in of EURIBOR panel banks to the hybrid methodology. The article is available [here](#).
- Norges Bank became the administrator of the reformed Norwegian Overnight Weighted Average (NOWA) rate on January 1, 2020. The article is available [here](#).
- EMMI granted authorization by the Belgian FMSA for the provision and administration of EONIA under The EU Benchmark Regulation (EU BMR). The article is available [here](#).
- European Securities and Markets Authority (ESMA) has provided information on pending applications for benchmark administrators. The article is available [here](#).
- In Italy and Germany, EURIBOR fallback rates may be subject to legal difficulties. Article available [here](#).
- The EU BMR rift fuels "zombie" LIBOR uncertainty. The article is available [here](#).

Japan

- The application period for proposals on the calculation of Term Tokyo Overnight Average Rate (TONAR) closed on December 31, 2019. The article is available [here](#).
- Japanese market participants preference for a forward-looking TONAR term rates verse a compound in arrears. The article is available [here](#).



Our Perspective

Heightened Pressure on LIBOR Transition Plans

The letter from NYDFS requesting risk management plans related to the LIBOR transition has placed a heightened pressure for regulate entities to assess their impacted areas, define important transition risks, and appropriately define attainable milestones as part of their transition program. Similar to the FCA encouraging market participants to reference Sterling Overnight Index Average (SONIA) for interest rate swaps and loans in 2020, the trend seems to continue from regulatory bodies of placing a higher degree of pressure on market participants for LIBOR readiness as time progresses toward 2021. With regulatory bodies around the world requesting similar data points and information, it is important to develop the LIBOR transition and risk management plans at an enterprise view and develop a standardized, regulatory review package which can be customized as needed. It may also be prudent to be conscientious of market challenges and be able to anticipate and adapt to new regulatory requests.

Relief to the SOFR Swap Market

CFTC's announcement of the regulatory relief for swaps and the prompt releases of letters with the details of the relief is a vital step to being able to issue and transitioning to SOFR-linked swaps. As long-dated swaps referencing LIBOR are transitioned to SOFR, it may likely provide liquidity in the long-dated market and facilitate developing the SOFR term structure. The relief to swap dealers also allows for market participants to implement SOFR swap capabilities at a faster rate which may result in alignment of technology plans with implementing SONIA swaps in early 2020 as encouraged by the FCA.

Increasing Availability of SOFR Products

The new products such as the revolving credits linked to SOFR and the K-Certifications shows the willingness of market participants to enter the market and pave the way for new products referencing SOFR. With more firms—both financial and non-financial—getting involved in the transition, we can expect more alternative reference rate products entering the market to facilitate the growth of the market as demand grows. CME listing SOFR linked options, the first non-linear product on the SOFR benchmark, also helps with the market's adoption of SOFR.

Contact Us

For further details on how we can help firms experience an effective transition away from LIBOR, please visit our website:

[DELOITTE LIBOR TRANSITION WEBSITE](#)

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