Deloitte LIBOR Transition Newsletter
May 2020
Regulatory Updates: 04.03.20 – 04.30.20
Market Updates: 04.01.20 – 05.13.20

Deloitte[i] US LIBOR Transition Newsletter

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

Executive Summary

The Alternative Reference Rate Committee (ARRC) published objectives for 2020 on April 17, 2020 to provide guidance for the transition from LIBOR to Secured Overnight Financing Rate (SOFR). These objectives have been developed in parallel with their recommended "Best Practices" and cover six main areas to help facilitate the transition. The objective areas include milestones related to supporting SOFR use and liquidity, market infrastructure and operations, contractual fallbacks, consumer products, legal, tax, accounting and regulatory clarity and outreach, education and global coordination.

With the COVID-19 impacting operations and businesses around the globe, the Financial Conduct Authority (FCA) released a statement in March noting that the assumption that LIBOR will be discontinued post 2021 has not changed. UK regulators have recognized that some of the interim milestones may be delayed due to COVID-19, particularly in the loans market. To provide some relief to market participants, Bank of England's (BoE)'s Working Group on Sterling Risk-Free Reference Rates (RFRWG) released a statement on April 29, 2020 setting out newly drafted expectations that firms will cease to issue LIBOR based loans by the end of Q1 2021, veering from the original expectation of Q3 2020. However, BoE still expects firms to have the capacity to lend leveraging non-LIBOR linked products by Q3 2020.

Due to operational concerns brought on by COVID-19, the London Clearing House (LCH), Chicago Mercantile Exchange (CME), and Eurex Clearing (Eurex) announced a five-week delay of the planned switch from Euro Over Night Index Average (EONIA) to Euro Short-Term Rate (€STR) for discounting of cleared trades, pushing the go-live date from June 22, 2020 to July 27, 2020. However, the Central Counterparty Clearing Houses (CCP)s also noted that there are no anticipated delays in the Effective Fed Funds Rate (EFFR) to SOFR CCP discount rate switch on October 19, 2020.

Our Perspective

ARRC's 2020 Objectives

The ARRC has published its long-awaited 2020 objectives which were developed with the expectation that LIBOR can no longer be referenced post December 2021. The ARRC's objectives aim to provide the resources for market participants to execute their plans to transition to SOFR. They also include establishing a Request for Proposal (RFP) for the administrator for the forward-looking term SOFR and establishing a RFP for the administrator for the spread adjustment. It is crucial for market participants to understand where and how those rates will be published for contractual, system and modelling implications. The ARRC is also looking to publish the final recommendations for market conventions for floating rate notes (FRNs), business loans and securitizations along with finalizing the student loans consultation to facilitate issuances of SOFR referencing products. The recommendations aim to further increase demand for SOFR products across the markets, including the derivatives market as firms look to hedge their risks. Further focus areas of the objectives include providing legislative relief for legacy contracts that are difficult to amend as well as working with the tax, regulatory and accounting bodies to help firms avoid unintended tax or accounting consequences as a result of the transition. Market participants may want to monitor progress in this area closely as the results of this work can provide more flexibility for businesses to remediate LIBOR contracts

Delayed Issuance of LIBOR-Linked Loans

With the recent COVID-19 pandemic and resulting market shocks, market participants are experiencing challenges meeting interim milestones of their LIBOR transition plans as resources are reallocated to focus on dealing with the market volatility. Although the BoE's RFRWG reiterated in its statement from April 29, 2020 that LIBOR won't be available as a reference rate after 2021, they have recognized the challenges faced and have provided relief to market participants by delaying interim milestones. This includes a six-month extension to cease issuance of LIBOR-linked loans from Q3 2020 to Q1 2021. However, they are still expecting market participants to be able to lend non-LIBOR linked products by Q3 2020 and to have contractual arrangements for LIBOR referencing loans with pre-agreed conversion terms after Q3 2020. Firms may want to continue to engage with their clients to understand the market appetite for non-LIBOR loans and prioritize the types of products they are looking to utilize. In addition, tracking and comparing issuances of non-LIBOR loans and LIBOR loans with the appropriate fallback language may help analyze differences from a financial and a conduct perspective for the eventual cessation of LIBOR.

CCP Delay in EONIA to €STR Discounting Change

Market participants have expressed diverging opinions on the EONIA to €STR discounting change delay which was announced mid-April. Opponents to the delay raised concerns related to the the added uncertainty and negative impacts to their firms' transition plans. They also pointed out that the delay may cause challenges for trades recently negotiated assuming a switch date in June 2020. Accordingly, market participants should continue to review their books for potentially impacted bilateral contracts and assess the associated valuation adjustments. On the other end of the spectrum, many welcomed the delay as it provided an opportunity to manage imminent business priorities and shift their focus on areas caused by the COVID-19 pandemic. While supporters of a delay might have hoped for a more generous postponement, the new date will provide some relief in preparing for the switch. Nevertheless, with the upcoming SOFR discount switch date still scheduled for mid-October 2020, it will be important to reevaluate and potentially adjust existing internal roadmaps to reflect the narrower time buffer between EONIA/€STR and EFFR/SOFR switch dates.

Regulatory Updates

Regulatory Highlights

- ARRC published objectives for 2020 to provide guidance for the transition from LIBOR to SOFR. The objectives are available **here**.
- BoE's RFRWG released a statement on April 29, 2020 that firms may cease to issue LIBOR based loans by the end of Q1 2021 as opposed to the original timeframe of Q3 2020. The statement is available **here**.
- CME, LCH and Eurex have postponed the switch from EONIA and begin to use €STR for discounting future cashflows and calculating interest payments on collateral from a go-live date of June 22, 2020 to July 27, 2020. The CME announcement is available **here**. The LCH announcement is available **here**. The Eurex announcement is available **here**.
- LCH and CME confirmed there is no change to the timeline for the SOFR discounting in the US market scheduled for October 19, 2020. The LCH statement is available **here** and the CME proposal 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 April 1, 2020 through April 30, 2020. 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:

LIBOR-Referencing Federal Reserve Facilities

- Recently established Federal Reserve Facilities were designed to supply credit to the economy as efficiently as possible. As many banks were already configured to accept LIBOR, the Federal Reserve issued LIBOR-linked loans to ensure timely relief.

LIBOR Cessation Date Unchanged

- Although the FCA released a statement delaying several interim milestones, the assumption that banks will no longer be able to reference LIBOR post 2021 remains unchanged. The Financial Stability Board (FSB) also echoed confirmation that the 2021 LIBOR cessation date still stands.

SOFR Spreads and Tenors

- SOFR tenors to be published will be the same as currently available for LIBOR. The current assumption is that spreads will continue to be published for LIBOR tenors. SOFR spread adjusted rates will also likely be published in advance of LIBOR's cessation so the market can observe their behavior.

SOFR Spread Calculation Methodologies

- The ARRC's recommendations for spread calculation method (i.e., simple average, compound average, term average) have not yet been finalized. However, the ARRC's consultation analyzed International Swaps and Derivatives Association's (ISDA)'s methodologies for calculating fallback rates. Although the simple and compound averages for SOFR are very close in value, a method consistent across fallback rates may be adopted.

Emerging Products in the SOFR Market

- SOFR swaps are currently structured similar to the Fed Fund Overnight Indexed Swap (OIS) which is an annual payment as opposed to monthly or quarterly payment. It is anticipated that as more cash products transition to SOFR, swaps may be structured to conform with cash products, i.e. swaps with -30, -90, -180 day reset periods, or 3-month SOFR swaps paying quarterly.

NY State Legislative Proposal Discontinuation Events

- New York State's legislative proposal lists three scenarios for a LIBOR discontinuation event. The first two match the triggers described in the ISDA fallback language, while the third event is written in a manner to match ISDA's decision on derivatives were they to implement a pre-cessation trigger. In addition to derivatives, this could still apply for cash products using the ARRC's fallback language.

SOFR Floors in Contracts

- The ARRC will not opine as to whether a contract should or should not include a SOFR floor and, if included, what that floor should be. However, due to several instruments typically including floors in their contract language, the ARRC will publish, in its convention matrices, how to implement a floor, if a deal maker wishes to add one.

Negative SOFR Rates

- As with money market rates, it will be possible for the SOFR rate to fall below zero. To avoid this pitfall, some floating rate notes and loans build in floors to prevent the rate from dropping to zero or falling in the negatives.

ARRC Working Group

- ARRC February-March 2020 Newsletter with highlights, including Student Loan fallback language; SOFR averages; and draft legislation. The newsletter is available **here**.
- ARRC agreed on a recommended spread adjustment methodology for cash products referencing USD LIBOR. The statement is available **here**.
- ARRC conducted a webinar titled "Overview of ARRC Proposal for New York State Legislation for U.S. Dollar LIBOR Contracts". The webinar is available **here**.

ISDA Updates

- March version of "ISDA In Review" newsletter was published. The newsletter is available **here**.
- ISDA conducted a webcast on Swaptions and CCP discounting change. The recording is available **here**.
- ISDA announced the preliminary results of its consultation on the implementation of pre-cessation fallbacks for derivatives referenced to LIBOR. Initial results which favored a pre-cessation trigger are available **here**.
- ISDA released a bilateral template for EONIA Amendment Agreement. The agreement enables parties to amend one or more existing confirmations, existing credit support documents or existing master agreements to update references to EONIA in light of the anticipated permanent cessation of EONIA on January 3 2022. The bilateral template is available **here**.
- The summary of ISDA COVID-19 updates was released. The summary is available **here**.
- Bloomberg published the IBOR Fallback Rate Adjustments rule book. The rule book is available **here**.
- The report of ISDA's "Interest Rate Benchmarks Review for First Quarter of 2020" was released. The report is available **here**.
- The summary of ISDA's "SwapsInfo First Quarter of 2020 Review" was released. The summary is available **here**.

COVID-19 Impact

- The Federal Reserve announced that it is establishing a Main Street Lending Program to facilitate lending to small and medium-sized businesses that were in sound financial condition before the onset of the COVID-19 pandemic. The press release is available **here**.
- COVID-19 is complicating the LIBOR transition and could even damage the risk profile of CME and LCH. The article is available **here**.
- Banking groups have criticized US plans to benchmark emergency loans made to businesses during the COVID-19 pandemic to SOFR, instead of LIBOR. The article is available **here**.
- Reuter's article titled "Coronavirus pandemic could slow loan market transition from LIBOR" is available **here**.

Other News / Useful Reading

- Fannie Mae and Freddie Mac announced additional details about their adjustable-rate mortgage (ARM) products indexed to the 30-day Average SOFR. The press release is available **here**.
- Federal Reserve pressured to expand access to "Main Street Lending Program" ahead of launch. The article is available **here**.
- US banks seek term changes as the Federal Reserve finalizes Main Street Lending Program. The article is available **here**.
- US Treasury repos were used to calculate SOFR transacted at negative rates at the end of March 2020. The article is available **here**.
- "LIBOR Risk – Quarterly report Q1 2020" has been published by risk.net. The report is available **here**.
- The National Law Review released April edition of LIBOR transition newsletter. The newsletter is available **here**.
- Pensions & Investment's article titled "LIBOR transition won't be easy for money managers" is available **here**.
- "LIBOR transition: How you can manage and mitigate operational risk" webinar is available. The link to register for the webinar is available **here**.
- Regional banks express concerns about the lack of credit sensitivity in the replacement benchmark. The article is available **here**.

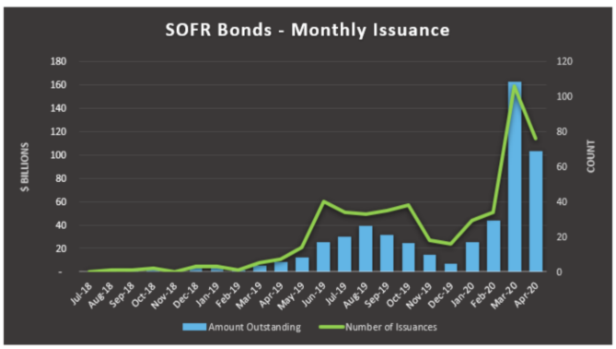
Market Updates

Increase in Debt Issuance Referenced to SOFR

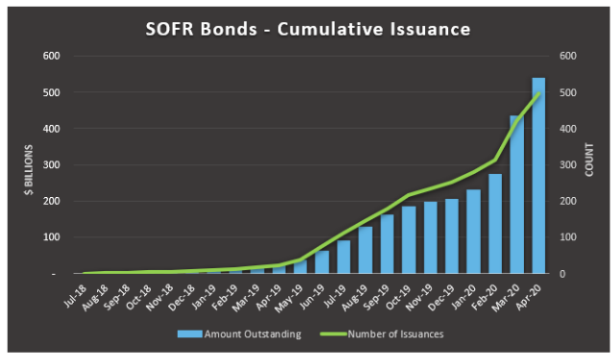
The issuance in SOFR referenced debt remained strong in April 2020 following the record high of floating-rate debt issuances linked to SOFR in March 2020. The issuance was $103.2 billion in April 2020 which has decreased from $162.3 billion in March 2020. The issuance continues to remain on the upside as compared to February 2020 issuances of $43.4 billion. The graphs below represent data through April 30, 2020.

The cumulative issue size of SOFR bonds outstanding currently stands at $559.2 billion with 518 bonds (this excludes the matured bonds) through May 13, 2020. There were 76 new issuances in April 2020 compared to 106 and 33 issuances in March 2020 and February 2020 respectively.

In April 2020, federal agencies issued 61 SOFR referenced FRN's worth $73.7 billion. There were 11 other institutions which contributed $29.5 billion to the outstanding amount of SOFR referenced debt.



Source: Bloomberg, compiled by Deloitte
Data as of Apr 30, 2020

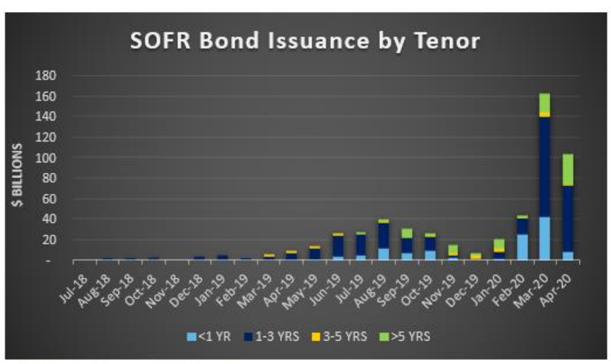


Source: Bloomberg, compiled by Deloitte
Data as of Apr 30, 2020

Increase in Longer Dated Debt Issuance Referenced to SOFR

April 2020 included a monthly high of SOFR referenced debt issuances which have a maturity greater than or equal to five years. During April 2020, 14 bonds with an amount outstanding of $29.2 billion, which have a maturity greater than or equal to five years, were issued. This includes 8 bonds with an amount outstanding of $16.2 billion which have a maturity greater than or equal to ten years.

There were 73 issuances worth $76.1 billion, with a maturity greater than or equal to five years, through May 13, 2020 including 51 issuances worth $49.4 billion with a term greater than or equal to 10 years.



Source: Bloomberg, compiled by Deloitte
Data as of Apr 30, 2020

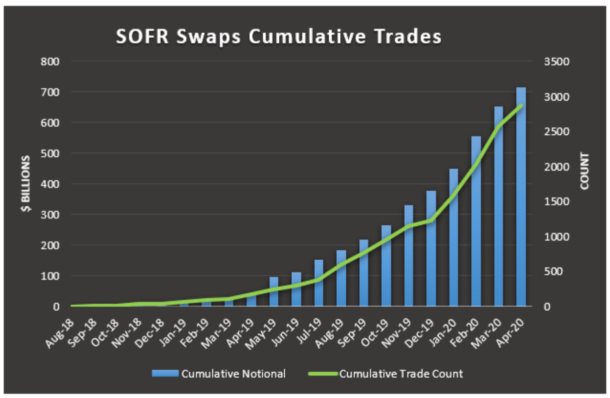
Cumulative SOFR Interest Rate Derivatives

SOFR Swaps

- The cumulative traded notional for SOFR based interest rate and basis swaps totaled $740.4 billion through May 8, 2020.
- For the month of April 2020, the notional volume of SOFR-based interest rate and basis swaps totaled $60.8 billion compared to the $97.3 billion in March 2020, and $107.5 billion in February 2020.

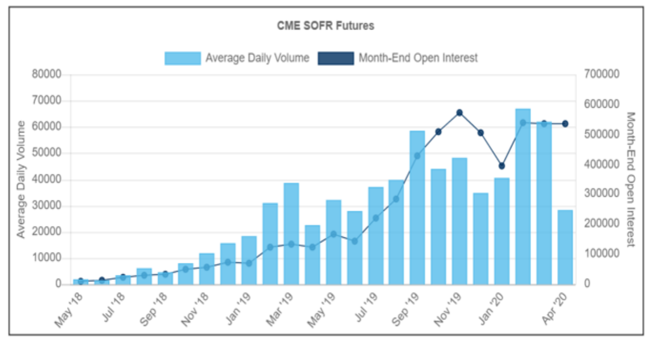
SOFR Listed Derivatives

- Per the data available on CME, SOFR futures are among the fastest growing new products in CME Group's 172-year history. For April 2020, SOFR futures average daily volume was around 28K contracts/day. The article is available **here**.
- Data from the CME highlights that 3-Month SOFR options which were launched on January 6, 2020 include over 500 contracts traded. 1-Month SOFR options were launched on May 4, 2020.



Source: http://swapsinfo.org/, compiled by Deloitte

**Data as of May 1, 2020*



Source: CME Group

**Data as of Apr 30, 2020*

Global IBOR Activity

There is a continued focus on the broader market adoption of the global alternative reference rates. Market activity in Sterling Overnight Index Average (SONIA), Swiss Average Rate Overnight (SARON) and €STR based debt issuances and swaps have continued to increase. The table below represents the cumulative bond issuances (does not exclude matured bonds) and the cumulative notional of swaps outstanding through May 8, 2020.

Alternative Reference Rate	Swaps Cumulative notional amount (US $ Billions)	Bonds Cumulative issuance amount (US $ Billions)
SONIA	24,355.80	81.73
SARON	36.40	NA
TONA	482.23	NA
€STR	8.50	4.41

Source: Bloomberg, http://swapsinfo.org/, compiled by Deloitte
Data as of May 8, 2020

Global Highlights

United Kingdom

- BoE Working Group's March 2020 newsletter was produced. The newsletter is available **here**.
- London Stock Exchange Group's webinar titled "*The Future of Derivatives in LIBOR Transition"* was released. The webinar is available **here**.
- Banks and borrowers are slowing down on LIBOR transition plans progress due to the impact of COVID-19. The article is available **here**.

European Union

- European Central Bank (ECB) Working Group produced their meeting minutes from the April 7, 2020 session. The minutes are available **here**.
- A delay to the June 2020 switchover of the discount rate for EONIA to €STR swaps could cause problems for the pricing of swaptions. The article is available **here**.
- Alternative risk-free rates (RFR)s hit Main Street as Swiss banks launch SARON mortgages. The article is available **here**.

Asia

- The Bank of Thailand has begun publishing the Thai Overnight Repurchase Rate (THOR) on April 30, 2020 for 1, 3, and 6-month compounded in arrears averages. The rate is published **here** and the methodology is available **here**.
- Bank of Japan (BoJ) and Financial Services Agency (FSA) published the "Summary of Survey Results on the Use of LIBOR and Main Actions Needed". The results are available **here**.
- Japanese Bankers Association (JBA) sample fallback language for bilateral loans along with hardwired and amendment approaches were produced. The results are available in Japanese **here**.
- Japanese dealers join calls for LIBOR extension due to COVID-19 impact. The article is available **here**.
- Asian lenders lag in LIBOR transition. The article is available **here**.

Australia

- The Australian Securities and Investments Commission (ASIC) released feedback on responses to the "Dear CEO" letter from selected major Australian financial institutions. The findings are available **here**.

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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