

# Deloitte<sup>i</sup> US LIBOR Transition Newsletter

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

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## Executive Summary

The Alternative Reference Rates Committee (ARRC) published their “Internal Systems and Processes: Transition Aid for SOFR Adoption” document in early July 2020 as a continued effort to support market participants in their transition from U.S. Dollar LIBOR to the Secured Overnight Financing Rate (SOFR). Undertaking the transition has many operational challenges. This document aims to facilitate identification of internal processes and systems which may need to be updated to support the transition from LIBOR. Market participants can use the guide to evaluate their programs on a number of topics broadly grouped by activities ranging from trading and brokerage and client servicing to data management, operations, and risk controls.

The ARRC also released updated recommendations on hardwired fallback language for syndicated loans and their final recommendation for contractual fallback language for private student loans. Both are aimed to minimize market disruption upon a LIBOR cessation event. For syndicated loans, the ARRC recommends using a simple daily SOFR in arrears in the second step of the waterfall and a more accessible early opt-in trigger. However, private student loans may fall back to a spread adjustment based on the 5-year historical median of the difference between LIBOR and SOFR, with a 1-year transition period to the spread.

The International Swaps and Derivatives Association (ISDA) and Bloomberg jointly announced that Bloomberg has started calculating and publishing fallback rates for ISDA for several key interbank offering rates (IBORs). ISDA is preparing to release amended language for the ISDA Protocol which plans to incorporate the updated fallback language for standard interest rate derivatives for firms who have signed the protocol. Bloomberg has preemptively begun publishing associated calculations which include the adjusted compound in arrears Risk Free Rate (RFRs), the spread adjustment, and the “all in” fallback rates for the impacted IBORs.



## Our Perspective

### **ARRC Releases an Internal Systems and Processes Tool**

Firms may find ARRC’s “Internal Systems & Processes: Transition Aid for SOFR Adoption” as an important tool in planning a smooth transition from LIBOR. The paper broadly classifies transition activities into 10 categories with a one-page summary for each of 50 selected sub-categories. Similar to previous publications, such as the ARRC’s “User Guide to SOFR” or its “Practical Implementation Checklist”, market participants are able to use it as a taxonomy for organizing their strategy for the transition to SOFR. Firms who have established LIBOR transition programs can leverage the checklist to confirm they have covered potentially impacted areas. Firms who are still developing a program, can leverage this tool to identify key areas to perform impact assessments.

### **ARRC Releases Recommended Fallback Language for Private Student Loans and Updated Recommended Hardwired Fallback Language for Syndicated Loans**

The ARRC’s recent publications regarding private student loans and syndicated loans provide valuable guidance to prepare for USD LIBOR’s cessation. For syndicated loans, it is encouraged that market participants take a close look at the “hardwired” approach to include fallback language, while the “amendment” approach remained unchanged from the original April 2019 version. Student loans, similar to other consumer products, require special attention, because contract language is required to be simple and without ambiguity. Market participants may therefore want to review the ARRC’s updated and more robust fallback language and apply them where applicable.

### **Bloomberg Begins Publishing Calculations Related to IBOR Fallbacks**

Bloomberg’s publication of calculations related to fallbacks for ISDA can help facilitate the withdrawal of certain key interbank offered rates prior to the official LIBOR cessation date at the end of 2021. Bloomberg plans to make the adjusted rates and spreads broadly available through various distribution channels. Consequently, market participants may want to take early advantage of the opportunity to begin to refine their systems’ technical designs for the consumption of the rates into internal systems. Businesses may also want to track and leverage the calculations as contractual fallback rates in order to achieve a smooth transition strategy away from LIBOR.



## Regulatory Updates

### 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 July 1, 2020, until July 31, 2020. Weekly office hour information can be found [here](#). The information below does not represent the view of the FRB but represents the personal views of David Bowman outside of his official capacity. Below are some of the specific topics discussed:

#### *Floating Rate Instruments and LIBOR Cessation*

- In the US, floating rate instruments require unanimous consent by noteholders to change a term in the trade (e.g., interest rate). Unless a provision is baked into the agreement which allows the issuer/agent to make a rate change, the note's interest rate cannot be changed. When LIBOR ceases to exist, LIBOR-linked floating rate notes would technically default to the last published value of LIBOR. If LIBOR is declared unrepresentative, legacy agreements would similarly pay using LIBOR declared inaccurate, leaving involved parties dissatisfied. If New York State (NYS) legislative language is adopted, markets would follow a big bang approach away from LIBOR upon its cessation or declaration of unrepresentativeness.

#### *Big Bang Approach for Bonds*

- Assuming ARRC language is adopted and the LIBOR transition even were to happen in the middle of a bond coupon period, the switch would occur at the next coupon reset date.

#### *Applicability of ARRC Fallback Language*

- The ARRC recommended fallback language is meant to apply to both the LIBOR transition and any potential future transitions. The ARRC does not intend on changing any fallback language in the future.

#### *Calculating SOFR Compound Average*

- The index published by the FRB is designed to facilitate the calculation of the 3-month compound average (or any other time frame) by taking a ratio. This can eliminate the need to be concerned with the details of the compound formula.

#### *Hedging and ISDA's Spread with Observation Shift*

- The ISDA recommendations include language that can be used if one wants to keep a good hedge relative to ISDA. The logic allows parties to remove the term rate (first step of the fallback) and fall back to compound average in arrears and use the ISDA spread. As the implementation of an observation shift is difficult with loans, the recommended convention will be to use a look back without observation shift. This change does create some hedging basis relative to ISDA. Although there is no perfect solution to this situation, the recommendation is considered more favorable than falling back to a term rate.

#### *Decreasing SOFR Index*

- It is logically possible that the SOFR index be lower at the end of an accrual period than at the start of the interest period (i.e., falls over time), but could only do so if SOFR is negative (SOFR has never been negative). If the FRB continues to not consider negative policy rates, repo rates should remain positive. Additionally, loans can impose floors which some products like ARMs have as standard language.

#### *NYS Legislative Solution for Legacy Contracts*

- There are no updates on NYS Legislative Solution for legacy contracts. Any movement on this topic will depend on when the legislature is open to discussing anything other than COVID-19 related issues.

#### *Effects of LIBOR Transition on Equity Products*

- The discounting switch that Chicago Mercantile Exchange (CME) and London Clearing House (LCH) will be enacting in October moving from fed funds interest rate to SOFR affects their cleared interest rate products (impacted products are listed by the groups). None of the equity options should be included in this switch. Over time, dealers will likely move over to SOFR for bilateral Credit Support Annex (CSAs) – although this may be reserved for rate products the switch could in theory be applied to a wider set of products. It is recommended that inter-dealer CSAs move by the year end.

*Financial Conduct Authority (FCA) New Powers Under the UK Benchmark Regulation (BMR)*

- The UK has not yet adopted the powers required to compel panel banks to continue to administer the benchmark or make changes to the rate (“Synthetic LIBOR”) once LIBOR has been declared unrepresentative, and there is no guarantee that the conditions will be such that these powers would be used. They also still need to assess whether these powers could be applied to USD LIBOR or any non-sterling LIBOR. The FCA has said they would only use these powers if LIBOR was declared non-representative and it would not make LIBOR representative again.
  - If a contract has ARRC fallback language, these powers would have no impact because LIBOR would have been declared non-representative and the rate would be changed regardless of if there was a synthetic LIBOR.
  - If the ARRC’s proposed legislative solution is passed in NY and the contract is under NY law, these powers would have no impact and the rate would be changed from a non-representative LIBOR to SOFR.
  - If there was no ARRC legislative solution, no ARRC fallback language, and the UK decided to apply these powers to USD LIBOR, the FCA powers would have an impact but market response may be mixed. There may also be associated legal challenges.

**Regulatory Highlights**

- The ARRC published guidance to help stakeholders with the internal systems and processes in the transition to SOFR. The report is available [here](#).
- The ARRC released updated recommended hardwired fallback language for Syndicated Loans. The press release is available [here](#).
- Bloomberg begins publishing calculations related to IBOR Fallbacks. The article is available [here](#).

**ARRC Working Group**

- The ARRC announced further details regarding its recommendation of spread adjustments for cash products. The press release is available [here](#).
- The ARRC released recommended fallback language and conventions for using SOFR in student loans. The press release is available [here](#).
- The ARRC is running a series of SOFR focused webinars throughout July and August. The schedule and registration details are available [here](#).
  - “LIBOR: Entering the Endgame” stream is available [here](#).
  - “SOFR Explained” is available [here](#).
  - “Preparing to move from LIBOR Derivatives” is available [here](#).
- The ARRC FAQs were updated on July 16, 2020. The updated FAQs are available [here](#).
- The ARRC released conventions related to using SOFR in arrears for syndicated loans. The press release is available [here](#).
- The ARRC issued a letter with a relief issue list to The Commodity Futures Trading Commission (CFTC) requesting revisions to the existing IBOR no-action relief. The letter is available [here](#) and the relief issue list is available [here](#).
- The ARRC published its June/July monthly newsletter. The newsletter is available [here](#).

**ISDA Updates**

- ISDA published its guide on COVID-19 and the impact on liquidity. The guide is available [here](#).
- ISDA published its guide on reforming the EU BMR. The guide is available [here](#).
- ISDA published a brochure titled: “*Benchmark Reform at a Glance*”. The guide is available [here](#).
- ISDA published the SwapsInfo First Half of 2020 and Second Quarter of 2020 Review. The report is available [here](#).
- ISDA launches risk-free rate adoption indicator. The press release is available [here](#).

**Other News / Useful Reading**

- The Association for Financial Markets in Europe (AFME) and Simmons & Simmons published a white paper on conduct risks and client communications during LIBOR transition. The white paper available [here](#).
- Risk.net published an article titled: 'Potential LIBOR transition cliff edge in valuation'. The article is available [here](#).
- Intercontinental Exchange (ICE) Bank Yield Index webpage launched. Website, publications, and test results are available [here](#).
- Lawmakers have to sort 'tough legacy' LIBOR products. The report is available [here](#).
- ICE Benchmark Administration Limited (IBA) consultation on LIBOR cessation is expected in September. The article is available [here](#).
- "LIBOR replacement II: completing the generalized forward market model". The paper is available [here](#).
- ARRC pumps up the summer heat on LIBOR transition. The article is available [here](#).
- The details of CME's new Eris SOFR swap futures contract to be launched on October 5, 2020 are now available. The details are available [here](#).
- Risk.net published its LIBOR Risk Quarterly Report – Q2 2020. The report is available [here](#).
- Risk.net published its article titled: "Term SOFR rate still possible this year". The article is available [here](#).
- Risk.net published an article titled: "How Covid-19 is impacting transition preparations". The article is available [here](#).
- Bloomberg published its article titled: "Trade-web ICE Offer Treasury Yield curve as LIBOR Alternative". The article is available [here](#).
- Bloomberg published an article titled: "Banks scramble to cut derivatives losses on eve of market reset". The article is available [here](#).



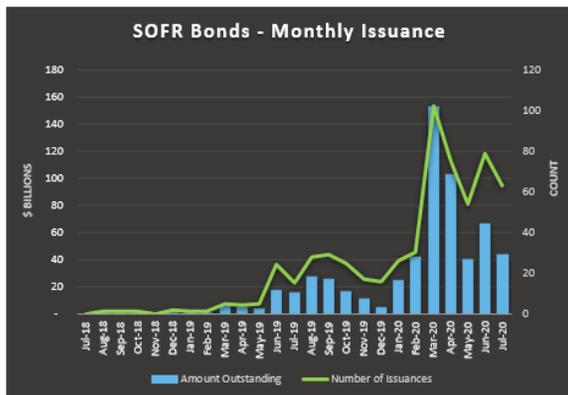
## Market Updates

### Decrease in Debt Issuance Referenced to SOFR

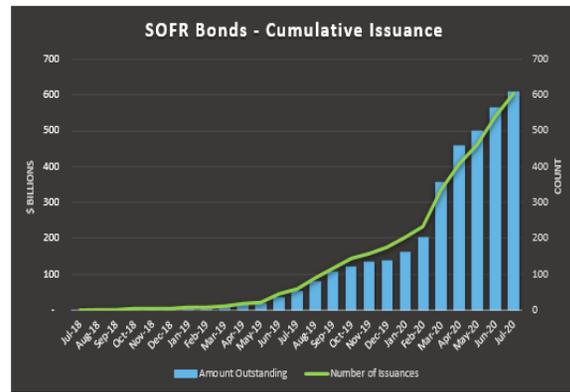
The issuance of SOFR referenced debt decreased in July 2020 compared to the issuances in June 2020. The issuance was \$43.7 billion in July 2020 which decreased from \$66 billion in June 2020. The graphs below represent data through July 31, 2020.

The cumulative issue size of SOFR bonds outstanding (this excludes matured bonds) is currently \$610.14 billion with 619 bonds through August 12, 2020. There were 63 new issuances in July 2020 compared to 79 and 54 issuances in June 2020 and May 2020 respectively.

In July 2020, federal agencies issued 47 SOFR referenced FRNs worth \$39.8 billion. There were 16 other institutions which contributed \$3.98 billion to the outstanding amount of SOFR referenced debt.



Source: Bloomberg, compiled by Deloitte  
\*Data as of July 31, 2020

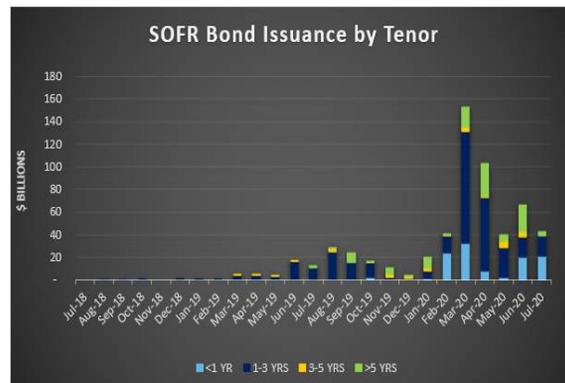


Source: Bloomberg, compiled by Deloitte  
\*Data as of July 31, 2020

### Decrease in Longer Dated Debt Issuance Referenced to SOFR

SOFR debt issuances with a maturity greater than or equal to five years decreased in July 2020 compared to the previous month of June 2020. During July 2020, there were no bonds issued which have a maturity between five and ten years. The issuances during July 2020 includes 15 bonds with an amount outstanding of \$3.7 billion which have a maturity greater than or equal to ten years and has decreased as compared to 30 bonds with an amount outstanding of \$11.5 billion in June 2020.

There were 144 issuances of SOFR bonds outstanding worth \$106.5 billion, with a maturity greater than or equal to five years, through August 12, 2020 including 111 issuances worth \$65.2 billion with a term greater than or equal to 10 years.

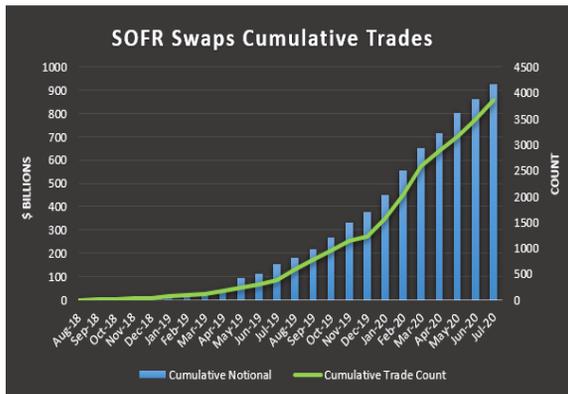


Source: Bloomberg, compiled by Deloitte  
\*Data as of July 31, 2020

## Cumulative SOFR Interest Rate Derivatives

### SOFR Swaps

- The cumulative traded notional for SOFR based interest rate and basis swaps totaled \$924 billion through July 31, 2020.
- For the month of July 2020, the notional volume of SOFR-based interest rate and basis swaps totaled \$64.5 billion compared to the \$59.5 billion in June 2020, and \$85.7 billion in May 2020.



Source: <http://swapsinfo.org/>, compiled by Deloitte  
\*Data as of Jul 31, 2020

### SOFR Futures

- As per the data available on CME, for July 2020, SOFR futures average daily volume reached 34K contracts/day. The data is available [here](#).
- The month-end open interest for July 2020 was around ~400K contracts. The data is available [here](#).
- Effective October 5, 2020, and pending regulatory review, CME Group will list SOFR-based Eris and Mac Swap futures in different tenors.

## Global IBOR Activity

The market activity in Sterling Overnight Index Average (SONIA), Swiss Average Rate Overnight (SARON) and Euro Short-Term Rate (€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 July 31, 2020.

Alternative Reference Rate	Swaps Cumulative notional amount (US \$ Billions)	Bonds Cumulative issuance amount (US \$ Billions)
SONIA	26,566.1	83
SARON	53.3	NA
TONA	518.6	NA
€STR	24.6	4.2

Source: Bloomberg, <http://swapsinfo.org/>, compiled by Deloitte  
Data as of July 31, 2020



## Global Highlights

### United Kingdom

- The Working Group on Sterling Risk-Free Reference Rates published its June 2020 newsletter. The newsletter is available [here](#).
- FTSE Russell began publishing indicative forward-looking SONIA term rates. The article is available [here](#).
- Prudential Regulation Authority (PRA) issued a statement on LIBOR transition and resolution-related rules. The statement is available [here](#).
- Andrew Bailey's speech at the Bank of England (BoE) and FRB LIBOR webinar *LIBOR: Entering the Endgame* available. The transcript is available [here](#).
- BoE published the latest updates on the SONIA Compounded Index which will be published starting in August 2020. The discussion paper is available [here](#).
- Risk.net published an article: 'Potential Tough Legacy considerations in the US and UK'. The article is available [here](#).
- Risk.net published an article: 'UK's tough legacy fix spells trouble for US LIBOR transition'. The article is available [here](#).
- The Financial Stability Board (FSB) issued a statement on the impact of COVID-19 on global benchmark reform. The statement is available [here](#).

### European Union

- The European Central Bank (ECB), Financial Services and Markets Authority (FSMA), The European Securities and Markets Authority (ESMA), and the European Commission Working Group issued a letter to the IASB on IFRS9 and IAS39 and potential relief. The letter is available [here](#).
- Agenda from July 2, 2020 ECB working group meeting. The agenda is available [here](#).
- ECB Survey on replies on forward-looking rates production. The report is available [here](#).
- The European Commission addresses risks of LIBOR cessation and proposed amendments to EU rules on financial benchmarks. The press release is available [here](#).
- The ECB announces public consultation on the publication of compounded €STR rates. The press release is available [here](#).
- The ECB published its horizontal assessment of SSM banks' preparedness for benchmark rate reforms. The report is available [here](#).
- The ECB published its report on preparations for benchmark rate reforms. The report is available [here](#).
- The ECB Criticizes Banks for being unprepared for benchmark reforms. The article is available [here](#).

### Asia

- Hong Kong Monetary Authority (HKMA) published a letter on the progress of LIBOR transition in Hong Kong and outlining transition milestones to achieve before end-2021. The letter is available [here](#).
- Asia Securities Industry and Financial Markets Association (ASIFMA) released its July IBOR Transition Guide for Asia. The guide is available [here](#).
- Hong Kong Exchanges and Clearing's (HKEX) cleared the first HKD Overnight Index Average (HONIA) swaps through Over-the-Counter (OTC) Clear. The article is available [here](#).
- OCBC Bank Launches Singapore's first Singapore Overnight Rate Average (SORA) based home loan. The press release is available [here](#).

### South Africa

- The South African Reserve Bank (SARB) published a statement on the methodologies and policies governing SARB-administered interest rate benchmarks. The press release is available [here](#).

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## Contact Us

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

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## Deloitte LIBOR Transition Newsletter

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