Deloitte LIBOR Transition Newsletter
July 2020
Regulatory Updates: 06.01.20 – 06.30.20
Market Updates: 06.01.20 – 07.15.20

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's (ARRC) added two key points to their recommendation for spread adjustments for cash products in response to the feedback from their supplemental consultation on spread adjustments. The initial recommendation was for LIBOR to the Secured Overnight Financing Rate (SOFR) spread adjustment calculation based off of a five-year lookback median and a one-year transition period. The five-year lookback median largely aligns with International Swaps and Derivatives Association (ISDA)'s plan for derivatives, although ISDA does not include the one-year transition period. The ARRC has now added the following stipulations: 1) the ARRC's recommended spread adjustment to match the value of ISDA's spread adjustment for cash products (excluding consumer products), and, 2) the ARRC's recommended spread adjustment to be determined at the same time as ISDA's spread adjustment (i.e., at the time of a LIBOR cessation or unrepresentative announcement).

The first Credit Sensitivity Group (CSG) workshop was held in early June 2020. A first of several workshops designed to address regional banks request to explore a credit sensitive rate and spread that could be used in replace of SOFR for certain loan products. The first workshop was designed to discuss the nature of the challenges and explore potential data which could be used to create such a rate. A panelist discussion highlighted several challenges associated with transitioning certain loan products from LIBOR to SOFR, specifically expressing concerns around a potential mismatch between bank funding costs and commercial loans especially during times of economic strain. A follow-up workshop is planned to be held in July intended to dive deeper into the data that could be used to develop such a credit sensitive rate.

On June 23, 2020, UK Parliament issued a statement on 'Tough Legacy' contracts under English contract law providing the Financial Conduct Authority (FCA) additional powers under the amended UK Benchmark Regulation (BMR). 'Tough Legacy' contracts are contracts lacking adequate alternative fallbacks and are difficult to reasonably renegotiate or amend. With the additional powers granted by the Parliament, the FCA now has the power to direct the administrator to change the methodology of LIBOR, by essentially creating a synthetic LIBOR for those 'Tough Legacy' contracts to facilitate in winding down their exposures.

Our Perspective

Th ARRC's Updated Recommendations for Spread Adjustments to Cash Products

The ARRC's changes to the recommendations for spread adjustments to cash products were well received from the overall industry. The ARRC noted that the responses were broadly similar across industry types and there was almost unanimous consensus on the timing of the change. With more products aligned to the ISDA spread adjustment methodology and timing, this may help alleviate concern on the potential basis risk which would have arising if all products required the one-year transition period or if the date the change took effect were not aligned between the ARRC and ISDA. Industry participants may want to continue to evaluate their hedging relationships and review their current strategy based on the updated recommendations by the ARRC and continue to respond to the various consultations published by the ARRC so their opinions can be factored in.

Additional Alternative Reference Rate Possibilities

With the recent spikes in spreads due to the COVID-19 pandemic, there was a renewed call for a credit sensitive rate to capture the credit component during periods of economic strain. The CSG was convened to provide further insights on the group's thoughts on how these rates may be created due to the ARRC not exploring other options besides SOFR as an alternative reference rate. Industry participants may want to closely monitor the CSG's work to explore new opportunities for possible alternatives and may want to be open to the possibility of a new rate or spread to be published in addition to SOFR lead by the ARRC. There is much more that needs to be done before the group can provide a recommendation and we encourage firms not to change the transition plans away from migrating to SOFR. However, we recommend that market participants maintain awareness of the potential possibility of additional rates being added to the scope of the rapidly increasing number of alternative rates being recommended around the world.

'Tough Legacy' Contracts

UK Parliament's statement provides some relief to parties who hold 'Tough Legacy' assets governed under English contract law. Similar to the ARRC's proposed legislative solution to the New York State, this would ease some worry on 'Tough Legacy' contracts becoming a fixed rate contract after the cessation of LIBOR. Market participants may want to keep a lookout for subsequent information on the relief due to the finer details to still be clarified such as the scope of which products this will affect, the timing and other factors. There is also a possibility that the FCA may not execute these additional powers granted by Parliament. We encourage LIBOR transition programs, including plans around amending 'Tough Legacy' contracts to continue to work towards completing the transition by the end of 2021, as this date has been continuously communicated to be the cessation date of LIBOR by the various regulatory bodies and industry groups.

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 June 1, 2020, until June 30, 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:

Proposed Amendments to UK's BMR

- LIBOR is considered a critical benchmark in the UK and has stringent regulations and regulatory requirements. BMR sets out an authority, the FCA, as the regulator of the benchmark and gives the FCA several powers and responsibilities. One of their responsibilities is to judge whether a critical benchmark is representative of the underlying market it seeks to represent. If the benchmark is panel-based and a bank leaves the panel, the regulator is required to assess if the benchmark is still representative. Although the regulators may compel banks to submit quotes for a period of time, the FCA has said they will not use this power since they had a voluntary agreement with the banks to submit LIBOR quotes until the end of 2021. The FCA can also compel an administrator to continue to administer the benchmark or make changes to the rate. A recent announcement has suggested that the UK may amend regulation to make it clear that the FCA has the power to compel administrators to make these types of changes and create a 'synthetic LIBOR'.
  - Bank of England's (BoE)'s Working Group on Sterling Risk-Free Rates (RFRWG) has called for this type of synthetic LIBOR concept as an alternative for their 'Tough Legacy' contracts (floating rate debt instrument and some types of securities). This alternative, however, forces contracts to use this LIBOR rate. These changes to LIBOR, if compelled, would not make LIBOR representative again so certain products (derivatives) would immediately switch to a replacement rate plus spread at the moment LIBOR is declared unrepresentative.
  - It is not clear that this could be performed for USD LIBOR as the FCA operates under UK law and this could raise potential legal challenges. The ARRC's proposed legislation has different rules depending on fallback or lack of fallback language aimed to avoid some issues posed by synthetic LIBOR.

Vendor's Support of SOFR-linked Floating Rate Notes (FRNs)

- The ARRC is still comfortable with the June 2020 deadline for vendors to support SOFR-linked FRNs due to market participants already issuing SOFR-linked FRNs, and the majority being able to provide SOFR-related alternatives. In early 2020, more SOFR-linked debt was issued than LIBOR-linked debt.

SOFR Term Rates and Tenor Publication

- The original ARRC goals pushed for the publication of SOFR term rates by the end of 2021. The ARRC is currently working towards establishing a request for proposal (RFP) by the end of 2020 to begin publishing term rates in the first half of 2021. However, there is still no guarantee that this milestone will be met. The publication of tenors (1-month, 3-month, 6-month, and 1-year tenors) will largely be depending on market volumes.

Payment Delays, Look Backs, Observational Shifts, and Lock Outs

- A payment delay grants the payer an extra few days to pay the interest during the relevant period. The delay in payment is factored into the price to avoid an interest free loan. A lookback with observational shift, applies the weight and rate of the day the rate is pulled for compounding (e.g., a rate pulled on Friday carries a weight of 3 to account for the weekend). However, a lookback with no observational shift does not use the adjust the weight used for that day (e.g., a Friday's rate used on a Tuesday keeps the Tuesday weight of 1 as opposed to 3). Separately, a lock out does not look back but uses an observed rate which is applied and compounded for the rest of the period.

Median Used in SOFR Spreads

- The median used in calculating the SOFR spread will be a "static" median (as opposed to a rolling median). The spread adjustment will be calculated once at LIBOR cessation and will be used going forward.

Post 2021 LIBOR Interest Periods

- The ARRC's language does not provide any penalties for LIBOR-interest period extending beyond 2021. The contract would continue using LIBOR until the next reset period at which point the fallback language would kick in and the spread adjusted SOFR would be used.

SOFR's Floor for Legacy LIBOR Products

- When calculating SOFR's floor for legacy LIBOR products, the spread adjustment needs to be considered. The convention used by the ARRC's working group uses as an example a -25 basis point (bps) spread adjustment. If LIBOR were to reach its floor at zero, assuming SOFR were to drop to -25 bps, the spread adjustment returns the prevalent rate to zero, guaranteeing a non-negative daily accrual as the LIBOR floor was intended to do.

*SOFR A*djustable Rate Mortgages (ARMs)

- For SOFR ARMs, a 30-day compound SOFR in advance will be provided. Securitizations may see rates in arrears but few have been issued as of yet.

Hardwired vs. Amendment Opt-in Language

- The concept of early opt-in language allows parties to move away from LIBOR before a benchmark transition event has occurred. In the loan language, the designated party can propose to move away from LIBOR before the transition event if a certain number of SOFR transactions have occurred in the market. The ARRC is currently refreshing this language to lower the threshold and provide mechanics for the transition. The ARRC may also recommend when parties may want to use the hardwired language instead of the amendment language or may even remove the amendment language altogether.

New York State (NYS) Legislative Solution and Corporate Loans

- The NYS legislative solution would not affect corporate loans as they typically fallback to prime. The proposed legislation would not affect a contract which falls back to another floating rate. However, the ARRC's recommendations would take the place of LIBOR in any contract that does not have fallback language or fallback to some value of LIBOR (e.g., try to re-create LIBOR by polling banks). Contracts in which one or more parties have discretion to name a new rate would be offered a "safe harbor" if they named the ARRC's rate but are free to select another rate.

ARRC's Voluntary Recommendations

- The ARRC's recommendations are voluntary only and have no supervisory or regulatory enforcement behind them. They solely represent a considered opinion about the timing of steps firms can take in order to ensure they are well prepared for the potential end of LIBOR. It is possible, however, that a regulator could view the updates as sensible guidelines and impose requirements to meet or adjust them.

Regulatory Highlights

- ARRC announces further details regarding its recommendation of spread adjustments for cash products. The publication is available **here**.
- The first FRB CSG workshop was held to address regional bank's request to explore a credit sensitive rate and spread that could be used in replace of SOFR for certain loan products. The minutes from the June 4, 2020 meeting are available **here**.
- UK Parliament releases a statement on proposed increased powers to the FCA to address 'Tough Legacy' LIBOR contracts. The statement is available **here**.
- The FCA released a statement on the planned amendments to UK's BMR to give the FCA enhanced powers to manage 'Tough Legacy' LIBOR contracts. The statement is available **here** and the Q&A is available **here**.

ARRC Working Group

- The ARRC published best practices for completing the transition from LIBOR to SOFR. The press release is available **here**.
- The ARRC welcomed Fannie Mae and Freddie Mac's LIBOR transition playbook. The press release is available **here**.
- The ARRC welcomed the Consumer Financial Protection Bureau's (CFPB)'s updated consumer handbook on proposed rule facilitating the transition away from LIBOR. The press release is available **here**.
- The ARRC extended the comment period for its student loan and spread adjustment consultations, both of which were open for feedback until June 15, 2020. The press release is available **here**.

- The ARRC published a request to the US Commodity Futures Trading Commission (CFTC) for swaptions relief. The letter is available **here**.
- The ARRC updated its Frequently Asked Questions (FAQs) on June 2, 2020. The updated FAQ's are available **here**.
- The ARRC published its April-May newsletter. The newsletter is available **here**.
- Bloomberg released its podcast on the ARRC and SOFR. The podcast is available **here**.

ISDA Updates

- ISDA Chief Executive Officer Scott O'Malia's had informal comments on 'Tough Legacy' LIBOR contracts. The comments are available **here**.
- ISDA published a factsheet on understanding IBOR benchmark fallbacks. The factsheet is available **here**.
- ISDA, Bloomberg, and Linklaters published an IBOR fallbacks factsheet. The factsheet is available **here**.
- ISDA report on key trends in the size and composition of OTC derivatives markets in the second half of 2019. The report is available **here**.
- ISDA Chief Executive Officer Scott O'Malia offers informal comments on important OTC derivatives issues. The comments are available **here**.
- ISDA released a video on understanding benchmark fallbacks. The video is available **here**.
- ISDA IBOR fallback rate adjustment FAQs were updated on June 20, 2020. The FAQ is available **here**.
- ISDA/Bloomberg conducted a webinar titled "LIBOR Transition Series: ISDA Fallback Rates". The webinar is available **here**.

  ISDA published a paper on "The Importance of Reforming the EU Benchmarks Regulation". The paper is available **here**.

Other News / Useful Reading

- The Chicago Mercantile Exchange (CME) Group has begun publishing SOFR-based MAC Rates as an addition to the existing suite. The first SOFR MAC Rates have been published for December 2020 (in a standalone file) and March 2021 start dates. The details are available **here**.
- The FRB has expanded the Main Street Lending Program to allow more small and medium-sized businesses to be able to receive support. The press release is available **here**.
- Intercontinental Exchange (ICE) swap rate adds safety net with Tradeweb quotes. The article is available **here**.
- Bloomberg on-demand webinar replay series on LIBOR transition. The registration is available **here**.
- US benchmark switch splits swaptions market. The article is available **here**.
- The US now has a clearer plan for transition to SOFR. The article is available **here**.
- The Basel Committee on Banking Supervision created FAQs on the impact of benchmark reform. The FAQ's are available **here**.
- LIBOR trap lurks in 2021 US stress tests. The article is available **here**.
- The potential use of AMERIBOR, an Etherium-linked LIBOR alternative. The articles are available **here** and **here**.
- LIBOR Transition within the context of COVID-19. The article is available **here**.
- An article on Ameribor's Resilience to COVID-19 was published. The article is available **here**.
- As replacement rate concerns become more pressing, firms fear LIBOR lawsuits and regulatory wrath. The article is available **here**.
- Financial firms are hoping for delays in some LIBOR deadlines. The article is available **here**.
- U.S. Securities and Exchange Commission (SEC) Office of Compliance inspections and examinations report on the LIBOR transition preparedness. The report is available **here**.
- Fitch Ratings published an article on the LIBOR transition and remaining hurdles. The article is available **here**.
- Deloitte insight published an article on data considerations with the IBOR transition. The article is available **here**.

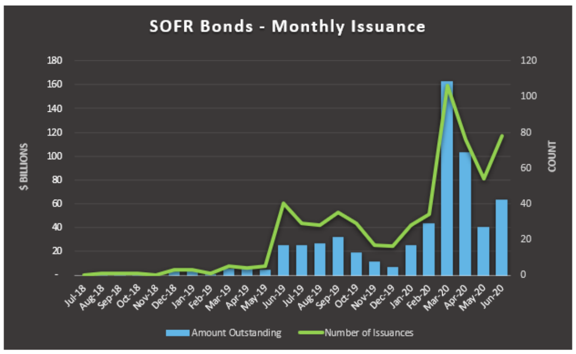
Market Updates

Increase in Debt Issuance Referenced to SOFR

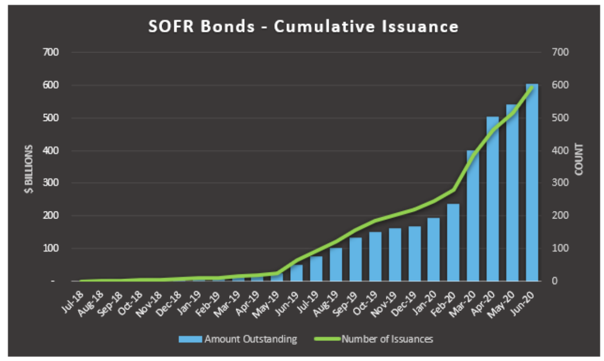
The issuance of SOFR referenced debt increased in June 2020 compared to the issuances in May 2020. The issuance was $63.0 billion in June 2020 which increased from $39.7 billion in May 2020. However, the June 2020 issuances were less than the issuances in April 2020 of $103.2 billion. The graphs below represent data through June 30, 2020.

The cumulative issue size of SOFR bonds outstanding currently stands at $623.0 billion with 623 bonds (this excludes the matured bonds) through July 15, 2020. There were 78 new issuances in June 2020 compared to 54 and 76 issuances in May 2020 and April 2020 respectively.

In June 2020, federal agencies issued 37 SOFR referenced FRNs worth $38.4 billion. There were 36 other institutions which contributed $24.6 billion to the outstanding amount of SOFR referenced debt.



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

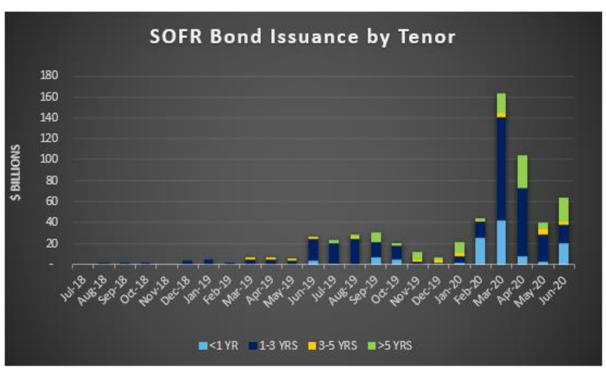


Source: Bloomberg, compiled by Deloitte
Data as of June 30, 2020

Increase in Longer Dated Debt issuance referenced to SOFR

SOFR debt issuances with a maturity greater than or equal to five years increased in June 2020 compared to the previous month of May 2020. During June 2020, 37 bonds with an amount outstanding of $21.3 billion, which have a maturity greater than or equal to five years, were issued, increasing from an outstanding amount of $5.6 billion issuances during May 2020. The issuances during June 2020 includes 29 bonds with an amount outstanding of $9.4 billion which have a maturity greater than or equal to ten years.

There were 131 issuances worth $100.4 billion, with a maturity greater than or equal to five years, through July 15, 2020 including 99 issuances worth $60.2 billion with a term greater than or equal to 10 years.



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

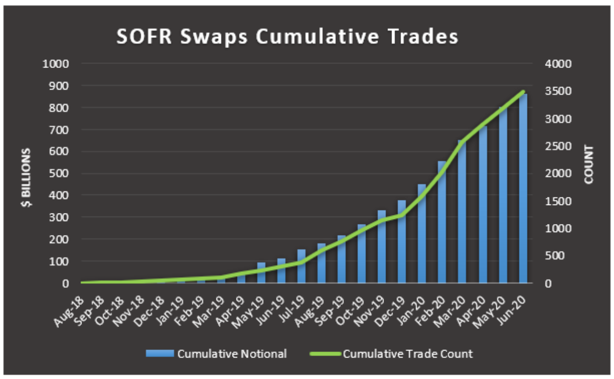
Cumulative SOFR Interest Rate Derivatives

SOFR Swaps

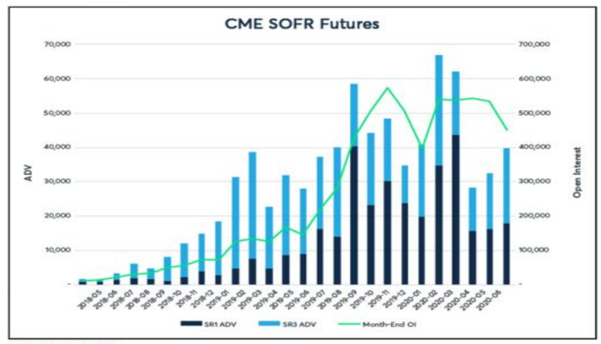
- The cumulative traded notional for SOFR based interest rate and basis swaps totaled $880.9 billion through July 10, 2020.
- For the month of June 2020, the notional volume of SOFR-based interest rate and basis swaps totaled $59.5 billion compared to the $85.7 billion in May 2020, and $60.8 billion in April 2020.

SOFR Futures

- As per the data available on CME, for June 2020, SOFR futures average daily volume reached 40K contracts/day. The article is available **here**.
- The month-end open interest for June 2020 was around ~45K contracts.



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



Source: CME Group
**Data as of June 30, 2020*

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 6, 2020.

Alternative Reference Rate	Swaps Cumulative notional amount (US $ Billions)	Bonds Cumulative issuance amount (US $ Billions)
SONIA	25,895.2	81.8
SARON	50.3	NA
TONA	511.6	NA
€STR	13.6	4.2

Source: Bloomberg, http://swapsinfo.org/, compiled by Deloitte
Data as of July 15, 2020

Global Highlights

United Kingdom

- BoE's working group has published a paper on the identification of 'Tough Legacy' issues. The report is available **here**.
- UK Treasury intends to amend legislation to help the FCA to manage the end of LIBOR and 'Tough Legacy' contracts. The article is available **here**.
- Banks requesting a UK legislative solution for LIBOR-linked financial contracts. The article is available **here**.
- BoE has published the summary and response to supporting the transition to compound SONIA and how compound SONIA would function. The report is available **here**.
- UK Finance and ISDA response to Her Majesty's Revenue and Customs' (HMRC's) consultation on taxation impacts arising from the withdrawal of LIBOR. The letter is available **here**.
- BoE plans to publish daily compounded SONIA index in August. The article is available **here**.
- ICE Benchmark Administration (IBA) published the feedback on the ICE Swap Rate SONIA consultation which covered outstanding questions including waterfall methodology, swap conventions and tenors. The report is available **here**.
- SONIA term rate nears 'beta' release, while SOFR struggles. The article is available **here**.
- Fallback spreads widened more than 20% after UK regulator says Libor's end could be announced this year. The article is available **here**.

European Union

- The European Central Bank (ECB) working group on euro risk-free rates recommends voluntary compensation for legacy swaption contracts affected by the discounting transition to the €STR. The press release is available **here** and the recommendations are available **here**.
- Experts fear trades referencing SOFR and €STR will not be eligible for hedging relief. The article is available **here**.
- Association for Financial Markets in Europe (AFME) produced a white paper on conduct risks and client communications during LIBOR transition. The white paper is available **here**.
- CME educational videos on €STR and SOFR discounting transitions FAQs. The videos are available **here**.
- CME proposed discounting transition for €STR and SOFR presentation. The presentation is available **here**.

Asia

- The Bank of Japan (BoJ) and Japan Financial Services Agency have jointly issued a 'Dear CEO Letter' to prepare for the permanent cessation of LIBOR. The letter is available **here**.
- Taiwan-based computer maker has changed the structure for its loans in preparation of the cessation of LIBOR. The article is available **here**.
- Oversea-Chinese Banking Corporation (OCBC) Bank and CapitaLand have inked Singapore's first loan facility agreement referencing Singapore Overnight Rate Average (SORA). The article is available **here**.
- Singapore's new rate, SORA, will change the derivatives market. The article is available **here**.
- Singapore has made significant progress in preparation for the Singapore Swap Offer Rate (SOR) to SORA transition. The press release is 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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