Deloitte LIBOR Transition Newsletter
September 2021
Regulatory Updates: 08.01.21 – 08.31.21
Market Updates: 08.01.21 – 09.24.21

Deloitte[i] US LIBOR Transition Newsletter

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

Executive Summary

On August 27, 2021, the Alternative Reference Rates Committee (ARRC), released a list of frequently asked questions (FAQ's) on the best practices recommendations related to the scope of use of the Secured Overnight Financing Rate (SOFR) term rates. The FAQ's build on the ARRC's formal recommendation of the Chicago Mercantile Group's (CME's) SOFR Term rate announcement in late-July 2021. Specifically, the ARRC supports the use of SOFR Term Rates in situations where the use of overnight and averages of SOFR has been shown to be difficult, for example in business loan activity. The ARRC does not support the use of SOFR Term Rates for almost all derivatives products because these markets already leverage SOFR compounded in arrears. Transitioning to the more robust overnight risk free rates (RFRs) is a main component in developing the depth of transactions necessary in the underlying derivatives markets to construct the SOFR Term Rate over time. The FAQ's also highlight some considerations and recommendations for "end-users" including supporting the end-users' use of SOFR Term Rate derivatives to hedge their cash products that reference SOFR Term Rates. The ARRC considers an end-user to be a direct party (e.g. a borrower or a lender) to a SOFR Term Rate product such as a business loan, securitization linked to a SOFR Term Rate product, or a legacy product with fallback language or legislative directive that converted a legacy product to a SOFR Term Rate product. Under the ARRC's recommendations, end-users could enter a SOFR Term Rate hedge for their cash product position using a swap, cap, swaption or similar derivative product. Dealer counterparties to these types of hedges would not be considered "end-users" under the ARRC's recommendations and thus should not seek to hedge their resulting SOFR Term Rate position.

Alternatively, these dealer counterparties can seek to hedge their resulting positions with derivatives linked to forms of overnight SOFR. However, the ARRC recognizes that some lending institutions are not structured to: 1) make markets, or, 2) warehouse the risk of offering derivatives products to end users, but, may wish to enter in to SOFR Term Rate derivatives as part of their services to help a borrower hedge a SOFR Term Rate business loan. In this instance, provided that the institution does not make two-way prices in interest rate derivatives and is not a market maker in the interdealer market for such derivatives, the ARRC considers that the use of offsetting derivatives matching the derivatives exposure that the institution has offered to its borrowers would fall under the ARRC's recommended use of a SOFR Term Rate derivative.

In the Financial Conduct Authority's (FCA) June 2021 consultation paper (which seeks commentary by August 27, 2021), "Proposed decision under Article 23D Benchmark Regulation (BMR) for 6 Sterling (GBP) and Yen (JPY) London Interbank Offered Rate (LIBOR) settings", the regulator noted that a majority of the tough legacy contracts are within the cash markets (bonds, securitizations and loans, which includes retail mortgages and commercial lending) and reference the LIBOR settings: 1, 3 and 6-month for GBP and JPY. Due to many bondholders requiring sign-off for bonds and securitizations, this present difficulty in amending the contracts in a timely manner. Mortgage lenders may have similar difficulty in amending their contractual provisions as some mortgage borrowers may not be privy to LIBOR transition and not likely to participate with lenders' efforts in amending contracts. The FCA has consistently noted that their preference is to not rely on synthetic LIBOR, but rather push market participants on active LIBOR transition and amend contracts to develop a solid and more liquid benchmark – the compounded RFR. The FCA also realizes that contracts maturing after the end of 2021 that contain no or inappropriate fallbacks may not likely be amended by the time the LIBOR settings cease and thus active conversion may not be possible. In these touch legacy contract scenarios, synthetic LIBOR, although not preferred by the FCA, can offer a temporary safety-net as a rate of last resort. Under the Benchmark Regulation, the FCA plans to compel the continued publication of the LIBOR settings and propose requirements on the benchmark administrator on how the benchmark is to be determined. The FCA's aim with the synthetic LIBOR methodology is to create a reasonable approximation of the LIBOR benchmark's expected value. The decision from the FCA on which legacy contracts will be allowed to leverage synthetic LIBOR will be confirmed in Q4 2021.

Our Perspective

SOFR First/ End User Definition
The ARRC's formal recommendation of the CME Group's forward-looking SOFR term rates announcement is a key milestone of the USD LIBOR transition. The SOFR First initiative was a successful convention to prioritize the trading in SOFR rather than USD LIBOR and with the continued growth in both SOFR cash and derivative markets amongst market participants, ultimately allowed the ARRC to recommend SOFR term rates. The ARRC's best practice recommendations related to the scope of use for the term rate of SOFR and supporting FAQs help outline that market participants should transition to the more robust overnight RFRs for all products when no difficulties would result and hedges parties wish to implement in the most transparent and efficient manner. Should difficulties arise when transitioning to overnight rates for a specific product, or, when an end-user (borrower or lender) to a SOFR Term Rate product want to execute a hedge, the ARRC has provided a framework for market participants to transition those transactions. In addition, the ARRC has explicitly listed carve-outs for cases where lending institutions would be considered as 'end-users' even though they want to offer offsetting derivatives to their borrowers. These carve outs only apply when the lending institutions do not quote two-way prices, and do not operate as market makers in interdealer markets. The allowance of a SOFR term rate for end-users has been welcomed by smaller/mid-sized banks, who were concerned with how they would achieve a cost effective zero-basis solution to hedging term SOFR loans with overnight SOFR linear derivatives.

FCA Discussion on Tough Legacy
Although the FCA has consistently noted that synthetic LIBOR, where at all possible, should not be relied on – they also realize that active transition may not be possible for some tough legacy contracts that will not be amended by the time LIBOR settings cease. Thus, the FCA's support for synthetic LIBOR will likely help limit issues arising for market participants who may not have appropriate fallback language incorporated within their cash product contracts. By providing a rate of last resort (synthetic LIBOR) for tough legacy contracts, contracts that reference LIBOR, but do not include viable fallback language in the event of LIBOR's cessation, may help reduce uncertainty surrounding legacy contracts post LIBOR cessation. While the FCA is expected to provide feedback on which legacy contracts can be permitted to use synthetic LIBOR post December 2021, we encourage market participants to not however wait for confirmation and continue to press forward on active LIBOR transition in order to retain control of both economic and functional control over their contracts.

Regulatory Updates

Summary of ARRC Office Hours Q&A with David Bowman (The FRB)
This section represents a summary of the ARRC office hours Q&A with David Bowman from August 1, 2021 until August 31, 2021. 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:

Permissibility of Offering Swaps for Hedging

- Some regional banks would offer a term SOFR loan to a client and help the client hedge the loan by issuing a term SOFR swap. This is allowed under the ARRC recommended exceptions. The ARRC is working through several use cases for who would qualify as an end user and who can hedge.

Regulatory Guidance for Secondary Markets

- The ARRC's guidance is about no new issuance of LIBOR contracts and is not meant to impact a legacy contract entered before this year.

Impact of Negative Repo Rates

- If the bulk of treasury repo rates go negative, then SOFR could go negative as well. SOFR has not gone negative yet even with the current low rates. Keeping SOFR positive is not any stated policy goal of the FRB.

Definition of End-User

- For most cases, the ARRC is recommending overnight average of SOFR. There are carve-outs for the use of term SOFR for hedging within the derivative markets. Since the scope of use has been shared, there have been several discussions and questions about definition of an end user which does affect several banks. The ARRC has not yet made a formal statement but expects to do so in the next few weeks. The ARRC is gravitating towards the definition that direct parties (borrower, lender, investor, issuer) may be considered an end user by the ARRC. The ARRC will also look into use examples of community and smaller banks offsetting swaps to customers with another swap to a larger dealer and decide if this example would qualify.

Tenor Recommendation for Term-SOFR

- The ARRC walked through these provisions with consumer groups a few times and at any given time a 6-month term SOFR could be higher or lower compared to a potential 12-month SOFR. However, the long-run level between the two has been the same. There is a difference to LIBOR were one rate was typically always higher than another rate. You would use the 1 year spread adjustment because that does account for LIBOR 12-month always being higher than LIBOR 6-month.

Priorities of SOFR-First

- SOFR first has several steps to it. The first step was having interdealer markets move from quoting and trading LIBOR to SOFR. Some interdealer trading happens on screens with some happening by voice. The recommendation was for both was to trade SOFR as the convention. As of Oct 27, 2021 the LIBOR quotes that show up on the screen should go dark (only should be used for reference now). The next step is focused on cross currency basis swaps.

Regulatory Highlights

- On August 27, 2021, ARRC released a list of FAQ's on the best practices recommendations related to the scope of use of the SOFR term rates. The article is available **here**.
- Brodies.com published an article titled "FCA consults on synthetic LIBOR but don't rely on it". The article is available **here.**

ARRC Updates

- The ARRC welcomed the launch of Refinitiv's of USD IBOR cash fallbacks spread adjustment prototype. The announcement is available **here**.
- The ARRC published the minutes from their July 14, 2021 meeting. The meeting minutes are available **here**.
- The ARRC published the agenda from their August 11, 2021 meeting. The agenda is available **here**.
- The ARRC published the June-July 2021 newsletter. The newsletter is available **here**.

International Swaps and Derivatives Association (ISDA) Updates

- ISDA published a report: "Transition to RFRs review for the first half of 2021 and second quarter of 2021". The report is available **here**.
- ISDA reported the interest rate derivatives trading activity in the EU, UK and US markets. The report is available **here**.
- ISDA published the ISDA swapsinfo for the first half of 2021 and second quarter of 2021. The report is available **here**.
- ISDA published the ISDA-Clarus RFR Adoption Indicator: July 2021. The report is available **here**.

Other News/ Useful Reading

- Treasury department released a letter to non-financial corporate stakeholders on LIBOR transition. The letter is available **here**.
- "Brokers may flout deadline to darken USD LIBOR screen". The article is available **here**.
- "Federal tough legacy fix gives nod to alternative rates". The article is available **here**.
- "SOFR futures trading swells amid bets on Fed rate-path shift". The article is available **here**.
- "Banks weigh alternatives to LIBOR replacement as companies seek longer-term rates". The article is available **here**.
- "Companies aren't ready for the end of LIBOR". The article is available **here**.
- "Refinitiv launches USD IBOR cash fallbacks prototype". The article is available **here**.
- "Banks weigh alternatives to LIBOR replacement as companies seek longer-term rates". The article is available **here**.
- "SOFR futures trading swells amid bets on the Fed rate-path shift". The article is available **here**.
- "Fed tells judge scrapping LIBOR too soon would spur market chaos". The article is available **here**.
- "Mitsubishi to issue first Floating Rate Note (FRN) linked to Japan's risk-free rate". The article is available **here**.
- "Federal bill unpicks some, not all, US LIBOR legacy knots". The article is available **here**.
- "SOFR gains but still has far to go as LIBOR replacement". The article is available **here**.
- "Collateralized Loan Obligation (CLO) deals tied to SOFR set to begin in fourth quarter". The article is available **here**.
- "Large Eurodollar futures contract trade signals year-end funding pressure". The article is available **here**.
- "So near, SOFR: The race to find a Libor alternative". The article is available **here**.
- "Chicago Board Options Exchange (CBOE) launches Ameribor futures as LIBOR transition continues". The article is available **here**.
- "No rating impact on Clydesdale's covered bonds from proposed transfer/ Sterling Overnight Index Average (SONIA) transition". The article is available **here**.
- "LIBOR should die with a whimper, not a bang - Mark Gilbert". The article is available **here**.

Market Updates

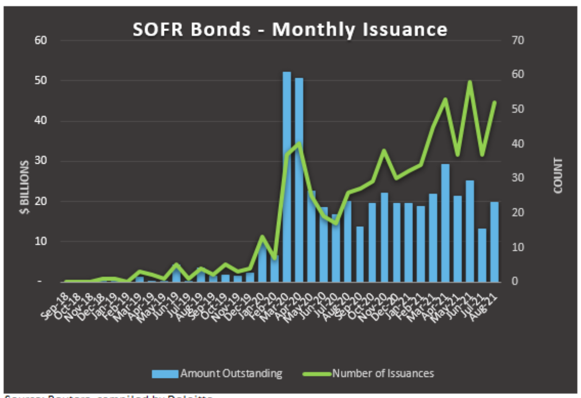
** Please note that the change in numbers and trend lines for bonds compared to figures in previous newsletters is due to change in the data source. Issuance data for bonds has been sourced from Reuters.*

Increase in Debt Issuance Referenced to SOFR

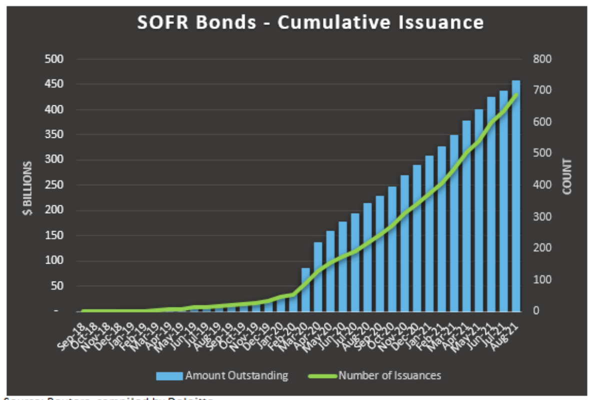
The issuance of SOFR referenced debt increased in August 2021 compared to issuance in July 2021. The issuance size was $19.64 billion in August 2021, which increased from $13 billion in July 2021. The graphs below represent data through August 2021.

The cumulative issue size of SOFR bonds outstanding (this excludes matured bonds) is currently $477.67 billion with 730 bonds through September 22, 2021. There were 52 new issuances in August 2021 compared to 37 in July 2021 and 58 in June 2021.

In August 2021, federal agencies issued 22 SOFR referenced FRN’s worth $6.87 billion. There were 30 issuances from other institutions which contributed $12.77 billion to the outstanding amount of SOFR referenced debt.



Source: Reuters, compiled by Deloitte
**Data as of August 31, 2021*

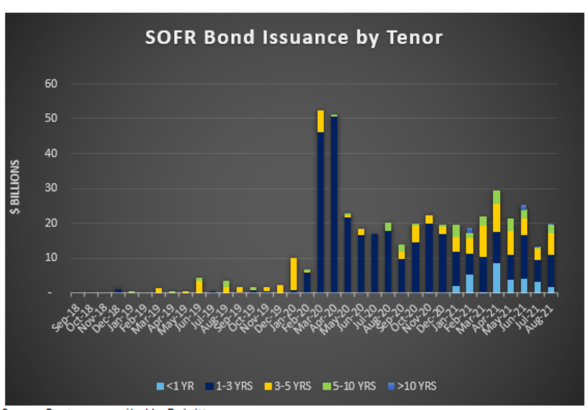


Source: Reuters, compiled by Deloitte
**Data as of August 31, 2021*

Increase in Longer Dated Debt Issuance (maturity ≥ 5 years) Referenced to SOFR

SOFR debt issuances with a maturity greater than or equal to five years increased in August 2021 compared to July 2021. During August 2021, there were 11 bonds issued which have a maturity between five and 10 years. There was one issuance during August 2021 that had a maturity greater than or equal to 10 years, as compared to two such issuances with a maturity greater than or equal to 10 years for July 2021.

There were 83 issuances of SOFR bonds outstanding worth $30.60 billion, with a maturity greater than or equal to five years, through September 22, 2021 including nine issuances worth $3.10 billion with a term greater than or equal to 10 years.

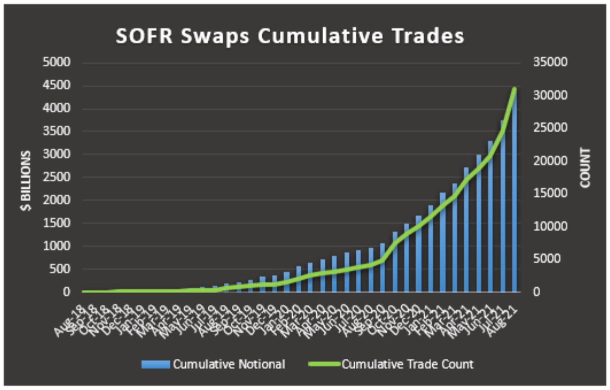


Source: Reuters, compiled by Deloitte
**Data as of August 31, 2021*

Cumulative SOFR Interest Rate Derivatives

SOFR Swaps

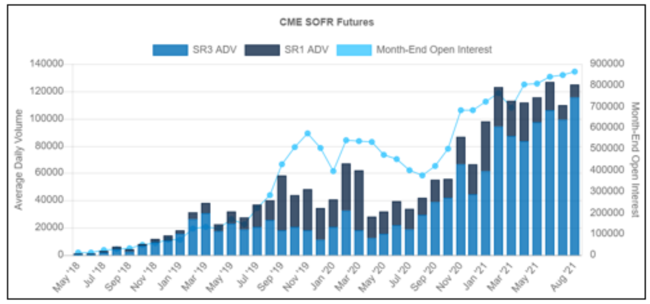
- The cumulative outstanding notional amount for SOFR based interest rate and basis swaps totaled $4,384.6 billion through August 31, 2021.
- For the month of August 2021, the notional volume of SOFR-based interest rate and basis swaps totaled $641.6 billion compared to $443 billion in July 2021 and $293 billion in June 2021.



Source: http://swapsinfo.org/, compiled by Deloitte
**Data as of August 31, 2021*

SOFR Futures

- According to data available on CME, for August 2021, SOFR futures (including both 1-month and 3-month futures) average daily volume reached 125K contracts/ day. The data is available **here**.
- The month-end open interest for SOFR 1-month and 3-month futures as of August 2021 was ~862K contracts.



Source: CME Group
**Data as of August 31, 2021*

Global IBOR Activity

The market activity in SONIA, Swiss Average Rate Overnight (SARON), Tokyo Overnight Average Rate (TONAR) 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 August 31, 2021.

Alternative Reference Rate	Swaps Cumulative notional amount (US $ Billions)	Bonds Cumulative issuance amount (US $ Billions)
SONIA	41,990.4	130.2
SARON	122.0	NA
TONAR	827.6	NA
€STR	296.6	5.7

Source: Reuters, http://swapsinfo.org/, compiled by Deloitte
Data as of August 31, 2021

Global Highlights

United Kingdom

- FCA consults on proposed miscellaneous amendments to their Handbook in CP21/27: Quarterly Consultation Paper No. 33. The article is available **here**.
- "Published term SONIA standards give niche debt transition clarity". The article is available **here**.

European Union

- European Securities and Markeys Authority (ESMA) published a Q&A on the BMR. The questions and answers are available **here**.
- ESMA Working Group on Euro-Risk Free Rates issued recommendations on the proposed Euro Short Term Rate (ESTR) First Initiative. The statement is available **here**.

Asia

- The Association of Banks in Singapore (ABS) published updated timelines to cease issuance of Swap Offer Rate (SOR)and Singapore Overnighted Offered Rate (SIBOR)-linked financial products. The timeline is available **here**.
- "Yen LIBOR death knell sounds as traders close in on replacement". The article is available **here**.
- Steering Committee for SOR & SIBOR Transition to Singapore Overnight Rate Average (SORA) (SC-STS) reported the SOR compression/ conversion cycle forecast (as of August 12, 2021). The report is available **here**.
- "Singapore's shift to SORA from LIBOR quickens as contracts jump fourfold". The articles are available **here** and **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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