Deloitte US LIBOR Transition Newsletter

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

Executive Summary

The Federal Reserve Bank of New York (The Fed) released a proposed publication of SOFR Averages and SOFR Index marking an important step for the US in the transition away from LIBOR and increases the availability and reliability of using SOFR averages for financial contracts. The ARRC welcomed a consultation about the publication and encouraged market participants with US dollar LIBOR exposure to provide feedback in order to facilitate a smooth transition.

Another important milestone in the reform has been related to the IRS releasing its proposed regulations which provide relief for taxpayers when altering financial contracts to use alternative reference rates. This relief provides a similar message as other regulatory bodies such as the IASB and the FASB by helping to alleviate uncertainties and financial impacts caused by the transition.

CME has recently re-published their proposal to switch to SOFR Discounting and Price Alignment with the proposed date changed to October 16, 2020 aligning with LCH’s plans to transition discounting to SOFR. CME’s proposed approach will transition the current EFFR discounting and price alignment to SOFR at the close of business on a single day, October 16, 2020, and will attempt to mitigate potential risks and account for valuation changes that could occur if performed over a period of time.
ARRC Office Hours Q&A with David Bowman (Federal Reserve Board)
This commentary does not represent the view of the Federal Reserve and are the personal views of David Bowman outside of his official capacity. Weekly office hour information can be found [here](#). Below are some of the specific topics discussed:

*End to LIBOR Post-2021*
- The official sector expects some banks to leave the LIBOR panels by 2021. If the FCA finds that LIBOR is no longer representative, then EU supervised entities may likely no longer be able to enter into transactions based on LIBOR. LCH and CME have indicated they intend to move cleared transactions to SOFR if LIBOR is deemed non-representative, subject to discussions with regulators.

*ARRC Operations/Infrastructure Working Group*
- ARRC has a vendor list that the infrastructure working group is continuing to build. ARRC will attempt to make the list of vendors as complete as can be. Vendors that feel that they have some stake in the LIBOR transition are more than welcome to interact with the operations and infrastructure group.

*Federal Reserve to Publish Average SOFR in 2020*
- The Federal Reserve plans to publish an average of SOFR in the first half of 2020. Preliminary analysis for spread adjustments for cash products is available. They are thinking publishing compound averages at 30d, 90d, 180d (calendar days). Additionally, proposing to produce an index. The value that will represent the ISDA compound average over a certain period will be based on a ratio of the index between the two days.

*LIBOR-OIS Spread*
- Research on the LIBOR OIS spread was performed to understand the spread changes in times of stress. The data showed that financial stress does not normally increase the spread. The Fed used the indicative term-rate methodology based on the Fed Funds data to create OIS series back in the 90’s. The Fed observed the following: the 91 recession saw a 30bps increase in spread, the 2001 recession saw no increases in spread, and the great recession saw a 100bps increase in spread. It was also noted that the LIBOR OIS spread increased by around 40bps 3 times in the past 4 years and there was no indication that the banks’ funding costs increased during those periods due to change in banks’ funding models.

*SOFR Rate Differences Published by the Fed, ISDA & Bloomberg*
- The SOFR rate should be the consistent across the Fed, ISDA and Bloomberg sources where the maturity is the same. Since the Fed cannot control the precision a party calculates the rate using the index, there may be some differences. The value of the Fed publishing the rate is so consumers can easily find the rate, but more complex investors will be able to use the index to be more precise.

*Treasury IRS Proposed Rule-Making on Qualified Rates*
- The ARRC is appreciative that the Treasury published the proposed rule-making on qualified rates [here](#) and the ARRC Tax group is reviewing and will provide comments to Treasury for clarifications on the technical aspects.

*SOFR and the Repo Market*
- SOFR excludes trades with the Federal Reserve. SOFR doesn’t just reflect transactions amongst primary dealers, but includes triparty transactions by entity and cleared bilateral repo transactions by entity. SOFR is just overnight treasury repo and does not include uncleared bilateral treasury repo nor does it include repo based on other securities. One source to identify some of the data is the Office of Financial Research website [here](#).

*Assessing SOFR for Representing Borrowing Costs*
- “Representativeness” is a term in the European Union Benchmark Regulation. Under the Benchmark Regulation, FCA is required to judge LIBOR by this standard as it is the regulator of LIBOR. In the U.S., there is no benchmark regulator, but there are the IOSCO principles. The Fed performed an audit of SOFR and has a statement of compliance with IOSCO principles on the website. The Fed will continue to assess SOFR against those processes and audit it.
ARRC Working Group & CME Updates

- ARRC released a consultation of the proposed publication of SOFR averages and a SOFR index issued by the Federal Reserve on November 4, 2019 [here].
- CME has updated its Discounting & Price Alignment Plan for transitioning to SOFR [here]. The intention is to finalize the Plan by December 2, 2019.
- CME has released SOFR Options Contract specifications which will be available on January 6, 2020 [here].

ISDA Updates

- ISDA held a conference call to discuss the Final Parameters Consultation on October 3, 2019. A recording of the call is available [here].
- ISDA’s Q3 2019 SwapsInfo report is available [here].
- ISDA published “The Anonymized Narrative Summary of Responses to the ISDA Pre-Cessation Consultation” on October 21, 2019—available [here]. The key points from the Executive Summary are:
  - “A significant majority of respondents (71.9%) stated that generally they would not want to continue referencing a covered IBOR in future derivative contracts following a public statement by a regulator that such IBOR was no longer representative.”
  - “A smaller majority of respondents (64.0%) replied that generally they would not be content to continue referencing an unrepresentative covered IBOR in legacy contracts following such a statement. However, a notable portion (45.6%) of this majority explained that despite this position, they might nonetheless continue to reference an unrepresentative covered IBOR in certain circumstances. A minority of respondents (22.5%) stated that they would continue to reference an unrepresentative covered IBOR in legacy derivative contracts following a statement by a regulator that such an IBOR is no longer representative.”
  - “Generally, the respondents to the Pre-Cessation Consultation broadly desired a uniform transition to fallback rates across products and currencies.”
  - “Respondents fell into four general categories with respect to how to implement a pre-cessation trigger, without a clear majority in any one category.
  - “Although a majority of respondents (64.0%) supported the inclusion of a pre-cessation trigger in the amended 2006 ISDA Definitions, the responses revealed significant disagreement about how to implement such a trigger.

Accounting and Tax Updates

- The IRS released its proposed regulations on October 9, 2019 that provide guidance on the tax consequences of the transition to the use of the reference rates for IBOR reform [here].
- IASB published a proposed update on October 14, 2019 to the “IFRS Taxonomy 2019 for Interest Rate Benchmark Reform” which includes additional disclosure requirements related to hedging relationships impacted by the reform [here].

Other News / Useful Reading

- “Synthetic LIBOR” could be potential solution for LIBOR’s tough legacy contracts. Article available here.
- Surge Pricing in the LIBOR transition. Article available here.
- Progress on volumes of SOFR and Sonia swaps and futures. Article available [here].
- U.S. Companies Advised to Prepare for Multiple Benchmark Rates in Transition from LIBOR. Article available [here].
- Some banks are concerned about life after LIBOR and the effect of credit availability. Article available [here].
Decrease in Debt Issuance Referenced to SOFR

Issuance of floating-rate debt linked to the secured overnight financing rate, or SOFR, has slipped to $24.6 billion in the month of October 2019. That’s down from $50.6 billion in September and $56.2 billion in August.

The cumulative issue size of SOFR bonds outstanding currently stands at $281.2 billion with 296 bonds (this excludes the matured bonds) through November 12, 2019. There were 39 new issuances in the month of October 2019 compared to 42 and 48 issuances in September and August respectively.

Considering the cumulative SOFR referenced issuances through October 2019, around 79% of the total issuances are by federal agencies. In the month of October 2019, Federal agencies issued SOFR referenced float rate notes worth $17.7 billion.

Decrease in Longer Dated Debt Issuance Referenced to SOFR

Majority of the SOFR bonds issued have a maturity less than 5 years. During the month of October 2019, bonds worth $61.5 million which have a maturity greater than or equal to 5 years were issued. This is a sharp decline compared to the previous month as in September 2019 bonds worth $5.7 billion with a maturity greater than or equal to 5 years were issued.

There are 20 issuances worth $12.2 billion with a maturity greater than or equal to 5 years through November 12, 2019. Included in this are 14 issuances worth $6.1 billion with a term greater than or equal to 10 years.
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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 $18.1 billion through November 8, 2019.
- At the end of October 2019, the notional volume of SOFR-based interest rate and basis swaps totaled $49.2 billion which is a significant increase from $34.1 billion in September 2019.

**SOFR Futures**
- SOFR futures market saw an influx of new participants and with the continued usage in repo market applications, open interest in CME SOFR futures grew to 508K contracts ($1.9T notional) in October on an average daily volume of 44K contracts. The spike in open interest in September and lingering effects in October was likely linked to the jump in SOFR and Federal Reserve actions in the repo market here.
- Currently, for 3-month futures (SR3) open interest exists on contracts till December 2021 and for 1-month futures (SR1) open interest exists on contracts till August 2020.

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**SOFR Swaps Cumulative Issuance**

Source: http://swapsinfo.org/, compiled by Deloitte
*Data as of Nov 1, 2019

**CME SOFR Futures Volume and Open Interest (Contracts)**

Source: CME Group
*Data as of Oct 31, 2019
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Global Highlights

United Kingdom

- Minutes of the October 2, 2019 BoE Financial Policy Committee meeting available [here](#).
  - Paragraph 88: "In July 2019, the FPC had agreed that the continued reliance of global financial markets on LIBOR posed risks to financial stability that could be reduced only through a transition to alternative benchmark rates by end-2021."
  - Paragraph 89: "At its October meeting the Committee reiterated its view that there was no justification for firms continuing to increase their exposures to LIBOR. The Committee continued to believe that the pace of market participants’ transition efforts to alternative benchmark rates needed to accelerate and committed to continue monitoring progress closely."
  - Paragraph 95: "In 2019 Q4 the Committee would consider further potential policy and supervisory tools that could be deployed by authorities to reduce the stock of legacy LIBOR contracts to an irreducible minimum ahead of end-2021."
- The UK’s Financial Conduct Authority has urged banks to use backward-looking versions of overnight rates in new contracts referencing risk-free rates (RFRs), rather than relying on the build-out of new forward-looking term rates to replace LIBOR. Article is available [here](#).
- The Working Group sent letters to domestic and international authorities on October 23, 2019 regarding the “Regulatory capital impediments to transition from ‘IBOR’ to new Risk-Free Rate (“RFR”) Framework”. A few of the letters are available [here](#), [here](#), and [here](#).
- BoE committee mulls policy action to reduce legacy LIBOR contracts by the end of 2021. Article available [here](#).
- LIBOR rigging inquiry shut down by Serious Fraud Office in London. Article available [here](#).

European Union

- €STR was published for the first time on October 2, 2019. The latest updated information published by the ECB can be found [here](#).
- LCH has outlined its methodology and operational process for determining and settling cash compensation in its transition from EONIA to €STR discounting [here](#).
- LCH has outlined its definition of EONIA and general approach to clearing EONIA contracts [here](#).
- UK Reuters explainer on €STR available [here](#).
- The September 25, 2019 ECB roundtable available videos and materials are available [here](#).
- The ECB Working Group has published recommendations to address impact of euro risk-free rates transition on risk management [here](#).
- LCH is first clearing house to offer clearing of Euro-denominated swaps benchmarked to the new reference rate, €STR– details available [here](#).
- The ECB Working Group has published on their website a checklist, FAQs, milestones, meeting agendas/minutes and, other useful information [here](#) to support the marketplace with the transition.
- The Association for Financial Markets in Europe held a webinar on the IBOR Transition on October 23, 2019. The presentation is available [here](#) and the audio [here](#).

Asia

- Masayoshi Amamiya, Deputy Governor of the Bank of Japan, spoke at the ASIFMA Annual Conference on the roles and challenges of Asia’s Capital Markets and emphasized LIBOR’s discontinuation.
- New ‘proxy’ Honia could help change discount rate from Hibor to OIS for local Hong Kong swaps. Article available [here](#).
- Bankers are readying Asian clients to issue more bonds linked to the new interest rate benchmarks replacing LIBOR. Article available [here](#).
Utilizing Published SOFR Averages
The proposed publication of SOFR averages and a SOFR index issued by the Federal Reserve increases accessibility and consistency in utilizing SOFR averages in financial contracts and marks an important step in the transition from LIBOR to SOFR. Although SOFR and other overnight repo rates are typically more volatile than term rates on a day-to-day basis, an average of SOFR can closely reflect movements in interest rates over a specified time period and smooth out daily fluctuations in market rates. This also means that market participants may have to assess their systems capabilities in incorporating a beginning and end date and retrieving the appropriate SOFR average rate when calculating compounded interest.

IRS Proposed Regulations Provides Tax Relief
The proposed regulations provides relief to taxpayers to avoid adverse tax consequences from changing the terms of debt, derivatives, and other financial contracts to replace IBOR related reference rates with alternative reference rates and address many of the tax issues in a taxpayer-favorable manner. The issuance of this guidance was a response to a request from ARRC which reiterates the value and importance of ARRC’s role in assisting with an efficient, orderly transition away from IBOR reference rates. The released tax guidance provides certainty and clarity to taxpayers and marks a critical milestone for the reform.

CME SOFR Discounting and PAI Adjustment Effects on Hedge Relationships
The delay of the date the CME plans on implementing their SOFR Discounting and PAI discounting reiterates the importance of the various consultations and working group’s coordination. With CME and LCH more closely aligned with their methodology and timing, it gives market participants more time to further review the impact the adjustments will take place and allow for firms to prepare and understand the impacts the transition will have on their books, systems and businesses. Although the delay by a half of a year may seem longer than expected, there is an increasing pressure for firms to begin exploring the details their financial assets currently trading through the CCPs and the associated implications related to the transition.