Deloitte LIBOR Transition Newsletter
June 2020
Regulatory Updates: 05.01.20 – 05.29.20
Market Updates: 05.01.20 – 06.09.20

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 the recommended best practices for market participants to follow in preparation for LIBOR's permanent cessation. These best practices outline certain proposed target dates for incorporating fallbacks, ending LIBOR-based activities and for when market participants are advised to transition to Secured Overnight Funding Rate (SOFR)-based products. The ARRC similarly published best practice guidelines for third-party technology and operations vendors including those with relevant upstream and downstream systems (e.g., booking, valuation, accounting systems). These guidelines specify target readiness dates for finalizing system enhancements required to accept SOFR products. Despite COVID-19 impacts, the Financial Conduct Authority (FCA) has also reiterated that the end date for LIBOR cessation remains as December 31, 2021.

Fannie Mae and Freddie Mac have jointly published a LIBOR transition playbook and Frequently Asked Questions (FAQs) to assist the housing finance industry prepare for the transition to SOFR. The playbook describes transition milestones and actions for stakeholders to consider in advance of the transition. The playbook along with the accompanying FAQs aim to assist participants adapt policies, procedures and processes related to transitioning LIBOR products to SOFR such as Adjustable Rate Mortgages (ARMs), Collateralized Mortgage Obligations (CMOs) and other housing related products.

International Swaps and Derivatives Association (ISDA) published a report summarizing the results of its consultation. The results summarize the decisions made related to whether the 2006 ISDA Definitions should be amended to include fallbacks that may likely apply to covered derivatives referencing LIBOR following permanent cessation or "non-representative" pre-cessation event. A significant majority of respondents to the consultation favored the inclusion of pre-cessation and permanent cessation fallbacks. As a result, ISDA plans on publishing updated definitions in July 2020 alongside a protocol launch to allow participants to include the new definition in legacy trades.

Our Perspective

Aligning Transition Plans with ARRC's Best Practices

The ARRC's best practice recommendations aim to assist in market participants in a timely transition to SOFR well in advance of the actual LIBOR cessation date. Market participants are advised to work towards the product and counterparty specific milestones related to fallback language integration, technical and operational vendor readiness, cessation of new use of USD LIBOR, and choice of anticipated fallback rates. It is advisable for firms LIBOR transition programs to benchmark existing initiatives against the recommendations and to incorporate the target dates outlined for each product across all related workstreams. Firms may want to assess their system readiness plans and align them accordingly. This also applies to ARRC's best practices for vendors which were published separately a few weeks ahead of the general recommendations. Market participants are encouraged to engage their vendors to determine if they are aware of the publication and that their targets align with those goals.

Fannie Mae and Freddie Mac's Valuable Guidance

Fannie Mae and Freddie Mac's playbook and FAQs are valuable resources for stakeholders when managing the transition from LIBOR to SOFR. Specific action items include the support of SOFR-linked mortgage products as well as the discontinuation of many LIBOR-indexed products (such as ARM participation certificates) by the end of 2020. Market participants may want to review the playbook to compare with their expectations on how mortgage products are to be structured and assess required adjustments. The FAQs can also be used to evaluate the impact of the transition related to mortgage products and it is advisable to align current impact assessments with the answers provided in the FAQs.

ISDA Final Results on Pre-Cessation and Permanent Cessation Fallbacks

ISDA's announcement confirmed the implementation of the pre-cessation and permanent cessation triggers in fallback provisions for LIBOR derivatives. The announcement confirmed their preliminary findings where a contractual clause may likely apply if LIBOR were considered "non-representative" prior to scheduled cessation (e.g., if FCA announces that LIBOR is no longer representative). Integrated as a fallback provision to new and legacy contracts, the suggested triggers may likely mitigate the uncertainty associated with otherwise ambiguous pre-cessation scenarios and may likely align more closely to the ARRC published fallback language decreasing basis risk. This may likely assist many firms in dealing with LIBOR transition, as confirmed by an overwhelming 91% of respondents who accept ISDA's plan. Within the broader context of IBOR transition, US market participants are now advised to align future changes to triggers in their derivatives portfolio with pre-cessation triggers that might have already been included in contracts for cash products recommended by the ARRC and other working groups.

Regulatory Updates

Regulatory Highlights

- ARRC produced their recommended best practices for completing the transition from LIBOR to SOFR. The best practices are available **here**.
- The ARRC published recommended best practices for vendors. The recommendations are available **here**.
- Fannie Mae and Freddie Mac have jointly published a LIBOR transition playbook and FAQs to assist the housing finance industry prepare for the transition to SOFR. The playbook is available **here** and the FAQs are available **here**.
- ISDA report summarizing the final results of consultation on pre-cessation fallbacks for LIBOR 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 May 1, 2020 through May 31, 2020. The 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:

Compounding Calculation Differences Across Products

- Guidance provided by the ARRC regarding compounding differs across product classes. Although the basic concept of compounding interest remains the same, there may be more appropriate variations based on economic terms of the product. For example, for derivatives and floating rate notes, principle over the interest period is typically constant. However, in the loan space, principle may be paid without interest, or both paid simultaneously. Syndicated loans may be traded multiple times over an interest period. These types of differences in product structure drive differences in compounding methodology.

SOFR and Trade Financing

- One of the first SOFR loans out of Hong Kong was a trade finance deal. The ARRC's "A User Guide to SOFR" provides guidance for hybrid models (such as setting the rate in advance like in Trade Finance deals) to determine trades are enacted in the same manner prior to the switch to SOFR. The user guide can be found **here**.

Unrepresentative Currency LIBOR Tenors

- It is possible for the FCA to declare certain LIBOR tenors to be unrepresentative without declaring other tenors of the same currency to also be unrepresentative. Similarly, the FCA could declare certain currency LIBORs unrepresentative and not others.

ARRC Spread Publication Cadence

- The ARRC has suggested a one-year transition period for consumer products and the SOFR spread plans to be adjusted daily from the date of LIBOR cessation to the date when the rate is permanently fixed. For products with a reset date, the spread adjustment plans to be updated on the reset date as opposed to daily. In the syndicated loans space with an opt-in option, the "indicative rate" (the published rate calculated as if LIBOR cessation occurred on that day) may likely be used prior to the cessation event. The refresh of the hardwired language for syndicated loans may likely determine whether the indicative rate may likely be adjusted daily until the cessation event or remain fixed.

ISDA's Supplemental Consultation and SOFR Spreads

- The ARRC has committed to publishing SOFR spreads for many available tenor. In both the ARRC and ISDA's language for a cessation event, the spread may likely be set on the date the FCA and Intercontinental Exchange (ICE) Benchmark Administration (IBA) announce as the date for LIBOR's cessation, and be applied on that date. In the case of a pre-cessation event, the ARRC had indicated in their original consultation that the spread may likely be set at the time LIBOR was deemed non-representative. However, uncertainty remains related to if ISDA were to set the spread prior to the ARRC's anticipated date.

The Need for Amending Fallbacks

- Depending on the term of a given contract, polling of banks for LIBOR may be required prior to using last published value of LIBOR every time a reset period occurs. This is one of the main reasons why fallbacks need to be amended.

12-Month SOFR Term Rate

- There is still a possibility for the publication of a 12-month SOFR term rate but may likely depend on its robustness and the level of activity in the 6 to 12-month range. If a 12-month SOFR term rate is not published, there is the option of replacing the 12-month LIBOR term rate with a spread adjusted 6-month SOFR term rate. If no term rates are published and there is a need to fallback to a SOFR average in advance, the ARRC may recommend a spread adjusted 30-day SOFR average similar to Fannie Mae and Freddie Mac's approach. The ARRC's research also found shorter averages to be preferred by both lenders and borrowers.

30-day SOFR Average vs. 30-day SOFR Index

- The calculated SOFR rates are likely be identical if the 30-day SOFR Average and 30-day SOFR Index are calculated on the same business day. However, the index may slightly differ from daily compounding due to rounding if either the beginning or end of the term lands on a non-business day.

ARRC Working Group

- The ARRC published the results of the vendor survey. The results are available **here**.
- ARRC issued a supplemental consultation on the spread adjustment methodology. The technical consultation is available **here**.
- The ARRC floating rate notes (FRN)'s sub-working group published a statement on the use of the SOFR index. The statement is available **here**.
- The ARRC's updated FAQs were released. The FAQs are available **here**.
- Charles Swartz, co-chair of the ARRC's outreach/communications working group produced an article on the industry wide use of SOFR. The article is available **here**.
- ARRC announced recommendation for voluntary compensation for swaptions impacted by the central counterparty clearing house (CCP) discounting transition to SOFR. The press release is available **here**.
- The ARRC extended the comment period for feedback on the consultation for fallback language for new variable rate private student loans until May 29, 2020. The press release is available **here**.
- The ARRC's April-May newsletter was released. The newsletter is available **here**.

ISDA Updates

- ISDA report on benchmark reform and transition from LIBOR was produced. The report is available **here**.
- ISDA rescheduled the annual general meeting and released a letter describing some of ISDA's accomplishments despite the impact from COVID-19. The letter is available **here**.

Other News / Useful Reading

- The FRB won't use Main Street Lending Program stimulus aid to push LIBOR replacement. The article is available **here**.
- The FRB announces it is expanding the scope and eligibility for the Main Street Lending Program. The press release is available **here**.
- First USD/CNY cross-currency swap using SOFR trades. The article is available **here**.
- LIBOR NY legislative alternative isn't a one-size-fits-all benchmark.The article is available **here**.
- Big banks worry small lenders could derail LIBOR switch. The article is available **here**.
- LIBOR goes from dying to in demand with the FRB pushing fast loans. The article is available **here**.
- SOFR one-year phase-in for cash products sparks 'mismatch' fears. The article is available **here**.
- ICE paper on the expansion of input data for the Swap Rate. The report is available **here**.
- Swaptions compensation method divides market. The article is available **here**.
- Potential issues for structured products during LIBOR transition. The article is available **here**.
- Discussions continue related to negative US rates. The article is available **here**.
- Understanding AMERIBOR: An American Interest Rate Benchmark. The article is available **here**.
- The Treasury Department is requesting comments on possibility of issuing a floating rate note indexed to SOFR. The article is available **here**.
- Markit plans a SOFR credit spread add-on using CDS data. The article is available **here**.

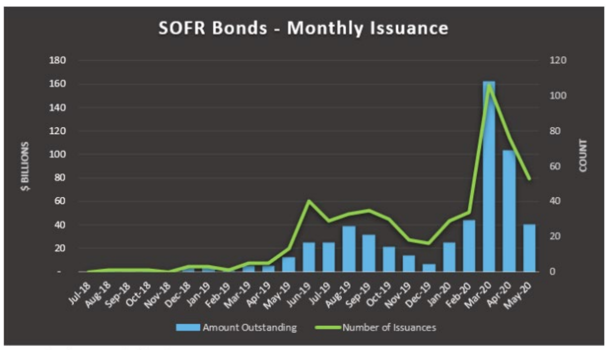
Market Updates

Decrease in Debt Issuance Referenced to SOFR

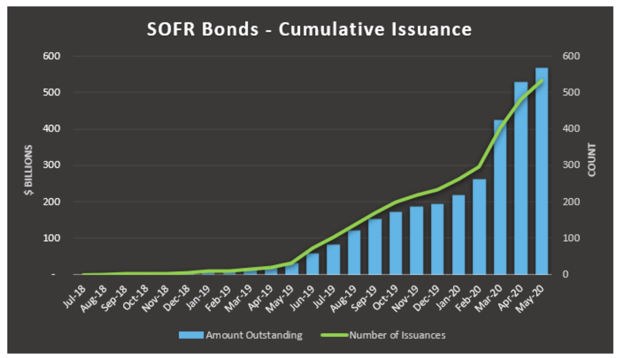
The issuance in SOFR referenced debt decreased in May 2020 compared to the issuances in the previous months of April and March. The issuance was $39.7 billion in May 2020 which has decreased from $103.2 billion in April 2020 and $162.3 billion in March 2020. The graphs below represent data through June 1, 2020.

The cumulative issue size of SOFR bonds outstanding currently stands at $595.9 billion with 559 bonds (this excludes the matured bonds) through June 9, 2020. There were 53 new issuances in May 2020 compared to 76 and 106 issuances in April 2020 and March 2020 respectively.

In May 2020, federal agencies issued 30 SOFR referenced FRNs worth $29.4 billion. There were 18 other institutions which contributed $10.3 billion to the outstanding amount of SOFR referenced debt.



Source: Bloomberg, compiled by Deloitte
Data as of June 1, 2020

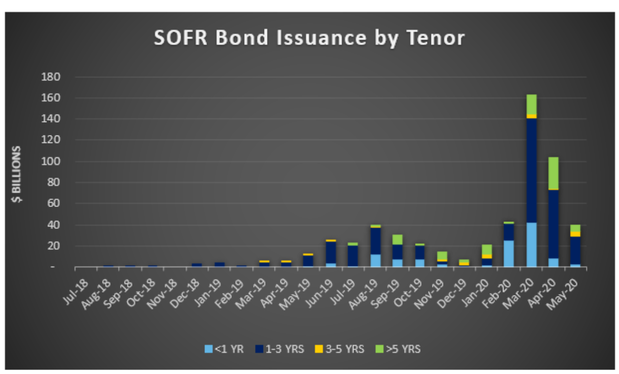


Source: Bloomberg, compiled by Deloitte
Data as of June 1, 2020

Decrease in Longer Dated Debt Issuance Referenced to SOFR

After a monthly high of SOFR debt issuances with a maturity greater than or equal to five years in April 2020, the month of May 2020 showed a significant decrease in issuances. During May 2020, 17 bonds with an amount outstanding of $5.6 billion, which have a maturity greater than or equal to five years, were issued, decreasing from an outstanding amount of $29.2 billion issuances during April 2020. The issuances during May 2020 includes 15 bonds with an amount outstanding of $4.1 billion which have a maturity greater than or equal to ten years.

There were 97 issuances worth $92.5 billion, with a maturity greater than or equal to five years, through June 9, 2020 including 68 issuances worth $55.4 billion with a term greater than or equal to 10 years.



Source: Bloomberg, compiled by Deloitte
Data as of June 1, 2020

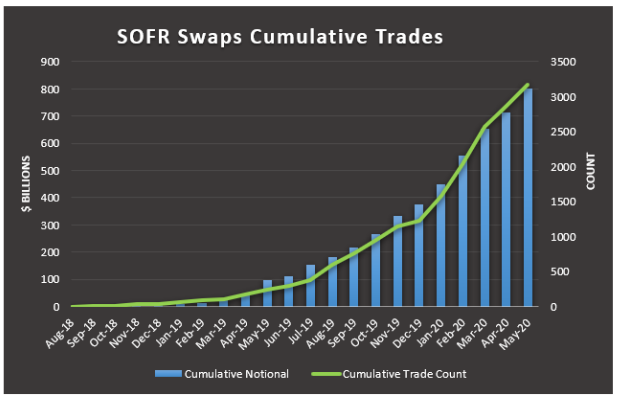
Cumulative SOFR Interest Rate Derivatives

SOFR Swaps

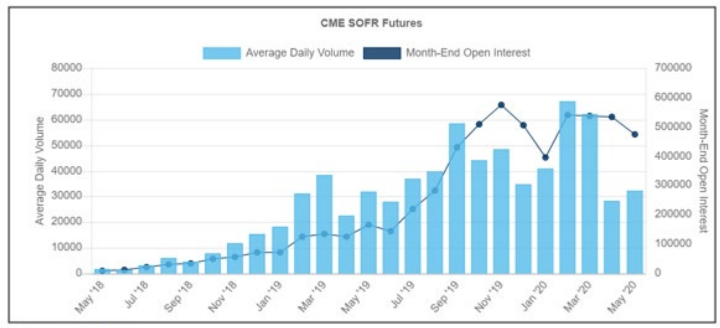
- The cumulative traded notional for SOFR based interest rate and basis swaps totaled $812.1 billion through June 5, 2020.
- For the month of May 2020, the notional volume of SOFR-based interest rate and basis swaps totaled $85.7 billion compared to the $60.8 billion in April 2020, and $97.3 billion in March 2020.

SOFR Futures

- As per the data available on CME, for May 2020, SOFR futures average daily volume reached 32K contracts/day. The article is available **here**. There is an increase of ~14% in the average daily volume compared to April 2020.
- The month-end open interest for May 2020 was around ~47K contracts. This is a decrease of ~12% compared to April 2020.



Source: http://swapsinfo.org/, compiled by Deloitte
Data as of May 29, 2020



Source: CME Group
Data as of May 31, 2020

Global IBOR Activity

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 June 1, 2020.

Alternative Reference Rate	Swaps Cumulative notional amount (US $ Billions)	Bonds Cumulative issuance amount (US $ Billions)
SONIA	25,023.3	81.7
SARON	38.1	NA
TONA	490.6	NA
€STR	9.2	4.4

Source: Bloomberg, http://swapsinfo.org/, compiled by Deloitte
Data as of June 1, 2020

Global Highlights

United Kingdom

- Bank of England (BoE) working group releases statement on COVID-19's impact on the timeline for firms' LIBOR transition plans. The statement is available **here** and the article is available **here**.
- BoE published an amendment on haircuts add-on for all LIBOR linked collateral and the timing. The amendment is available **here**.
- Despite COVID-19, the FCA will not compel banks to submit LIBOR quotes after 2021. The article is available **here**.
- Statement was released by the Prudential Regulation Authority on prioritization related to the COVID-19 impact. The statement is available **here**.
- BoE working group's LinkedIn page was updated on the transition away from LIBOR. The LinkedIn page is available **here**.
- BoE working group's sterling risk-free reference rate April newsletter was produced. The newsletter is available **here**.
- BoE Interim Financial Stability Report for May 2020 is available **here**.
- Loan Market Association (LMA) list of RFR referencing syndicated and bilateral loans in the market to date (table will be updated from time to time). The table is available **here**.
- SONIA term rate contenders tested by market mayhem. The article is available **here**.
- London Clearing House (LCH) released SOFR discounting auction process technical specification. The details are available **here.**

European Union

- The results of public consultation on swaptions impacted by the CCP discounting transition from EONIA to €STR were released. The results are available **here**:
  "*The main messages from the respondents may be summarised as follows.*
  - *The respondents broadly supported (23 out of 34) a working group recommendation that bilateral counterparties to legacy swaption contracts voluntarily exchange compensation.*
  - *Half of the respondents (17 out of 34) were in favour of the working group recommending that voluntary compensation exchange take place at a pre-agreed date prior to the CCP discounting switch date, with compensation exchange for each swaption at expiry as a backstop.*
  - *The respondents had split views on which contracts should be covered by the voluntary compensation mechanism*"
- The working group on euro risk-free rates is aiming to identify fallbacks for EURIBOR based on the €STR, to prepare for a scenario in which EURIBOR may permanently cease to exist. The website is available **here**.
- Executive summary was produced of the May 7, 2020 meeting of the national working group on swiss franc reference rates. The summary is available **here**.

Asia

- Singapore debuts first Singapore Overnight Rate Average (SORA) linked FRN. The article is available **here**.
- Two of Asia's largest clearing houses are preparing to clear swaps linked to Hong Kong Overnight Index Average (HONIA) and SORA. The article is available **here**.
- LCH debuts central clearing for SORA derivatives. The article is available **here** and **here**. The statement from LCH is available **here**.
- Bank of Korea (BoK) sent a letter to private financial institutions encouraging action ahead of the discontinuation of LIBOR in 2022. The letter is available **here**.
- The BoK benchmark rate reform task force is getting ready for a LIBOR roadmap release. 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:

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