Deloitte LIBOR Transition Newsletter
March 2020
Regulatory Updates: 02.01.20 – 02.29.20
Market Updates: 02.01.20 – 03.10.20

Deloitte[i] 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 Rate Committee (ARRC) released a consultation on swaptions impacted by Central Counterparty Clearing Houses' (CCPs) discounting transition to Secured Overnight Financing Rate (SOFR). The Consultation looks to gather feedback on the ARRC’s proposed recommendations on compensation methodology for USD LIBOR swaptions that may likely be affected by the discounting change for cleared derivatives from the Effective Federal Funds Rate (EFFR) to SOFR, expected to occur from October 16, 2020 by the Chicago Mercantile Exchange (CME) and London Clearing House (LCH). Responses for the consultation were due on March 9, 2020.

Similarly, the International Swaps and Derivatives Association (ISDA) has relaunched the Consultation on how to implement pre-cessation fallbacks for derivatives. The Consultation looks to gather feedback on adding a ‘non-representative’ pre-cessation trigger to the proposed amendments of the 2006 ISDA Definitions for parties that have signed the ISDA Protocol. Responses for the Consultation are due March 25, 2020 with results aimed to be published in late April or early May 2020.

The Federal Housing Finance Agency (FHFA) has announced that Fannie Mae and Freddie Mac will no longer accept Adjustable-Rate Mortgages (ARMs) based on LIBOR by end of 2020. The FHFA has also announced additional steps taken by Fannie Mae and Freddie Mac as they transition from LIBOR to Risk Free Rates (RFRs): (1) post-June 1, 2020, single-family uniform ARM instruments will need to include redrafted language; (2) to be acquisitioned, LIBOR-based single/multi-family ARMs will need to have loan application dates on or before September 30, 2020; and, (3) these acquisitions will cease on or before December 31, 2020.

The Bank of England (BoE) issued a Market Notice informing those which operate under the Sterling Monetary Framework (SMF) that LIBOR Linked Collateral will have a haircut add-on of 10 percent from October 1, 2020, 40 percent from June 1, 2021 and 100 percent from December 31, 2021. The BoE outlined the eligibility of the various collateral types and noted they will continue to monitor fallback based on market practice progression to distinguish between LIBOR-linked collateral with comprehensive fallback language and LIBOR-linked collateral without fallback language.

Our Perspective

CCP Price Alignment Interest (PAI) and Discounting Readiness

The ARRC's Consultation on the swaption discounting change compensation methodology provides a wider public insight on the methodology market participants are aiming to take. The price alignment interest (PAI) and discounting change for EUR-linked derivatives from Euro Overnight Index Average (EONIA) to Euro Short Term Rate (€STR) is expected to take place on June 19, 2020 and the USD-linked transition is expected to take place on October 16, 2020. The transition to CCP discounting for both €STR and SOFR should be considered a high priority requirement of LIBOR transition efforts and be communicated across front office functions, valuation control groups, treasury, risk management and impacted lines of businesses to evaluate the internal changes required to discounting curves. Firms may want to consider facilitating operation tests prior to the June and October target dates to assess the readiness of the adjusted curves and related, impacted operational processes.

ISDA Pre-Cessation Triggers Re-Consultation

ISDA has re-issued the 2019 consultation on including pre-cessation triggers to the 2006 ISDA Definitions based on a letter issued by the Financial Stability Board Official Sector Steering Group (FSB OSSG). The consultation looks to understand if market participants may want to incorporate both the pre-cessation and permanent cessation provisions and related impacts. The results of this consultation are based on the timing of the transition of derivatives, as inclusion of pre-cessation triggers could require additional time for ISDA to incorporate them into the protocol for legacy products. Respondents may want to consider differences in basis risk fallback language between product types, refer to ARRC's recommended language including pre-cessation triggers for new products, and assess the impact to their risk management framework if opted out of pre-cessation triggers.

First US Target Dates for Cessation of LIBOR Linked Products

FHFA, Fannie Mae and Freddie Mac have taken leading steps for the US's LIBOR plans for cessation and has provided direction for many US regulatory authorities. However, after the FCA Sterling Working Group goals, which has proactively set target dates from when they will stop accepting LIBOR linked ARMs, it is likely that similar guidance from the ARRC will be communicated once the February meeting minutes are released and goals are established for the year. Market participants may want to review their USD based ARM product plans and communications while keeping conduct risk into consideration as market standards for ARMs develop.

LIBOR Linked Collateral Haircuts

Although the UK Regulators have been clear on their goals on LIBOR cessation, the BoE's plan to start haircutting LIBOR-linked collateral and stop accepting LIBOR-linked collateral issued post-October could potentially be the first market notice provided that could result in non-compliance for market participants. Although the haircuts are phased from October 1, 2020 to the end of year 2021, BoE has noted that securities issued on or after October 1, 2020 and expiring past the end of year 2021 will not be eligible as collateral. The BoE is still reviewing the potential to distinguish between LIBOR-linked collateral with comprehensive fallback language which may result in the potential leverage opportunities. Market participants may want to review their trading book to identify LIBOR-linked collateral and consider including or negotiating fallback language for those assets which can be used as possible collateral.

Regulatory Updates

US Regulatory Highlights

- ARRC released a consultation on swaptions impacted by CCP's discounting transition to SOFR. The Consultation is available **here**.
- ISDA has launched a new consultation on how to implement pre-cessation fallbacks for derivatives. The article is available **here** and the consultation is available **here**.
- The FHFA has announced that Fannie Mae and Freddie Mac will no longer accept ARMs based on LIBOR by end of 2020. The article is available **here**.
- NY regulated entities will be submitting their LIBOR transition plans to the New York Department of Financial Services (NY DFS) by March 23, 2020. The original letter is available **here** and the letter describing the extension of the due date from February 7, 2020 to March 23, 2020 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 February 1, 2020, through February 28, 2020. 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:

Alternatives to SOFR

- Several regional banks and credit unions have voiced their recommendation that there should be an alternative rate to SOFR. The ARRC had strong criterion to be met when selecting a rate to replace LIBOR, and SOFR was deemed a reliable rate based on International Organization of Securities Commissions (IOSCO) principles. Although the ARRC welcomes thoughts on other alternative rates, it believes SOFR will be well suited for the loan space.

ARRC Adjustable Rate Mortgage Fallback Recommendations Update

- Fannie and Freddie will require the fallback language incorporated going forward and they will no longer accept LIBOR ARMs at the end of the year.

Updated ISDA Definitions

- When ISDA definitions are updated, interest rates in confirmations will be automatically updated for derivatives. When the new reference rate is pulled directly from the Master definition, this rate will automatically be applied to new trades. To amend legacy products, both counterparties are required to adhere to the Protocol for it to apply automatically.

Short-Term Securities Transition Period

- Per the ARRC spread consultation, if the transition period is included for securities maturing under 1 year, during the first year that LIBOR ceases, each day a new spread adjustment and spread adjusted rate that could move slowly towards a final value. The spread adjustment/spread adjustment rate could only be used on a reset date so the rate may not change daily.

Legacy Agreements with LIBOR-tied Interest/Penalty Provisions

- The ARRC's pursuit of a legislative solution in New York State may likely be beneficial in cases where LIBOR is referenced in the interest and/or penalty/damages provisions. If no solution is found, these types of provisions will need to be renegotiated bilaterally. The ARRC has commenced discussions with the NY Governor's Office, but no legislation has been concluded yet. Discussions have been positive and seem to have conveyed the importance of potential policy benefits to find a solution.

ISDA and Derivatives vs. ARRC and Loans

- Questions have been raised regarding whether there may be a disconnect between what ISDA is recommending in the derivatives space and what the ARRC is looking to accomplish with regards to Loans. Borrowers in the loan market may want a longer notice for payment, while lenders may not want to delay payments. As such, there may be different conventions to apply (e.g., look-backs, lock outs). The amount of basis introduced will depend on the types of conventions applied. However, within the loan market, some basis already exists unrelated to the LIBOR transition.

Transition Period for Securities Lasting Less Than One Year

- For securities lasting less than one year which include a transition period, the new spread adjustment and spread adjusted rate will slowly move towards their final value each day during the first year that LIBOR ceases to exist. There is no concern for this rate changing on a daily basis as the spread adjustment/spread adjusted rate can only be applied on a reset date.

Historical Data Used to Calculate Spread Adjustment

- Historical data is intended to be used to calculate the spread adjustment up until the date of LIBOR's cessation. However, it is possible (and desired) that a pre-cessation event is announced before the cessation date. Banks are required to give a prior intimation to the Intercontinental Exchange (ICE) Benchmark Administration (IBA) and Financial Conduct Authority (FCA) before leaving the panel. As such, the ARRC spread adjustment consultation proposes that the spread will be set on the day of the announcement but will not take effect until cessation. In the event of a transition period, the long-run spread could be set at the time of the announcement and the short-run spread could be set at the time of actual cessation. Over the next year, the spread will transition linearly from the spot spread at the time of LIBOR cessation to the long-run spread.

Jerome Powell's (FRB) comment regarding a credit sensitive alternative rate

- Although the FRB's Chairman, Jerome Powell, made comments to the U.S. Senate that the FRB is open to exploring a credit sensitive alternative rate, the FRB has communicated its continued support for the ARRC's recommendations and expressed that plans for transition should not slow down. The ARRC's recommendations are voluntary only, and the FRB and regulators often meet with banks to hear their concerns and the ARRC is not going to discount the possibility of another rate being viable at some point in the future.

ARRC Working Group

- FRB Chair Jerome Powell told the US Senate that the FRB is open to exploring a credit sensitive alternative to LIBOR following concerns raised by US regional banks. The article is available **here**.
- ARRC December 2019 / January 2020 newsletter is available **here**.
- On March 2, 2020, the FRB began publishing 30-, 90-, and 180-day SOFR Averages as well as a SOFR Index. The statement is available **here** and the index is available **here**.

ISDA Updates

- The latest issue of ISDA Quarterly Report is available **here**.
- ISDA published Supplements to the 2006 ISDA Definitions. The definitions are available **here**.
- ISDA published Collateral Agreement Interest Rate Definitions relating to overnight interest rates in ISDA published collateral agreements. The press release and definitions are available **here**.
- ISDA published a paper on major upcoming developments in the RFR adoption for 2020. The research note is available **here**.
- ISDA published Summary of ISDA workstreams relating to Interest Rate Reform. The summary table is available **here**.
- The ISDA/ Securities Industry and Financial Markets Association (SIFMA) Benchmark Strategies Forum 2020 on was held on February 26, 2020 and discussed issues in the adoption and trading of alternative RFRs. The information is available **here**.

Other News / Useful Reading

- The FHFA announced additional steps Fannie Mae and Freddie Mac (the Enterprises) are taking as they transition from LIBOR to RFRs. The article and timelines are available **here**.
- Banks build new tools to shift short-term borrowing. The article is available **here**.
- Regulators are turning up the heat on buy-side firms to begin preparing for the transition from LIBOR to new RFRs. The article is available **here**.
- ICE Interest Rate Report for January 2020 was published. The report is available **here**.
- CME February Rates Recap was released. Article is available **here**.
- IHS Markit develops a RFR calculator. The tool is available **here**.
- Bloomberg's article on LIBOR transition hits hurdle after SOFR-linked bond sales slump. The article is available **here**.
- CNN produces an article describing advantages and shortcomings SOFR compared to LIBOR. The article is available **here**.
- Fitch Ratings releases an article describing FHFA LIBOR index replacement as an important step for US mortgages. The article is available **here**.

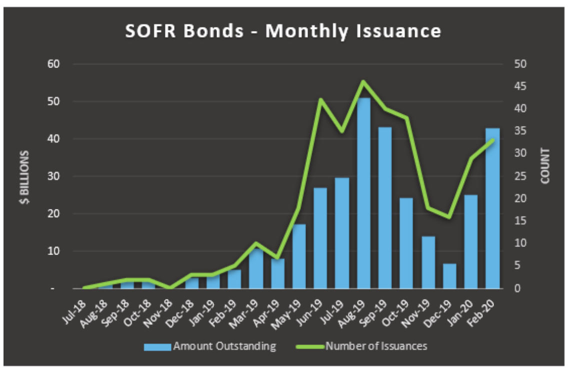
Market Updates

Increase in Debt Issuance Referenced to SOFR

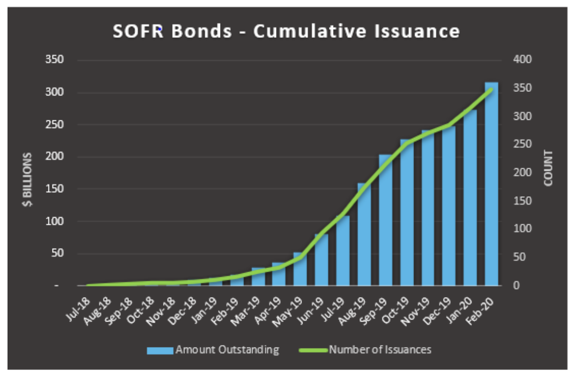
The issuance of floating-rate debt linked to SOFR continued to increase in the month of February 2020 in line with the trend observed in the previous month of January 2020. The issuance was $42.9 billion in the month of February 2020 which has gone up from $25.0 billion in January 2020 and $6.5 billion in December 2019. The graphs below represent data through February 29, 2020.

The cumulative issue size of SOFR bonds outstanding currently stands at $388.5 billion with 392 bonds (this excludes the matured bonds) through March 10, 2020. There were 33 new issuances in the month of February compared to 29 and 16 issuances in January 2020 and December 2019 respectively.

In the month of February 2020, federal agencies issued 19 SOFR referenced float rate notes worth $35.3 billion. There were 10 other institutions which contributed $7.6 billion to the outstanding amount of SOFR referenced debt.



Source: Bloomberg, compiled by Deloitte
*Data as of Feb 29, 2020

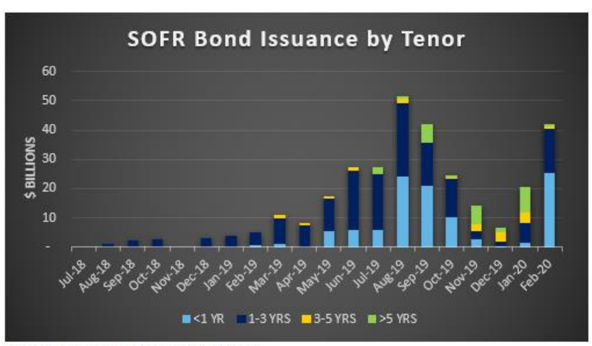


Source: Bloomberg, compiled by Deloitte
*Data as of Feb 29, 2020

Decrease in Longer Dated Debt Issuance Referenced to SOFR

After seeing a monthly high of issuances which have a maturity greater than or equal to three years in January 2020, during the month of February 2020, the number of such issuances decreased. During the month of February 2020, bonds worth $560.0 million, which have a maturity greater than or equal to three years, were issued. This includes a bond worth $10.0 million which has a maturity greater than or equal to ten years.

There were 45 issuances worth $27.2 billion, with a maturity greater than or equal to five years, through March 10, 2020. Included in this are 33 issuances worth $16.1 billion with a term greater than or equal to 10 years.



Source: Bloomberg, compiled by Deloitte
*Data as of Feb 29, 2020

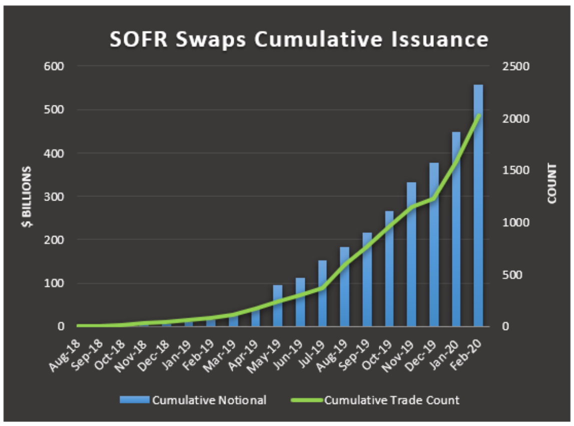
Cumulative SOFR Interest Rate Derivatives

SOFR Swaps

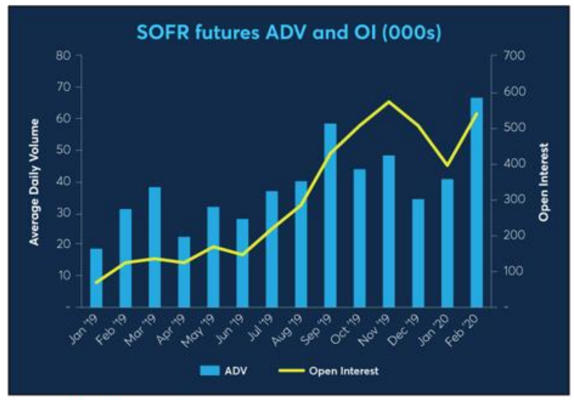
- SOFR swaps continued their momentum in 2020; the notional volume of SOFR-based interest rate and basis swaps totaled $44.1 billion through March 6, 2020.
- At the end of February 2020, the notional volume of SOFR-based interest rate and basis swaps totaled $107.5 billion compared to the $72 billion in January 2020, and $45.0 billion in December 2019.

SOFR Futures

- As per the data available on CME, for the month of February 2020, SOFR futures volume reached 67K contracts/day with more than 400 global participants. The article is available **here**. There is an increase of ~64% in the average daily volume compared to the month of January 2020.
- The month-end open interest increased by ~36% for the month of February 2020 compared to January 2020.



Source: http://swapsinfo.org/, compiled by Deloitte
**Data as of Feb 28, 2020*



Source: CME Group
**Data as of Feb 28, 2020*

Global Highlights

United Kingdom

- BoE to cut lending to banks using LIBOR-linked collateral. The article is available **here** and the speech by Andrew Hauser, BoE Executive Director for Markets, is available **here**.
- The BoE Working Group released a consultation on credit adjustment spread methodologies for fallbacks in cash products referencing GBP LIBOR. The consultation is available **here**.
- The BoE and FCA have published the aggregated and anonymized summary of a survey of 15 dealers in non-linear Sterling interest rate derivatives to understand the preferred approach for trading interbank Sterling Overnight Interbank Average Rate (SONIA) swaptions and caps and floors. The survey questions and answers are available **here**.
- The FCA published "Sector Views" with discussion on the LIBOR transition. The report is available **here** (LIBOR reference starting on page 26).
- Gilt investors have called on the UK Debt Management Office to issue floating rate notes (FRNs) linked to SONIA. The article is available **here**.
- LCH is seeking approval from users of its SwapClear service to strengthen its procedure for switching benchmarks. The article is available **here**.

European Union

- European Central Bank (ECB) Working Group report on the transfer of EONIA's cash and derivatives markets liquidity to €STR available **here** and press release is available **here**.
- EBR Analytics Financial Benchmarks Newsletter is available **here**.
- A synthetic LIBOR of Sterling LIBOR is under consideration to future-proof certain "tough legacy" contracts will lead to legal obstacles under EU Benchmark rules. The article is available **here**.
- The Swiss National Bank has reintroduced repos to steer interest rates downwards. The article is available **here**.
- One-fifth of EONIA-linked interest rate derivatives have maturities extending beyond 2021. The article is available **here**.

Asia

- Article is released on Asia's senior bankers feeling unprepared for the end of LIBOR. The article is available **here**.
- The Bank of Japan's (BOJ's) Cross-Industry Committee released a report selecting Nikkei QUICK as the administrator of the Tokyo Overnight Average Rate (TONA) Term Reference Rate. The report is available **here**.
- Dealers in South Korea are pushing for a benchmark based on repo transactions to be selected as the new risk-free rate for local currency interest rate swaps. The article 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

Upcoming Events

For further details on how to create effective repapering processes, while building scale to achieve regulatory deadlines related to the LIBOR transition, please register for our upcoming dBrief on 3/18/20:

TRANSITIONING FROM LIBOR TO ALTERNATIVE RATES: AN AI-ENABLED APPROACH

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