LIBOR Transition

Market update: June 16 - 30, 2020

548 days to December 31, 2021

1 Highlights

FCA's comments on possible cessation announcement

What happened? Edwin Schooling Latter, the Financial Conduct Authority's (FCA's) head of markets and wholesale policy, disclosed that an announcement on the timing of LIBOR's cessation could come as early as November or December of this year. With LIBOR expected to continue through the end of 2021, such an announcement would provide market participants at least one year's notice to prepare for LIBOR's end.

Our Take: The prospect of a definitive cessation date announcement (at least for some currency tenor pairs) should reduce the risk of large value transfers and market disruption at the time of transition. As the value of the replacement rate depends on the timing of such an announcement, a potential announcement also increases the clarity of what the actual fallback rate will be. In fact, since the FCA's comments, we have already seen an adjustment in interest rate markets.

The timing of a potential announcement will impact the dataset used in the calculation of the spread adjustment, which is expected to be based on the historical five-year median of the spread between LIBOR and its risk free rate (RFR) replacement. Since the spread adjustment will be calculated at the time of a cessation announcement, different announcement dates will result in different values for the spread adjustment, as the lookback period changes. The interest rate market adjustments reflect revised expectations for an announcement date and the corresponding value of the spread adjustment. While those market movements impact valuations today, they also provide greater economic certainty for issuers and investors alike during the critical period between a cessation announcement and the actual date of LIBOR cessation.

Schooling Latter's comments also further reinforce the end of 2021 as the likely LIBOR cessation date. Following his

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comments, GBP and USD 3 month versus 6 month LIBOR basis spreads widened, reflecting the impacts that an earlier window of historical data would have on the calculation of fallback spread adjustments for different tenors. These market movements could imply that the market had not expected the spread adjustment to be determined until late next year, with some market participants perhaps even expecting a delay of the of the likely 2021 cessation date.

It is also possible that announcements at the end of 2020 would not necessarily include all LIBOR tenor and currency pairs – for example, lesser used pairs could be subject to announcements about discontinuation earlier than more widely employed variations of LIBOR. For market participants, this underlines the importance of scenario planning as part of a comprehensive LIBOR transition strategy. For those firms with exposures indexed to less commonly used tenor bases in a given currency, such an announcement would likely impact the ability to manage tenor basis risk.

UK Government's plan to address tough legacy contracts

What happened? UK Chancellor of the Exchequer Rishi Sunak released a statement announcing the government's intention to expand the FCA's powers to deal with legacy LIBOR-based contracts that cannot be transitioned or amended prior to LIBOR's cessation. Under the proposed legislation, the FCA would be granted the authority to require a change in LIBOR's methodology in the event that the benchmark was found to be no longer representative. While the proposal does not include a specific methodology, the FCA notes that a market consensus has emerged to use "the RFRs chosen by each LIBOR currency area, adjusted for the relevant term of the contract, and with a fixed credit spread adjustment added." Such a methodology change would end the reliance on panel bank submissions and allow for a "synthetic LIBOR" to continue to exist for use in legacy contracts.

The end result would be a means for "tough legacy" contracts to function, similar to the objective of the Alternative Reference Rates Committee's (ARRC) legislative relief proposal to provide a mechanism to replace LIBOR with a spread-adjusted form of the Secured Overnight Financing Rate (SOFR), the recommended alternative to USD LIBOR.

The FCA welcomed the announcement and provided additional detail cautioning market participants that a methodology change to extend the publication of a synthetic LIBOR might not be possible, or even preferred, for all currencies and tenors. Over the coming months, the FCA will look for market input on the specifics of how such a methodology should look.

The Bank of England released a similar statement, echoing the FCA's warning to firms not to treat the proposal as a blanket solution for the transition of legacy LIBOR-based contracts.

Our Take: Firms should think carefully before relying on the continued publication of a synthetic LIBOR as a solution for legacy products. The uncertainties associated with the potential rate – including how it would be calculated, which currencies and tenors would be in scope, and the potential for litigation especially in regions outside the UK and eurozone – make it difficult to predict where it would apply and what exactly the economic impacts would be. Further, firms and their customers would be giving up control over the terms of such a solution, which may not be desirable to either party. Transitioning contracts away from LIBOR on terms that a firm can agree on with their counterparties should remain the preferred approach to the greatest extent possible.

More importantly, the prospect of a synthetic LIBOR does not solve firms' operational challenges associated with the transition. In fact, considering the FCA's comments on a potential announcement on cessation by year-end, firms should feel even greater urgency to develop new alternative reference rate indexed products, update systems and risk management capabilities and remediate legacy contracts.

SEC LIBOR transition exams

What happened? The SEC's Office of Compliance Inspections and Examinations (OCIE) published a risk alert regarding the scope and content of upcoming examinations focused on preparations for the transition from LIBOR. The OCIE will review how firms (e.g. broker-dealers, investment advisers or managers and other participants in the securities trading industry) have assessed the impact of LIBOR transition on their business activities, operations, services, and customers – including investors. Exams will also include a review of firms' transition plans, including steps taken to transition LIBOR-linked contracts, establish operational readiness, update disclosures or reporting to investors, manage potential conflicts of interests and prepare for their clients' efforts to transition from LIBOR.

The risk alert includes a sample request list, similar in nature to the information requested by US and other regulators in formal "Dear CEO" letters over the past year. The OCIE's list, however, includes additional items specifically relevant to investment advisers, as

firms are asked to provide detailed information on the impact of LIBOR transition on their investors, including their contracts and how they are engaging with them as part of managing the transition.

Our Take: The alert should draw immediate attention from firms that have been slow to prepare for the transition from LIBOR. Especially for asset management firms, the appended request list serves as clear indication that expectations for their preparedness are no different than those for large banking institutions. Investment managers will need to be prepared to provide information not only about how LIBOR transition impacts their own organization, but their investors as well. In order to provide a clear picture on investor impact, investment managers will likely need to be able to quantify exposures for different investors.

The issuance of the alert also appears to confirm the expected timeline of the LIBOR transition. Since the OCIE's examination priorities were published in January, market participants have questioned whether the current crisis and market conditions might result in a delay of interim industry milestones – or even the expected cessation date of LIBOR itself. Consistent with the message delivered by various other regulators over the past weeks, the SEC's alert reinforces that firms should be preparing for the transition from LIBOR under the assumption that the overall timeline remains unchanged.

€STR discounting switch

What happened? On July 27, a date that is now less than four weeks away, the Central Counterparties (CCPs) will switch their discounting and PAI methodologies from EONIA to €STR for cleared derivatives denominated in Euro.

The change in methodology will result in changes to the present value of cleared derivatives, creating a need for compensation to impacted parties. The CCPs have all outlined different approaches to calculating and processing such compensation, although all of them will extend compensation in cash.

Our Take: Operationally, the discounting switch is a large, complex project that involves many stakeholders from different departments within an organization. Firms should not underestimate these complexities and need to consider the downstream impacts of the switch as part of their preparations. Planning for the discounting switch should include the development of detailed, department specific playbooks that outline the required steps and actions that need to take place over the transition weekend. At the very least, playbooks should address five main challenges:

- *Parallel discounting regimes:* The switch, first and foremost, affects the cleared derivatives business. Many market participants are expected to implement a similar discounting switch from EONIA to €STR for their bilateral derivatives portfolios at a later point in time, following the repapering of their Credit Support Annexes (CSAs), which specify the terms of collateral provided in derivative transactions. Consequently, systems and processes will need to be able to handle multiple discounting environments.
- *Allocation of compensation payments:* Compensation payments will need to be allocated to the various trading desks involved. This is likely to require a large amount of additional internal trades. To facilitate the transition, firms should consider automating this process either by adapting existing systems and platforms, or possibly even developing and implementing new tools.
- *Transfer instrument for compensation payments:* Clearing houses are expected to use different channels to pay out cash compensation. LCH, for instance, will transfer any compensation through a 1 EUR notional EONIA trade, with a settlement date of July 28. EUREX is planning to directly book the compensation fee along with the variation margin. Firms' playbooks will need to consider all the different approaches.
- *Coordination:* The discounting switch will require seamless cooperation between IT, business departments and the clearing houses themselves. Firms' plans should explicitly address the role and responsibilities of a central PMO function and clearly communicate expectations for coordination and interaction to all businesses and functions.
- *Testing:* As a prerequisite for the go-live, any system and process changes, as well as actions required as part of the switch, should be tested well in advance of July 27. Many firms will likely need to conduct such testing at a time where many key employees are working remotely, adding to the importance of leaving additional time to remediate any potential issues prior to the transition weekend.

We have seen significant progress in the market with respect to preparations for the discounting switch. Many organizations are moving forward with the development of playbooks, coordinated testing and dry-runs. Firms should take advantage of this effort to capture and apply any lessons learned to the upcoming discounting and PAI switch from the Fed Funds Effective Rate to SOFR in the USD market, planned for October of this year.

ARRC's recommended fallback language for syndicated loans

What happened? The ARRC released updated recommendations for fallback language in new LIBOR-based syndicated loans. Compared to the prior version released last year the refreshed guidance includes updated hardwired fallback language that includes adjusted simple SOFR (i.e., daily averaging without compounding) as the second step in the waterfall (behind adjusted term SOFR), as well as a more permissive early opt-in trigger that would allow parties to replace LIBOR with SOFR prior to LIBOR's official cessation. The amendment approach, which would require parties to negotiate a new reference rate upon LIBOR cessation, has been removed as a recommended fallback approach.

The guidance suggests that firms may reasonably choose to omit the first step in the waterfall, or replace adjusted simple SOFR with compounded SOFR (i.e., interest accruing on a compounded daily basis). Such a modification would more closely align with ISDA's recommended fallback rate for derivatives.

Our Take: The removal of the amendment approach is consistent with our previous recommendation that market participants adopt hardwired fallbacks, as it is impractical to assume that a potentially large number of outstanding contracts could be adjusted on a contract by contract basis at the time of LIBOR cessation.

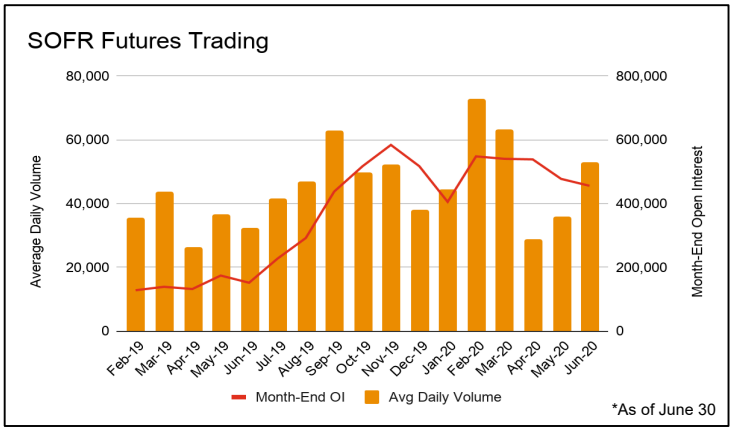
The inclusion of adjusted simple SOFR as preferred choice in ARRC's recommendations likely reflects pushback by segments of the industry on the use of SOFR compounded in arrears for traded loans. Market participants have cited yet to be finalized conventions, the ongoing development of systems capabilities and complexities in operationalizing SOFR compounded in arrears in syndicated loans as challenges.

With compounded in arrears rates being adopted by the derivatives markets and segments of the cash market (e.g. FRNs), the ARRC appears to have evaluated the trade offs between near-term operational challenges associated with switching to a compound interest rate and the economic basis differences between daily simple and compounded SOFR — and settled on the latter as the lesser of two evils.

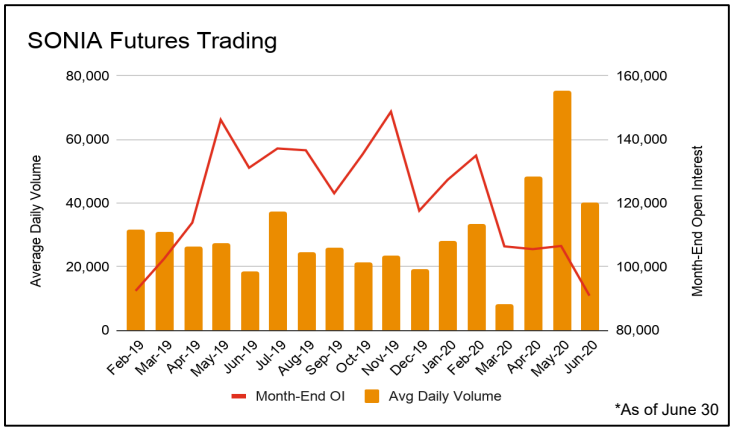
It remains to be seen whether the recommendation of daily simple SOFR as fallback in syndicated loans will extend into forthcoming guidance on conventions in new SOFR loans, or whether this simply represents a temporary fix as vendors and market participants race to implement system solutions to better align loan coupons to hedging instruments and funding exposures. All eyes will be on ARRC's recommendations for loan conventions, which are expected to be issued in July.

2 RFR adoption: Derivatives

Futures and options



Source: CME, ICE (accessed July 1, 2020)



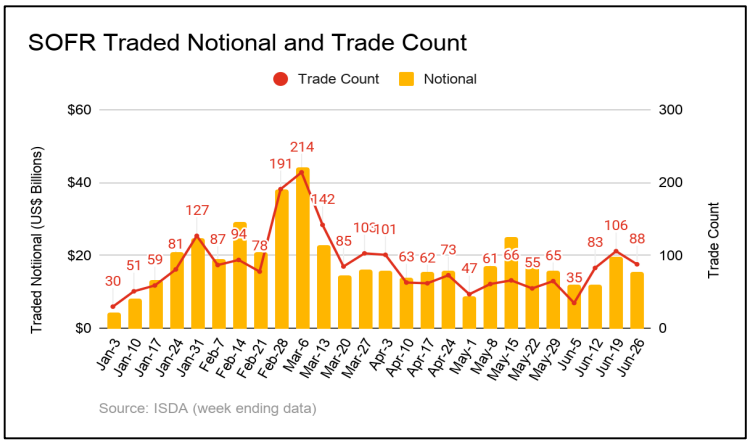
Source: CME, LCH, ICE (accessed July 1, 2020)

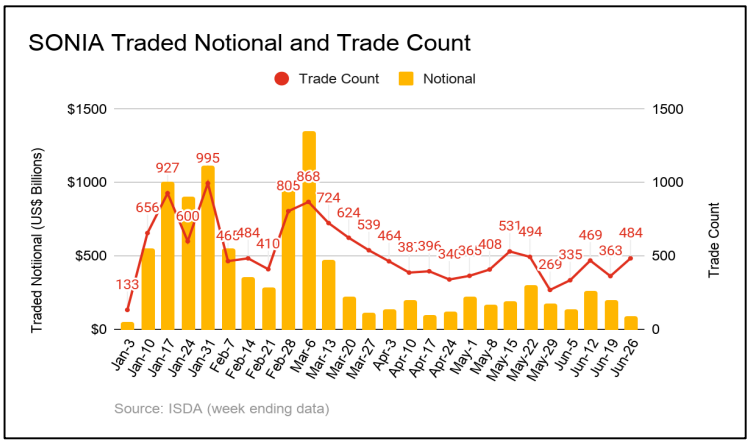
Our take

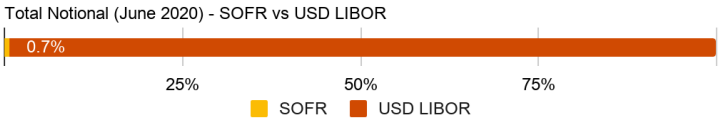
Trading in SOFR futures has remained steady. Volumes in 3M contracts at ICE continue to increase and are now approaching those seen at CME. For the first time in a while there were 25 options traded on 3M SOFR futures.

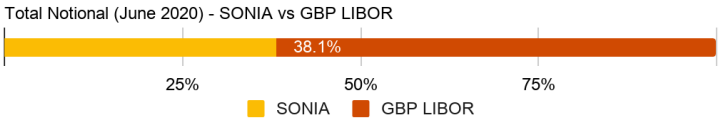
SONIA futures trading volumes have come down from their record highs in May, with open interest falling to levels last seen in early 2019. This was largely driven by a large fall in trading volumes in 3M contracts at ICE, which had been carrying the SONIA futures market since late April. Nevertheless, trading remains concentrated in 3M contracts, as neither the CME nor the LCH saw a 1M contract being traded over the past two weeks.

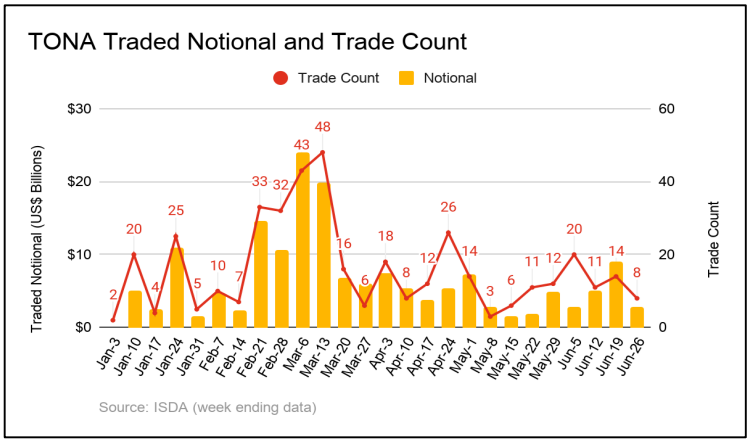
Swaps trading

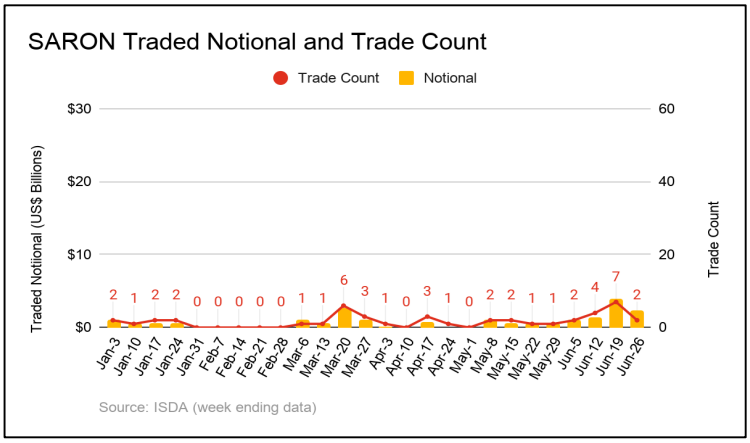


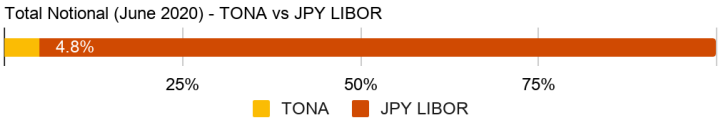


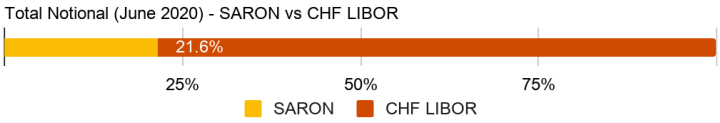








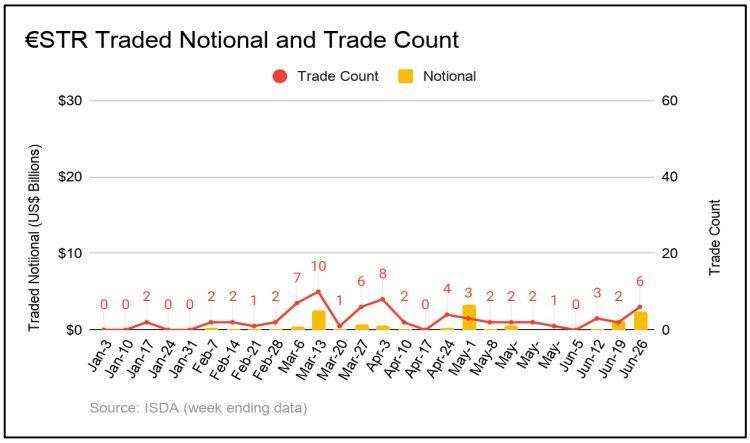




Our take

Trading in RFR swaps remained steady, with both average daily volumes and outstanding notionals showing only moderate movement since the all-time highs in early March.

Neither SOFR, SONIA or TONA have been able to increase their share of total swaps trading, which continues to be dominated by LIBOR-linked swaps. That is especially true for SOFR and TONA, where LIBOR-linked swaps continue to account for over 99% and 95% of all swaps trading, respectively. SARON's share as a percentage of total CHF LIBOR swaps trading, however, rose to over 20% in the month of June. That represents an all-time high, although small changes in trading volumes can have outsized impacts in the comparatively smaller CHF derivatives market.



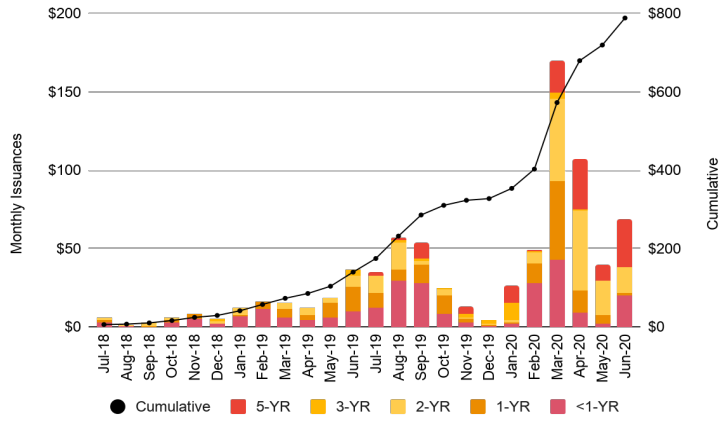
Source: analysis.swapsinfo.org
(Interest rate and credit derivatives weekly trading volume: Week ending June 26, 2020, accessed June 29, 2020)

3 RFR adoption: Cash products

FRN issuances *(as of June 30, 2020)*

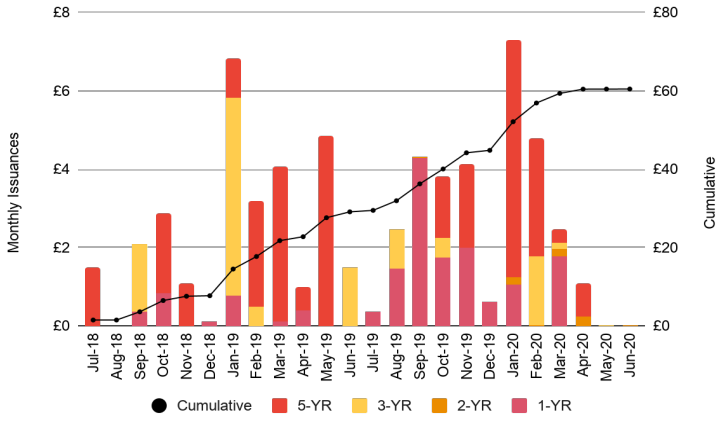
SOFR issuances (in billions)

- June was the third highest month for SOFR FRN issuances since the inception of the rate in April 2018, totaling almost $69 billion.
- While agency issuances continue to account for the largest share of total amount issued, the two largest issuances in June came from Bank of America, which issued two $3 billion FRNs.



SONIA issuances (in billions)

- Issuances of SONIA-linked FRNs continue to be limited. While SONIA remains the standard for GBP FRN issuances, current market conditions continue to provide more attractive, alternative funding schemes.



Source: Bloomberg

There have been €3.9 billion in **€STR FRN issuances** since the rate was first published in October of last year, with all issuances in maturities of three years or less.

Notable cash product issuances

RFR	Issuer	Detail	Resources
SOFR	NBT Bancorp	Smaller institutions are continuing issuances of fixed to floating-rate notes using SOFR as reference rate.	Press Release
	Bridgewater		Press Release
	Byline Bancorp		Press Release
	CIT Group		Press Release
	Horizon Bancorp		Press Release
	County Bancorp		Press Release
	Equity Bancshares		Press Release
SONIA	Town of Penarth	Successfully switched a series of FRNs from GBP LIBOR to SONIA by means of consent solicitation.	Notice of Amendment
	Kensington Mortgages	Issued a £400 million SONIA RMBS, the first issuance by a programmatic RMBS issuer since the onset of the current crisis.	Press Release
	TSB Bank	On its second attempt, successfully switched the reference rate on a series of FRNs from GBP LIBOR to SONIA.	Meeting Results
SORA	OCBC Bank	Finalized the first SORA-linked credit agreement, a SGD 150 million facility for CapitaLand.	News Coverage

4 Publications at a glance

Alternative reference rate working groups

Alternative Reference Rates Committee

- Released updated guidance for fallback language in new LIBOR-based syndicated loans, recommending the use of adjusted simple SOFR as second step in the waterfall, following term SOFR.
- Released its recommendations for fallback language in student loans, following a consultation on the topic earlier this year. In parallel, it also published a guide discussion option for using SOFR in student loan products.
- Published a summary of feedback received on its supplemental consultation on spread adjustments for cash products. Respondents largely indicated a preference to align with ISDA's proposed methodology.
- Sent a letter to the CFTC requesting relief for the voluntary exchange of compensation for swaptions impacted by the upcoming CCP discounting switch.

Working Group on Euro RFRs

- Issued recommendations for a voluntary compensation mechanism for swaptions affected by the EONIA - €STR discounting switch.

Working Group on ARRs for the Norwegian Krone

- Published a consultation on market conventions for its proposed IBOR alternative NOWA.

Steering Committee for SOR Transition to SORA

- Provided an update on the transition, indicating that it targeted a broader adoption of SORA beginning in 2021.

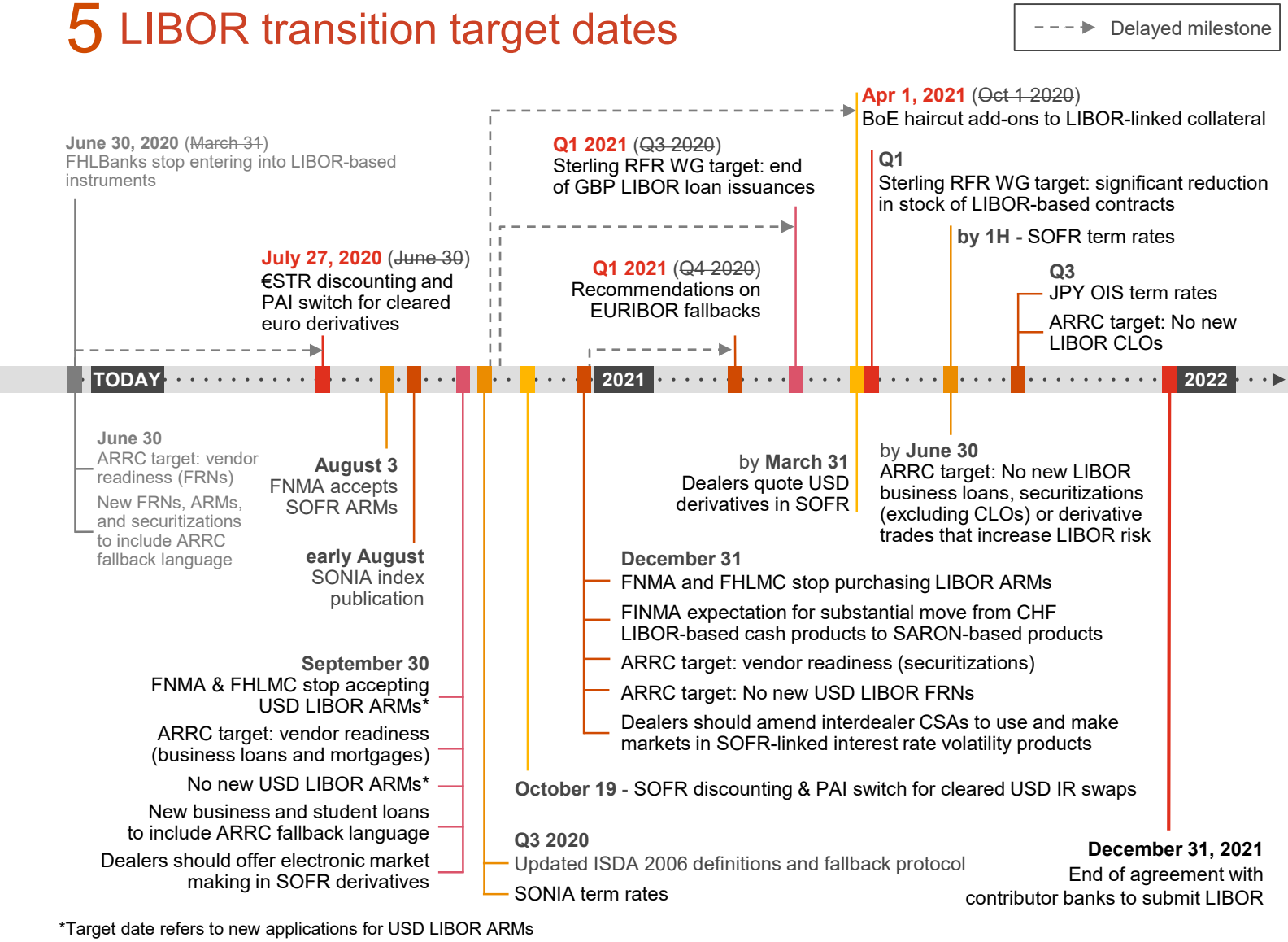
Regulators

- **FRB NY:** Published a FEDS Note examining the correlation between LIBOR and bank funding costs. The conclusion: funding costs aren't any more correlated to LIBOR than to any other interest rate.
  Published minutes and presentations from the first Credit Sensitivity Group workshop held earlier in June.
- **FCA:** Britain's finance minister Rishi Sunak announced that the UK Government is planning to expand the FCA's powers to enable the regulator to direct LIBOR methodology changes that would ensure the continued availability of LIBOR for the purpose of tough legacy contracts. The FCA welcomed the announcement, as did the Bank of England, although both cautioned that market participants should continue to make every effort to transition tough legacy contracts on their own account. The FCA also published a list of FAQs detailing the proposed legislation.
- **SEC:** The Office of Compliance Inspections and Examinations (OCIE) published a risk alert that provides information regarding the scope and content of upcoming examinations focused on firms' preparations for the transition from LIBOR.
- **U.S. regulatory agencies:** Published their final rule on swap margin requirements, which — among other changes — amends the Swap Margin Rule to provide relief with respect to interest rate benchmark reform.
- **IASB:** Provided an update on the Board's recent discussion of feedback received on its benchmark reform Phase 2 ASU. It had previously published its staff cover paper and meeting materials for its June 23-25 Board meeting, focused largely on feedback received on the IASB's IBOR Reform Phase 2 ASU released earlier this year.
- **BCBS:** In summary notes from its latest meeting, the BCBS reiterated that LIBOR transition remains a priority and that all banks are expected to be adequately prepared to meet the transition timeline.
- **South African Reserve Bank:** Published a draft statement outlining the methodologies and policies governing IR benchmarks it administers, including ZARIBOR, ZASFR, ZARONIA, two different term wholesale benchmark rates and JIBOR.
- **Bank of Russia:** Published a list of interest rate benchmarks as alternative to LIBOR.

Industry groups, infrastructure providers and other items

- **ISDA, Bloomberg** and **Linklaters:** Published an updated IBOR Fallbacks factsheet providing an overview of the calculation methodology and implementation of fallbacks.
- **ISDA:** In collaboration with a number of other industry groups, published a set of recommendations to update the EU Benchmarks Regulation (BMR).
  CEO Scott O'Malia commented on the UK's proposed approach to tackle tough legacy contracts.
- **ICMA:** Hosted an official sector panel discussion on LIBOR transition, featuring representation from the FCA, FRB NY, ECB, SNB, and EIB.
- **AFME:** Published a white paper on conduct risks and client communications during LIBOR transition.
- **LSTA:** Published its presentation slides and a summary of a panel discussion on LIBOR transition and CLOs at a recent CLO industry conference.
- **National Association of Federally-Insured Credit Unions (NAFCU):** Published a Regulatory Alert (members-only access) on the CFPB's proposed changes to Reg Z to facilitate the transition from LIBOR to SOFR, asking for comments from its member institutions.
- **Montreal Exchange:** 3M CORRA Futures began trading on the Montreal Exchange. The exchange also published a series of educational webinars.

5 LIBOR transition target dates



*Target date refers to new applications for USD LIBOR ARMs

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