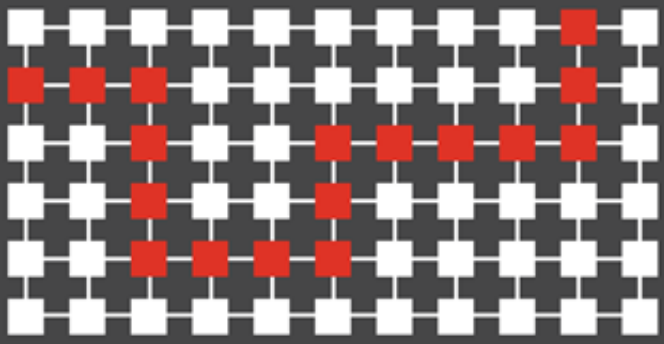
LIBOR Transition

Market update:
November 1 - 15, 2020



411 days to December 31, 2021

1 Highlights

Interagency guidance on benchmarks for loans

What happened? The Board of Governors of the Federal Reserve System (Fed), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC, collectively, the agencies) issued an interagency statement on reference rates for loans. The statement reiterates that "a bank may use any reference rate the bank determines to be appropriate for its funding model and customer needs," but also reminded market participants that all lending contracts should include robust fallback language to specify a replacement rate in case the rate ceases to be published. SOFR remains the recommended alternative for USD LIBOR.

The statement follows a previously released letter to the members of the Credit Sensitivity Group (CSG), organized by the FRB NY, which declared that the official sector did "not plan to recommend a specific credit-sensitive supplement or rate for use in commercial lending products." The group had been convened in response to concerns raised by a number of regional banks about the suitability of SOFR as a lending rate, amid fears that SOFR might not accurately reflect their funding costs — especially during stress periods.

Our take: The regulators' "non-objection" to the use of other benchmarks should not be understood as a point-blank endorsement of any of the alternatives currently being contemplated by market participants. Neither does the statement represent a change in course by the official sector, as the choice of SOFR as an alternative reference rate had always been characterized as voluntary.

pwc

We expect that firms will continue the exploration and evaluation of credit-sensitive alternatives or add-ons to SOFR — as the concerns raised by CSG members remain unaddressed as of today. At the same time, any such effort should not delay firms' preparation for LIBOR's cessation. While regulators have indicated that they would not criticize an institution based solely on the use of a specific benchmark rate, it is unlikely that examiners will turn a blind eye on firms whose efforts to manage the risks associated with LIBOR's cessation are found to be lacking.

With just over a year to go until LIBOR's anticipated cessation, firms should expect a sharp increase in the number of market participants looking to proactively remediate legacy LIBOR-based contracts. While some firms may feel that there are economic disadvantages to using SOFR as a lending rate, the consequences of not being prepared to engage with counterparties looking to amend or transition legacy contracts might carry much more significant risks. Or, as the statement put it: "Prompt action encouraged."

ARRC recommendations on capital and liquidity requirements

What happened? The ARRC published a memorandum to the Fed, FDIC and OCC on capital and liquidity regulatory considerations with respect to the transition from LIBOR to alternative reference rates (ARRs). The committee is suggesting that regulators and market participants should collaborate to avoid unintended effects of the transition that might discourage the adoption of ARRs. The memorandum includes a series of recommendations for guidance and relief in the following areas:

- *Models:* The ARRC is requesting guidance on the use of historical proxy data for ARRs as part of the comprehensive capital analysis and review (CCAR) process and implementation of the Fundamental Review of the Trading Book (FRTB); expectations for transition impacts on financial projections under stress scenarios; and a simplification of approval requirements for changes to models impacted by the transition.
- *Recalibration of regulatory requirements:* The ARRC is asking regulators to consider a recalibration of liquidity requirements, standards for financial collateral and the G-SIB surcharge.
- *Contract amendments:* The ARRC is recommending guidance to clarify that amendments made to an instrument as part of the transition from LIBOR would not impact its treatment under the total loss-absorbing capacity (TLAC) rule or affect its status as a capital instrument for the purposes of CCAR.

In addition to its specific recommendations for regulatory guidance or action, the memorandum discusses potential impacts on other capital and liquidity requirements that the ARRC believes should be considered and the consequent adverse impacts on facilitating the transition away from LIBOR.

The memorandum follows a series of letters on the topic of regulatory capital implications sent by the Working Group on Sterling Risk-Free Reference Rates to the Basel Committee on Banking Supervision (BCBS) and the Prudential Regulation Authority (PRA) in October of last year. The PRA responded to the letter late last year, while the BCBS released a set of FAQs in June of this year.

Our take: The ARRC's memorandum covers a lot of ground, addressing most, if not all, regulatory capital or liquidity requirements. The document references the term "liquidity" over 70 times, typically in the context of reduced liquidity in LIBOR instruments or evolving liquidity in ARRs. It seems clear that such widespread liquidity considerations will not only have capital implications for the banking sector, but may directly impact the value of existing instruments.

While the public sector has been supportive in clearing possible roadblocks by providing regulatory relief in areas such as financial reporting, taxation or margin requirements, it's not clear that regulators will be willing — or able — to accomodate the full slate of requests articulated in the ARRC's memorandum. Some of the ARRC's recommendations might be resolved in a relatively practical manner — for example, through adoption of the above-referenced guidance provided by the BCBS. Adoption of that guidance by US regulators would also promote global consistency. In other cases, it might prove difficult to ascertain whether an increase in capital requirements for a given organization is merely the result of a switch in reference rates or in fact reflects an increase in underlying risk. Some might argue that the transition introduces real risk, justifying increases in capital and liquidity as a protective measure.

Similarly, it's uncertain whether regulators will be amenable to requests for an easing of model governance expectations. Many of the changes to models required as part of the transition from LIBOR are expected to be complex. Rather than lowering the bar with respect to model governance expectations, regulators might point to the transition from LIBOR as precisely the type of event that requirements for model change notifications, back testing and other review processes were designed to address.

The economically correct answer might lie somewhere in the middle. In some cases, resulting increases in capital and liquidity requirements might far overcompensate for any additional risk taken on. In other cases, such increases might be appropriate.

At this point, banks should avail themselves of the memorandum to facilitate their own analysis, understand the possibly adverse impacts without regulatory relief, and prepare rationales for how they plan to approach the impacts from LIBOR transition on their capital and liquidity positions. Even non-bank institutions should consider the analysis as required reading. It illustrates some of the transaction-based cost pressures banks will face over the course of the transition, which may in turn affect risk management costs for both investors and borrowers.

IBOR Fallbacks Protocol adherence (as of Nov. 15)

- 720 total entities
- 23 out of 30 G-SIBs (up from 21)

Source: ISDA

ISDA's IBOR fallbacks conference

What happened? ISDA hosted a virtual forum on the recently launched IBOR Fallbacks Protocol. Below is a selection of quotes and commentary* from the event, which featured opening remarks from ISDA's General Counsel Katherine Tew Darras.

ARRC Chair Tom Wipf on transition progress:

ISDA @ISDA

Asked whether the industry is on track to meet the end-2021 deadline for LIBOR transition, Tom Wipf says "largely, yes". Large institutions in particular have engaged deeply and education and client outreach is well under way, he adds @ISDAConferences

8:16 AM · Nov 9, 2020 · Twitter Web App

Fallbacks should not be a primary means of transition:

ISDA @ISDA

Fallbacks aren't designed to be a primary means of transitioning from IBORs, but they do mean a critical safety net will be in place for those participants that still have exposure to IBORs when a cessation or non-representativeness announcement is made, says Tew Darras

8:05 AM · Nov 9, 2020 · Twitter Web App

ISDA @ISDA

With robust fallbacks in place, market participants should have greater confidence and capacity to focus on voluntary transition. Building momentum and liquidity in alternative rates is a priority for the whole market, says Tew Darras #isdabenchmarks @ISDAConferences

8:07 AM · Nov 9, 2020 · Twitter Web App

Heather Pilley (Markets Policy, FCA) urges firms to adhere to the ISDA protocol — and issues a warning:

ISDA @ISDA

Firms with material non-cleared IBOR derivatives exposures should consider signing the ISDA Fallbacks Protocol, says Heather Pilley @TheFCA. If they don't adhere, firms should be ready to answer questions on how they will deal with this risk from their supervisor @ISDAConferences

8:56 AM · Nov 9, 2020 · Twitter Web App

Quarles comments on legacy contracts

What happened? In testimony to the Senate Banking Committee, Randal Quarles, the Fed's Vice Chair for Supervision, remarked that a plan to address legacy contracts tied to LIBOR could be publicly announced in 1-2 months. He also cautioned against a solution based on a so-called "synthetic" LIBOR for the US market, given its different litigation framework. The following day, in front of the House Committee on Financial Services, Quarles alluded to work on a mechanism that would allow legacy contracts to mature on their existing terms, even beyond 2021, without a significant change. It was not immediately clear what such a mechanism would look like, or how it would interact with existing proposals for a legislative

**Source: twitter.com/ISDA*

solution. At both the federal and state level (New York), bills are under consideration that would facilitate the statutory replacement of LIBOR upon its cessation in contracts with no or insufficient fallback provisions.

Our take: Quarles' comments are likely to leave market participants with more questions than answers. While a mechanism allowing contracts to mature on existing terms would add yet another possible path forward for legacy LIBOR-based exposures, Quarles seemed to concede that such a mechanism would not solve the problem of tough legacy contracts (i.e., contracts that cannot be remediated prior to LIBOR's cessation). Whatever form this solution may take, it is unlikely to provide a universal fix that meets the needs and preferences of all parties. A proactive transition of exposures will continue to be favored by many, as firms look to retain control over economic outcomes.

The lingering uncertainty around what solutions, tools or mechanisms might eventually become available to address legacy LIBOR exposures should not slow firms' efforts to understand the contractual provisions in their existing contracts. In fact, we expect firms that have deeper, more comprehensive knowledge of their contracts may find it easier to adapt their transition strategy once additional details on official sector or industry solutions become available.

Contract analysis: AI won't replace your experts

What happened: As firms formalize their transition strategy, a thorough and complete understanding of contractual provisions across the portfolio of legacy LIBOR exposures is an absolute necessity. Not just large and complex financial institutions, but also smaller banks, asset managers and insurance companies, need to identify and analyze thousands of contracts. More and more organizations are turning to technology to support the effort. However, in many of our interactions with industry participants, questions have been raised around the value — and potential downsides — of relying on artificial intelligence (AI) as part of the process.

Our take: AI has a role to play in the remediation of existing LIBOR-based contracts — but it may not be the role the name suggests. In the context of contract analysis, technology can be immensely helpful during the data extraction process. Especially in the case of bespoke commercial lending agreements, subtle variations in fallback language and provisions, complicated interdependencies between master agreements, notes, guarantees and amendments, and the sheer volume of data to be processed make the identification and extraction of relevant LIBOR provisions a resource-intensive and error-prone undertaking.

While there isn't a single solution that will address every client's needs, contract digitization, extraction and analysis technology can accelerate and increase the accuracy of the extraction process. Tools can:

- Reduce the manual effort required to process large amounts of data
- Manage metadata to help manage relationships between master and subordinated agreements
- Normalize language, identify patterns and quickly separate contracts using standard language from those requiring expert analysis.

Contract management tools, including those employing AI or natural language processing (NLP), do not — and cannot — replace the need for manual analysis and the expert legal judgment required to formulate a remediation strategy. Legal agreements commonly include complex embedded conditionality, decision logic, antecedent and subsequent clauses, all of which require interpretation.

Rather than replacing legal and business experts, software can accelerate the processing and improve the organization of the contract population. This allows for a more efficient use of scarce legal and business resources, as firms look to develop remediation strategies tailored to various contract types.

2 RFR adoption: Derivatives

Futures and options

Source: CME, ICE (accessed November 16, 2020)

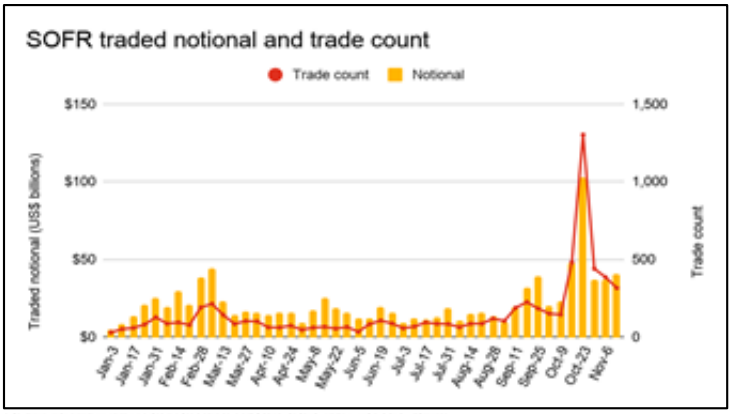
Source: CME, LCH, ICE (accessed November 16, 2020)

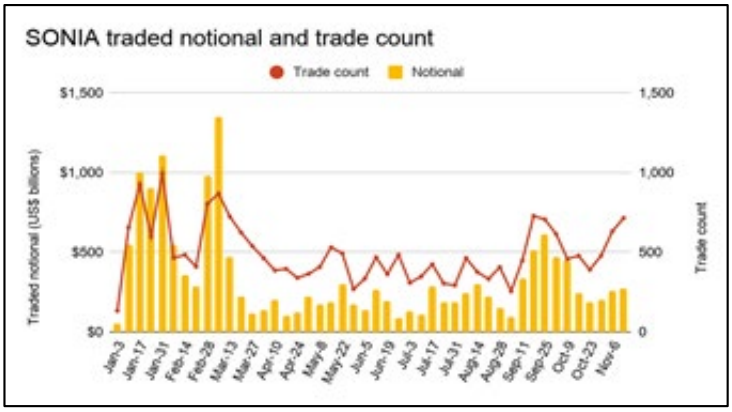
Our take

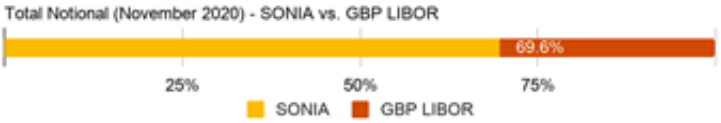
Following a drop-off in the second half of October, trading volumes in SOFR futures reached their highest levels this year, with a daily average of over 100,000 contracts traded during the week ending November 6. Open interest has remained above 500,000 contracts for each of the past four weeks.

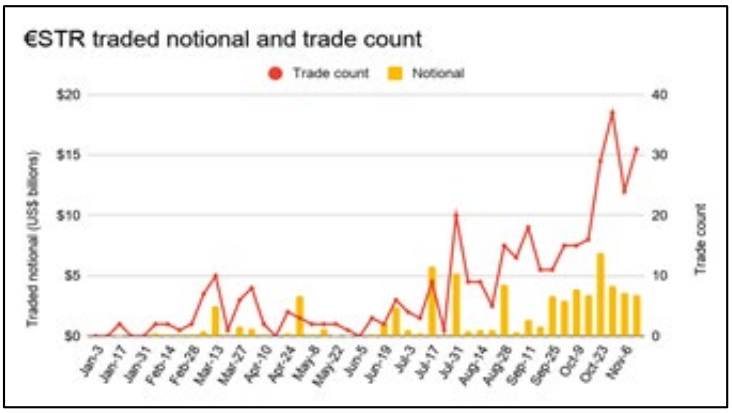
Trading in SONIA futures has been similarly robust in recent weeks, with trading volumes and open interest having increased in each of the past four weeks. Open interest now stands at just over 180,000 contracts, which represents an all-time high since SONIA futures began trading.

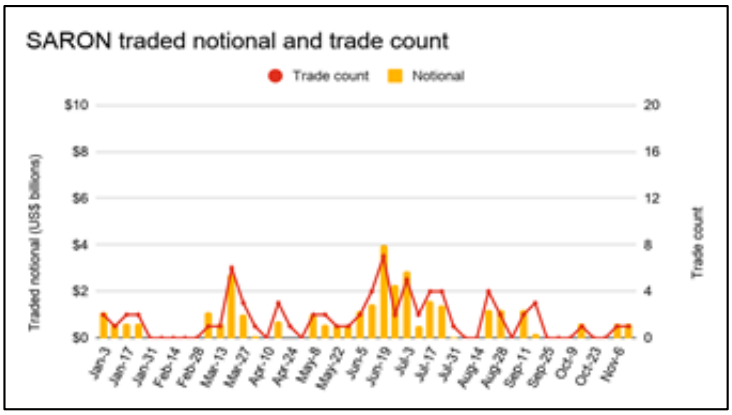
Swaps trading

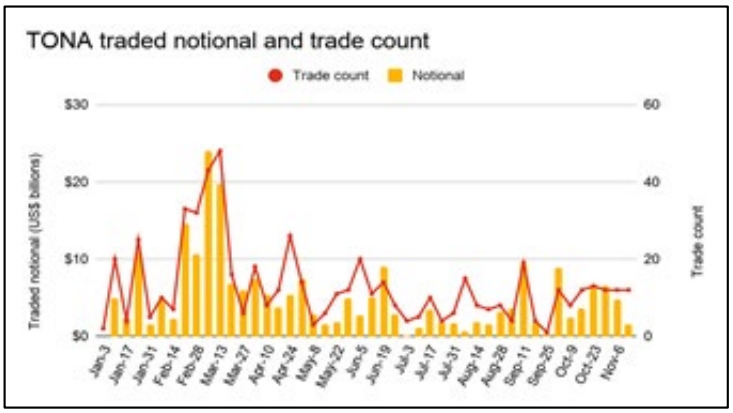


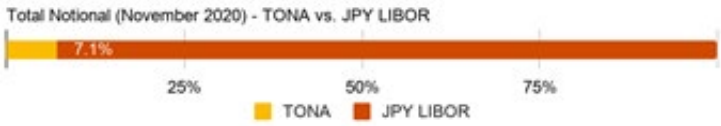












Source: analysis.swapsinfo.org (Interest rate and credit derivatives weekly trading volume: Week ending November 13, 2020, accessed November 16, 2020)

Our take:

The spike in SOFR swaps trading amid the central counterparties' (CCP) switch to SOFR as the rate used for price alignment interest (PAI, the interest paid on variation margin) — and discounting for cleared USD interest rate derivatives — was largely limited to the week following the switch. The temporary nature of the spike in activity was expected, as most of the volume increase at the time of the switch can likely be attributed to the resale of compensating swaps outside of the CCP auction process and the immediate adjusting of hedges. That said, there are clear indications that the switch will have the desired long-term effects in promoting liquidity in SOFR derivatives trading, as both trade counts and notionals have established themselves at levels more than twice those seen prior to the discounting transition. With SOFR still accounting for just over 3% of all swaps trading in USD, there clearly is room to grow — but we're trending in the right direction.

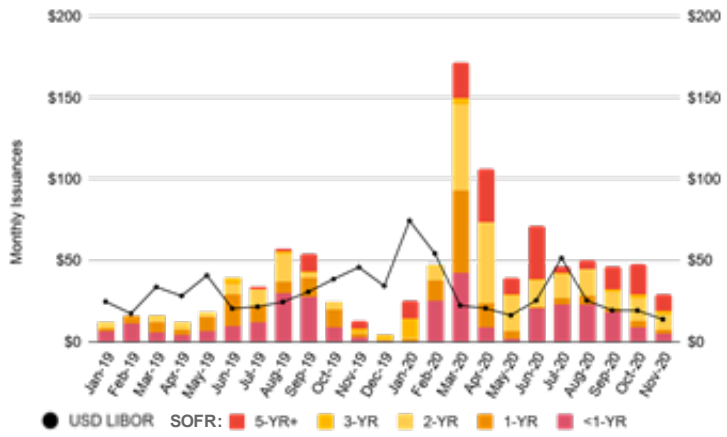
SONIA swaps trading increased both in trade counts and notional over the first two weeks in November. Over that time period, SONIA accounted for close to 70% of all GBP swaps trading.

3 RFR adoption: Cash products

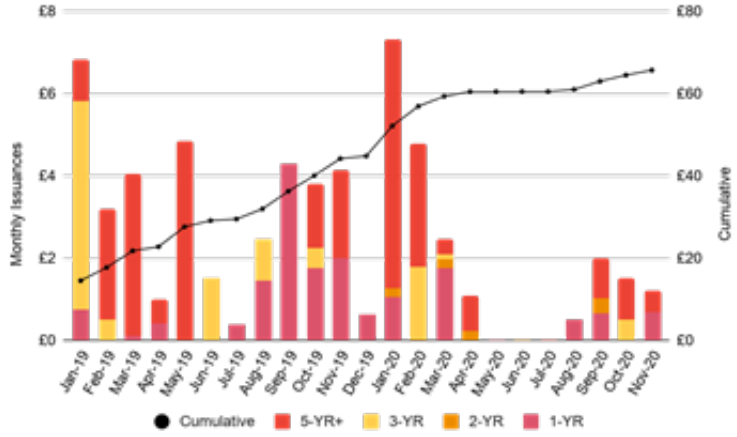
FRN issuances *(as of November 15, 2020)*

Source: Bloomberg

USD FRN issuances (in billions)



SONIA FRN issuances (in billions)



Our take:

There were a total of $29 billion in SOFR FRN issuances in the first two weeks of November — more than double the issuance total of USD LIBOR FRNs. For the past two months, the most popular maturity bucket has been that of 5 years or more. This is a stark contrast to USD LIBOR FRN issuances from the same time period, almost 90% of which have come in maturities of one year or less.

SONIA continues to be the standard for GBP sterling FRN issuances. Following this summer's slowdown in issuances, we have now seen close to £5 billion over the past three months.

Notable cash product issuances and other RFR adoption

RFR	Company	Detail	Resources
SOFR	Inter-American Development Bank	Issued a $500 million bond, its first in over a year, based on the SOFR Index.	Press Release
SONIA	Santander	Seeking consent to add ISDA fallback language to a series of GBP LIBOR-based Fixed Rate Reset Perpetual tier-one notes.	Press Coverage
	Lloyds	Revised its consent solicitation for two of its tier-one notes to use ISDA's fallbacks rather than fallbacks including a spread adjustment based on spot-basis swap market prices.	Consent Solicitation Memo
	Kensington Mortgages	Initiated a negative consent process to switch its Gemgarto 2018-1 RMBS from GBP LIBOR to SONIA.	Press Release
	Yorkshire Building Society	Initiated a negative consent process to switch two series of RMBS from GBP LIBOR to SONIA.	Notice to Bondholders
	Royal Bank of Scotland / HSBC	Refinanced revolving credit facilities with Target Healthcare, switching the reference rate from GBP LIBOR to SONIA and putting in place a new SONIA-based hedge.	Press Release
SARON	Thurgauer Kantonalbank	Began offering SARON-based mortgages on November 1.	Product Page (in German)

For additional details on employed conventions and other parameters of recent RFR-based loans, see the LMA's frequently updated list of RFR referencing syndicated and bilateral loans.

4 Publications at a glance

Alternative reference rate working groups

Alternative Reference Rates Committee (ARRC)

- Published a memorandum to the Fed, FDIC and OCC on capital and liquidity regulatory considerations in the context of LIBOR transition.
- Published minutes from its October 21 meeting.

WG on Sterling RFRs

- Published its October newsletter.

WG on Euro RFRs

- Published minutes of the working group's October 14 meeting.

Cross-Industry Committee on JPY IR Benchmarks

- Encouraged market participants to adhere to the ISDA IBOR Fallbacks Protocol.
- Published meeting materials from its Nov 5 meeting, incl. reports from sub-groups on loans, term reference rates & external communication, as well as updates on the publication of prototype term rates and recently released hedge accounting guidance from the ASBJ.

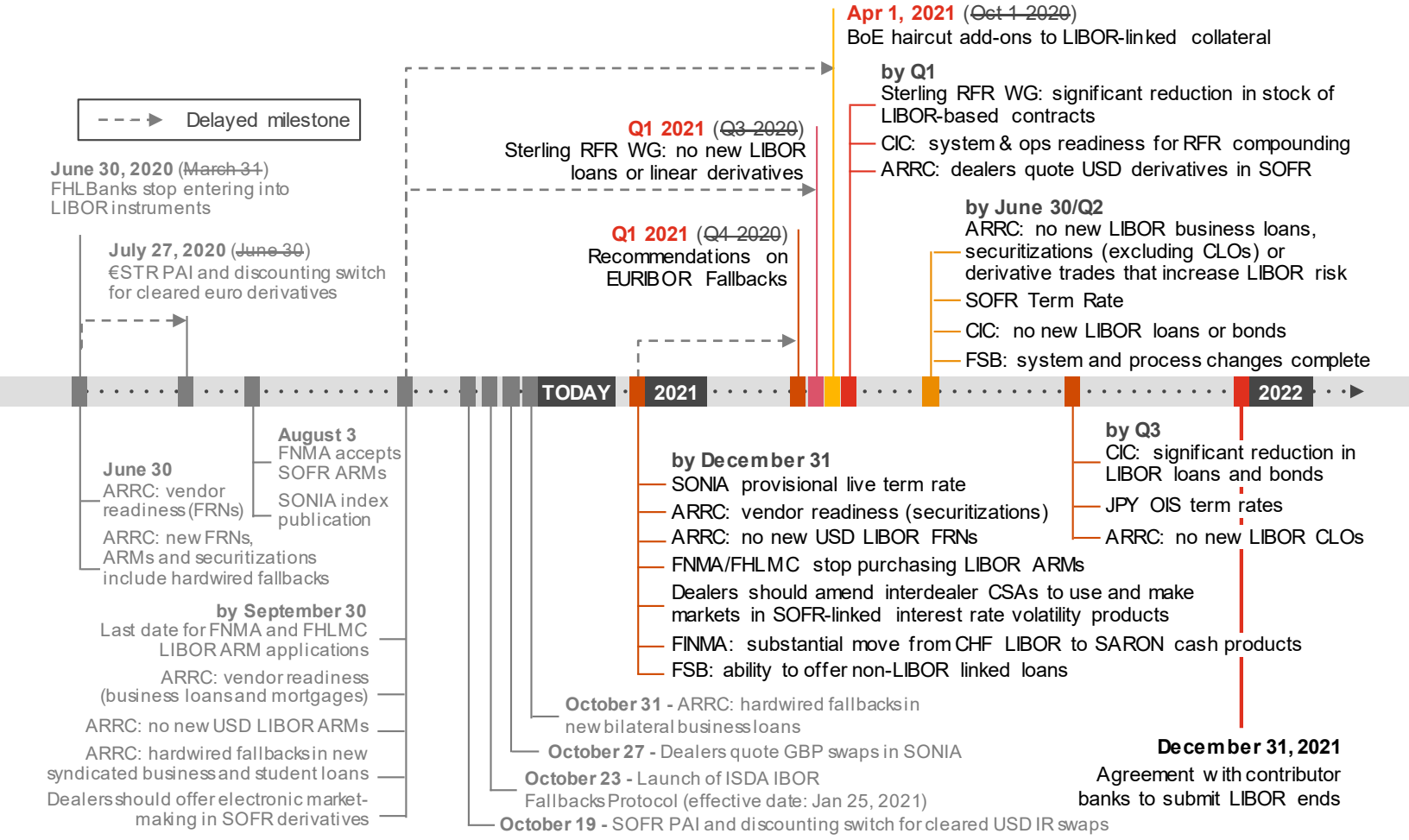
Regulators

- **Fed / OCC / FDIC:** Issued an interagency statement on reference rates in loans, reiterating that banks are free to choose any suitable reference rate,while reminding market participants that all lending contracts should include robust fallback language.
- **Federal Reserve Bank:** In testimony to the U.S. Congress, Chairman Quarles remarked that a plan to address legacy contracts tied to LIBOR could be announced in 1-2 months, alluding to work on a mechanism that would allow legacy contracts to mature on their existing terms. He also cautioned against a solution based on a so-called "synthetic" LIBOR for the USD market, given its litigation environment. Reported on LIBOR transition progress in its November 2020 Financial Stability Report.
- **New York State Assembly:** The ARRC's proposal for legislative relief related to legacy LIBOR exposures has been referred to the assembly's rules committee.
- **FRB NY:** Announced dates and topics of the two final sessions of the Credit Sensitivity Group, incl. a forums on the ongoing innovation in reference rates for commercial lending on Nov 18, 2020, and an implementation framework for commercial loan products (Dec 2020 TBD).
- **OCC:** Reminded institutions to "apply sound risk management principles" in anticipation of LIBOR's cessation in its Semiannual Risk Perspective. The OCC also notes it would "increase its oversight, particularly for banks with (...) less-developed transition processes."
- **FASB:** Published comment letters received on its proposed refinement of scope, which would clarify that derivatives impacted by the PAI and discounting switch are in scope for relief even if they do not reference LIBOR themselves.
- **FCA (w/ HMT):** On November 25, the HM Treasury and FCA will host a joint briefing and Q&A on the Financial Services Bill, which would provide the FCA with the powers to create a synthetic LIBOR.
- **HM Revenue & Customs:** Published a summary of responses to its consultation on taxation impacts associated with LIBOR's cessation. Released a policy paper describing proposed legislative changes that would amend statutory references to LIBOR in tax legislation dealing with leases, including the draft legislation and an explanatory note. Released guidance documents on taxation implications for businesses and individuals.
- **FINMA:** Noted in its Risk Monitor 2020 that overall LIBOR transition risk may be decreasing due to progress made on fallback language for derivatives. However, FINMA also noted that LIBOR-based contract volumes had actually increased in the first half of 2020.
- **Reserve Bank of Australia:** Warned in its latest Financial Stability Review of significant reputational, operational and legal risks to financial institutions if the transition from LIBOR is not finished before the end of 2021.
- **FSA:** The Japanese regulator published a series of summaries of issues raised by market participants and industry groups during meetings in June, July and September (Japanese language only).
- **HKMA:** Issued an RFP for vendors to assist with implementing the transition from LIBOR to RFRs in its Calypso system. Work is expected to begin in June 2021.
- **Reserve Bank of India:** Reiterated in its latest bulletin that work continues to develop an alternative to India's MIFOR benchmark, of which USD LIBOR is a component.

Industry groups, infrastructure providers and other items

- **LMA:** Published an updated list of syndicated and bilateral business loans referencing RFRs.
- **APLMA:** Published drafts of facility agreements based on compounded and simple SOFR (member-access only).
- **LSTA:** Released a template to facilitate the amendment of fallback language in legacy LIBOR-based CLOs. Commented on the interagency statement on reference rates, noting that banks cannot afford to slow their transition process amid the ongoing discussions on possible risk-sensitive alternatives.
- **ISDA:** Katherine Tew Darras, General Counsel, provided the opening remarks at ISDA's virtual event on the new IBOR Fallbacks. Introduced a new series of podcasts titled "The Swap." The first three episodes include an interview with the FCA's Edwin Schooling Latter, an interview with Frances Hinden and Tom Wipf, and a conversation with representatives from BlackRock and Société Générale. Published its RFR adoption indicator for October 2020 (w/ ClarusFT). Issued guidance on the permanent cessation of 6-month and 12-month CDOR tenors, which had been announced by Refinitiv.
- **ICMA:** Published minutes of the LIBOR Trade Association Working Party (TA WP) meeting on October 28.
- **SIFMA:** Reported at the October TA WP meeting that two prominent securitisation trustees had sent notices to holders on a number of transactions, stating they may potentially start article 77 court proceedings to resolve uncertainties in respect of LIBOR transition.
- **IMF:** Suggested in a recent newsletter that US markets seem to be ignoring the upcoming LIBOR transition deadline — based on an analysis of recently issued floating-rate notes.
- **Fannie Mae and Freddie Mac:** Published updates to the LIBOR Transition Playbook and the CMO Transition Playbook.
- **Federal Farm Credit Banks Funding Corporation:** Published the final results of its offer to exchange LIBOR-based FRNs for newly issued bonds containing ARRC's recommended hardwired fallback language.

5 LIBOR transition target dates



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