LIBOR Transition

Market update: October 16 - 31, 2020

426 days to December 31, 2021

1 Highlights

ISDA IBOR Fallbacks Protocol launch

What happened? ISDA publicly launched its much-awaited IBOR Fallbacks Supplement and Protocol. The protocol provides market participants with a mechanism to amend derivatives master contracts with hardwired provisions to automatically transition LIBOR-indexed contracts to alternative reference rates in the case of LIBOR's cessation. It had been made available for adherence "in escrow" to major market participants about two weeks ago, with the intent to demonstrate broad usage of the protocol prior to its official launch. At the point of its formal launch, more than 250 entities had already joined. All remaining market participants are now able to adhere to the protocol, with the amendments taking effect on January 25, 2021.

Regulators and industry groups around the globe have expressed strong support for the protocol and have urged firms to take advantage of the opportunity provided to them to manage transition risks through adherence to the ISDA protocol.

IBOR Fallbacks Protocol adherence
(as of Oct 30, 2020)

- 349 total entities
- 21 out of 30 G-SIBs

Source: ISDA

The protocol incorporates the supplement — which amends the 2006 ISDA Definitions — into existing trade documentation for uncleared derivatives, provided that each counterparty to a trade has adhered to the protocol. Any new uncleared trades referencing the 2006 ISDA Definitions will automatically incorporate the new fallbacks provisions once the supplement comes into effect. With respect to legacy cleared derivatives transactions,

It's game time: LIBOR transition enters critical next phase

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major central counterparties (CCPs) have indicated they will use the powers in their rulebooks to mirror ISDA's Fallbacks in all of their legacy cleared derivatives transactions.

Along with the protocol, ISDA has published several template agreements that allow parties to exclude certain trades or master agreements, include additional master agreements or change certain fallback provisions (such as pre-cessation triggers) in a bilateral manner.

ISDA also published a series of webinars in support of the protocol launch, including an explanation of the scope and mechanics of the protocol, the methodology and publication of fallbacks by Bloomberg, and a discussion of the provided bilateral templates and supporting technology solutions. There's also an animated introductory video on IBOR Fallbacks.

Our take: The publication of the ISDA IBOR Fallbacks Protocol represents a major milestone in the transition from LIBOR, given that the vast majority of USD LIBOR exposures are concentrated in derivatives. The protocol provides a clear transition plan for a large population of agreements. We expect that many more market participants will take advantage of the protocol now that it is available, even if it does not represent a universal fix for all LIBOR-based derivatives. There will remain a number of legacy contracts requiring bilateral remediation, as a) some organizations will inevitably choose not to adhere to the protocol, and b) the protocol may not be a solution for all derivatives — e.g., those that require the benchmark fixing to be known in advance of the interest period.

But even for those transactions that can be managed via the protocol, we nevertheless expect to see firms proactively transitioning contracts on terms on which they and their counterparties can agree on in advance of LIBOR's cessation. Firms will need to establish a clear strategy for the bilateral amendment of legacy trades — whether it is on a proactive basis or required as a result of limitations in scope of the protocol. The reduction of LIBOR exposures will generally require input from a number of different stakeholders, as it involves strategic considerations regarding client relationships and economic impacts, as well as downstream implications for hedge accounting, portfolio composition and possible overlap with other contract amendment efforts (such as Brexit-related considerations).

We also encourage firms to check with their counterparties bilaterally as soon as possible to get certainty early on, and to start bilateral negotiations where applicable.

For more information:

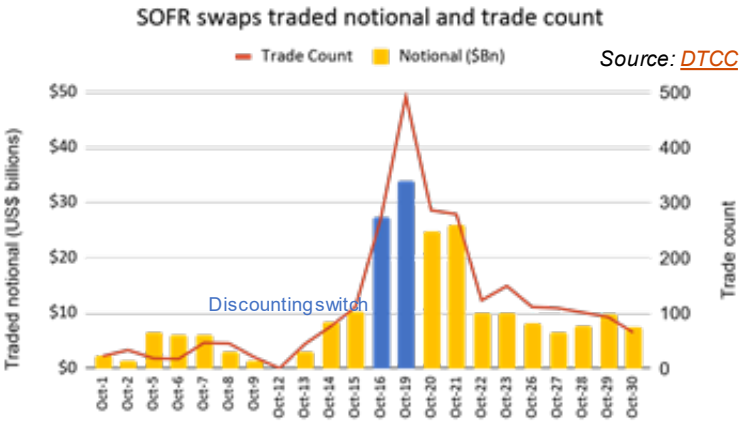
Finally here: What does the ISDA Fallbacks Supplement and Protocol mean for IBOR transitions?

Understanding ISDA's IBOR Fallback Protocol: What's next for financial institutions?

SOFR discounting transition

What happened? The major CCPs, such as the London Clearing House (LCH) and Chicago Mercantile Exchange (CME), have completed the switch from the Effective Federal Funds Rate (EFFR) to SOFR as the rate used for calculating price alignment interest (PAI, the interest paid on variation margin) and discounting for cleared USD interest rate derivatives. While there are nuances in the approaches taken by the CCPs, both clearinghouses compensated market participants for the change in market value and issued basis swaps to offset the change in discounting risk profile, while also facilitating an auction process for participants looking to contemporaneously unwind these basis swaps.

The change is considered important to further entrench SOFR, the recommended alternative to USD LIBOR, in the derivatives markets and drive liquidity in SOFR derivatives. In fact, we saw a significant uptick in SOFR trading activity in the days of — and immediately after — the switch. On October 16 and 19 (the days of the switch), a combined 762 SOFR swaps were reported to the DTCC Swap Data Repository, comprising over $61 billion in notional. Prior to October, the most active weeks since the inception of SOFR swaps trading saw a volumes of just over 200 swaps and just over $40 billion in notional — for an entire week.



Trading activity on October 16, the day of the LCH auction, was dominated by basis swaps, which accounted for 91.3% of the notional in SOFR swaps

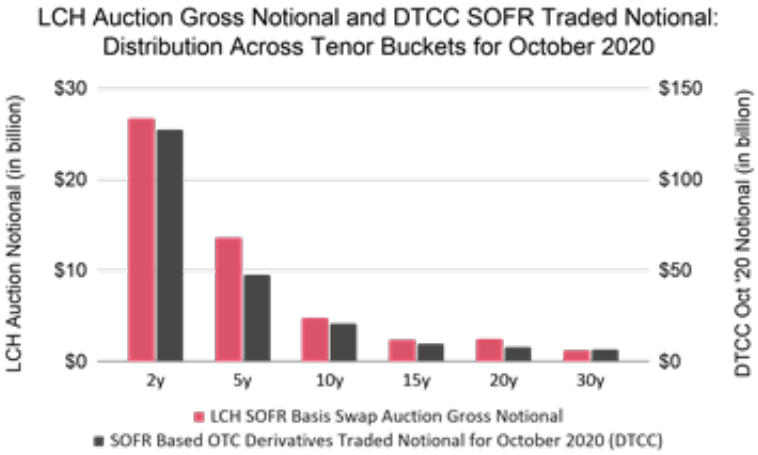
traded that day. Following the CME auction on October 19 — which allowed market participants to elect to receive fixed vs. floating OIS swap pairs instead of basis swaps — trading activity was dominated by fixed vs. floating OIS swaps, which accounted for 70% of trading activity. Trading volumes scaled back from these peaks over the course of the last week in October, yet they remain at notional and trade count levels more than double those observed in the weeks leading up to the discounting switch.

Our take: Since the CFTC had previously issued a pair of no-action letters to the CCPs — providing relief from real-time reporting requirements for swaps related to auction process —the above-referenced trading statistics do not yet include any compensating basis swaps that switched hands as part of the auction process or were retained by institutions for basis risks management purposes. Hence, the increase in trading volumes for the week starting with the discounting switch may be driven largely by a group of market participants that were comfortable receiving compensating swaps from the CCPs, but chose to exit these swap positions through trading outside of the auction process.

Following the switch, institutions now have to start managing their SOFR discounting risks by entering into new SOFR swap contracts on an ongoing basis. A key market concern in the months leading up to the discounting switch had been whether such risk management tools would be available across the full term structure — a concern that has been eased by the successful auction processes.

In addition, an analysis of the maturities of SOFR swap trades reported at DTCC for the month of October evidences the existence of transactions across the term structure.

Comparing the notional of these transactions against the overall risk profile in the market (based on the exposure underlying LCH's compensating swaps auction) suggests a strong correlation between the tenor of general SOFR trading and the underlying risk in the market. Furthermore, analysis of trade counts shows a flatter distribution of transactions across the term structure, with approximately half the reported transactions occurring across the 2y and 5y tenors.



Source:LCH, DTCC

Transition milestones: FSB and Singapore

What happened? The Financial Stability Board (FSB) published a global roadmap for the transition from LIBOR to alternative reference rates (ARRs). In addition to urging market participants to adhere to ISDA's IBOR Fallbacks Protocol, the roadmap lays out a series of milestones leading up to LIBOR's anticipated cessation by year-end 2021:

- *By end of 2020:* Be in a position to offer non-LIBOR linked loans to customers that either reference an ARR or contain a mechanism that would automatically switch the loan from LIBOR to an ARR prior to year-end 2021.
- *By end of H1 2021:* Have in place — and take steps to execute, where realistic — formal plans to amend legacy contracts and complete all necessary system and process changes required to transact in alternative reference rates.

The FSB suggests that, at this time, firms should have already assessed all existing LIBOR exposures and have a sound understanding of the fallback provisions contained in the related contracts.

In Singapore, the Steering Committee for SOR Transition to SORA (SC-STS) announced a series of milestones, suggesting — among other items — that banks should cease the issuance of new SOR-linked loans by the end of April 2021. Banks are further expected to reduce their SOR exposures to 20% of May levels by the end of Q3 2021. The committee also published an updated transition checklist.

Our take: The different sets of interim transition milestones set out by regulators and alternative reference rate working groups are all driven by the common assumption that LIBOR will cease to be published at year-end 2021, or shortly thereafter. The various target dates for system readiness, inclusion of hardwired fallback language or cessation of new LIBOR-based products can certainly inform transition planning, but firms' emphasis should be placed on finding ways to reduce their reliance on LIBOR as a benchmark as quickly as possible. The sooner a firm can employ hardwired fallback language, switching mechanisms or transition away from the use of LIBOR in new contracts to ARRs altogether, the more

manageable will be the amount of contracts requiring remediation in the latter half of 2021.

As a result, the timing for the inclusion of hardwired fallbacks, transition of legacy exposures or issuance of new products based on ARRs should not be driven only by a milestone. There are certainly firms that might need to balance transition timing around dependencies on third parties, concerns around fiduciary responsibilities to achieve the best possible economic outcome and other considerations. Many other firms, however, might find it advantageous to act much earlier than different target dates would suggest, given strategic, economic, regulatory or operational considerations.

Whatever the differences in milestones for different currencies or products may be, the end of 2021 looms large as a target date. As that date draws closer, we echo the LSTA's sentiment on the apparent lack of LIBOR transition progress in the CLO markets: "Get cracking, people."

Update on legislative solutions

What happened: Draft legislation based on the ARRC's legislative relief proposal was introduced in front of the New York State Senate by Senator Kevin Thomas, chair of the state's Senate Consumer Protection Committee. A draft of a similar legislation at the federal level has recently been circulated by Rep. Brad Sherman (D-CA), chair of the House Capital Markets Subcommittee. The bills would provide for a statutory replacement of LIBOR with spread-adjusted SOFR in legacy LIBOR-based contracts that contain no, or insufficient, fallback language at the time of LIBOR's cessation.

In Europe, the European Parliament's Think Tank published its initial appraisal of the European Commission's (EC) review of the benchmark regulation, noting that the problem's "definition, objectives and policy options are clearly linked." Similar to the legislation put forward in the US, the EC's proposal calls for a statutory replacement of a discontinued benchmark in cases of inadequate fallback language at the time of LIBOR's cessation.

Last but not least, the UK Parliament published a draft of the Financial Services Bill 2020[1], which provides the Financial Conduct Authority (FCA) with additional powers to address the issue of tough legacy LIBOR exposures, i.e. exposures that cannot be remediated prior to LIBOR's cessation. The bill enables the FCA to mandate a change in the methodology of a critical benchmark, such that, in the case of LIBOR, it is no longer reliant on panel bank submissions. The result would be a so-called "synthetic LIBOR" that would remain available only for reference by tough legacy contracts. The UK approach differs in scope, as it is expected to be limited to tough legacy contracts, whereas the legislative proposals brought forward in the U.S. and the EU would presumably apply to a broader population of contracts.

HM Treasury (HMT) published a supporting policy statement providing additional detail on the proposal. The FCA, which promptly welcomed the announcement, is now required to issue a policy statement describing how it would implement its new powers. A public consultation on the topic is expected later this year.

Our take: The progress on legislative solutions to address legacy exposures is a significant step forward by the official sector to support the transition and will certainly be welcomed by the market. However, as stressed by HMT (and many others before), market participants should proactively transition away from LIBOR to the greatest extent possible.

A legislative fix certainly represents a helpful safety net for some legacy exposures, but it can provide partial coverage at best. There isn't yet much clarity on the scope of prospective legislations, how a certain piece of legislation might interact with legislation in another jurisdiction and the extent to which legislations or their implementation will be challenged in court. The fact remains that many contracts present undesirable economic outcomes for the respective parties in the case of LIBOR's cessation and are unlikely to fall within the scope of the proposed solutions.

Rather than subjecting themselves to the uncertainty associated with the implementation of legislative fixes — or ceding control over the economic impact of a switch of reference rates in contracts subject to such a fix — institutions should continue to look to proactively minimize their exposures to LIBOR. That may include the renegotiation or amendment of contracts where possible, consent solicitations or voluntary conversion offers (such as the Federal Farm Credit Bank's recent bond exchange offer).

Firms should also closely monitor the further progression of proposed legislation, as ongoing deliberations and implementation specifics might well change the scope of contracts affected and the associated economic and operational impacts.

It's certainly nice to have a parachute when jumping out of an airplane, but only if one can be sure that it's big enough and fully functional. So it may be advisable to find a way to land the plane and disembark more comfortably and predictably.

[1] For additional information, please read *FS Bill sets out FCA's new powers to support the LIBOR transition*

No regulatory endorsement of a credit-sensitive rate or SOFR spread adjustment

What happened: The U.S. regulatory agencies sent a letter to the participants of the Credit Sensitivity Group (CSG) workshops organized by the FRB NY, indicating that the official sector did "not plan to convene a group to recommend a specific credit-sensitive supplement or rate for use in commercial lending products." The workshops 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 in stress periods.

The letter reasons that the official sector does not seem well-positioned to serve as arbiter in the selection of a reference rate between lenders and their customers. In acknowledging firms' calls to continue exploring possible credit-sensitive alternatives, the FRB NY confirmed that it would organize two more workshops with the objective of fostering innovation.

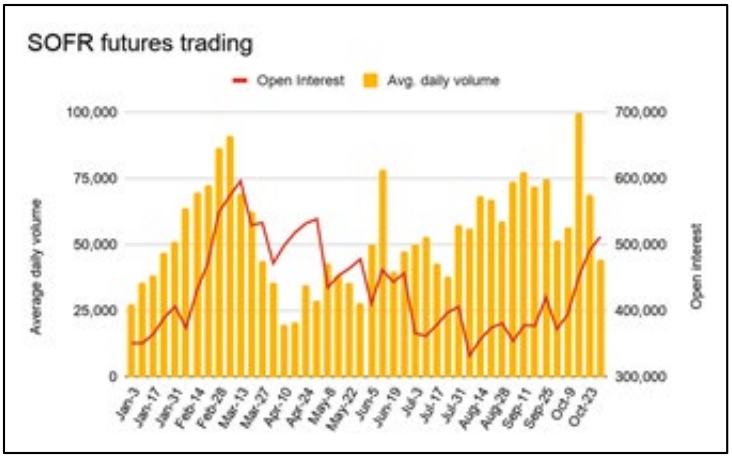
Our take: The regulators' letter seems to confirm what we have often cautioned in previous issues: the emergence of a credit-sensitive benchmark or incremental spread prior to LIBOR's cessation is highly unlikely. At the same time, we expect that some in the industry might point to the letter's reminder that the adoption of SOFR is voluntary as a rationale to further delay their transition efforts in the hope for the emergence of a credit-sensitive alternative. They should not delay their transition.

As the likelihood of a credit-sensitive SOFR add-on emerging prior to LIBOR's cessation clearly is remote, certain banks' concerns around funding pressures in economic downturns will continue to remain unaddressed. In the absence of a credit-sensitive rate or add-on, alternative solutions may need to evolve to mitigate the funding risks — for example, by reducing the tenor of contingent facilities or providing other avenues to compensate for the incremental risks banks are taking on as part of the shift to SOFR indexed structures.

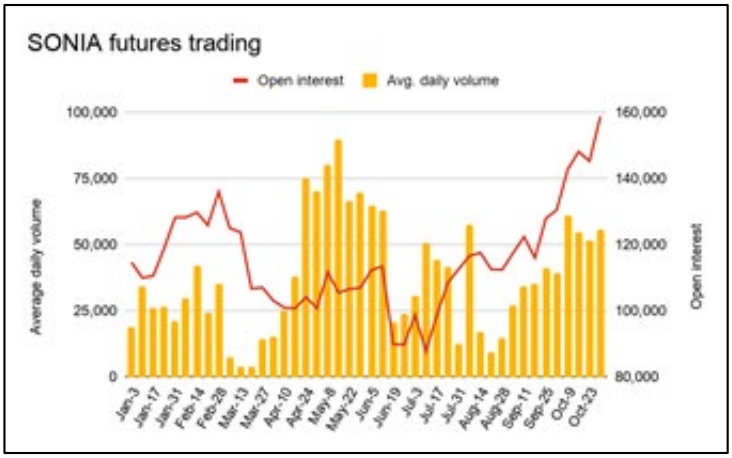
Regulators indicated they would not criticize an organization "solely" for using a rate other than SOFR. During the CSG workshops, the FRB NY reminded participants that any alternative rate would need to be sufficiently liquid and robust. While the mere choice of reference rate might not be grounds for regulatory criticism, it appears that the bar for defending the suitability of a possibly less established, less robust and less liquid benchmark rate has nevertheless been set rather high.

2 RFR adoption: Derivatives

Futures and options



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



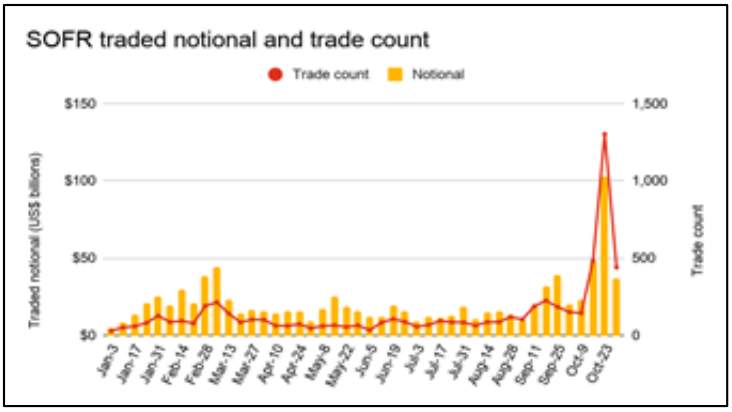
Source: CME, LCH, ICE (accessed November 1, 2020)

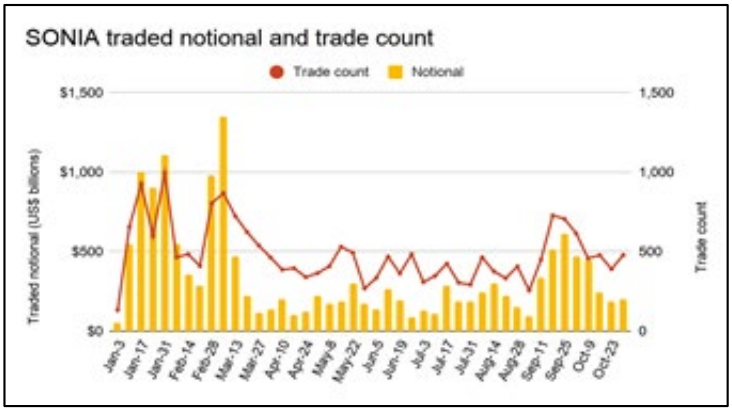
Our take

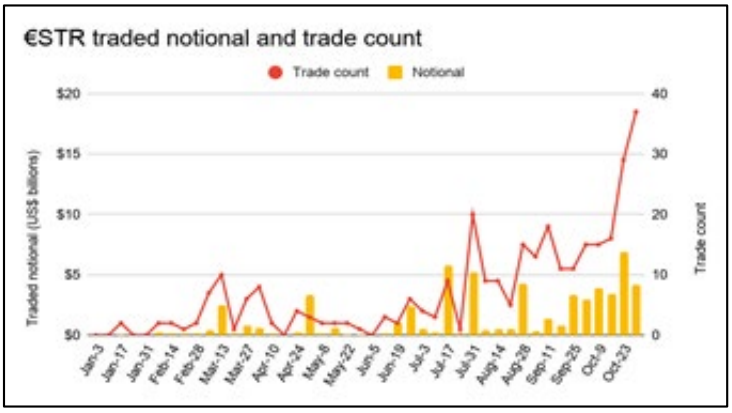
SOFR trading volumes have tapered off somewhat, after reaching a record high of nearly 100k contracts traded daily during the week ending October 16. Open interest has not yet followed that decline, instead climbing above 500k contracts for the first time since April this year.

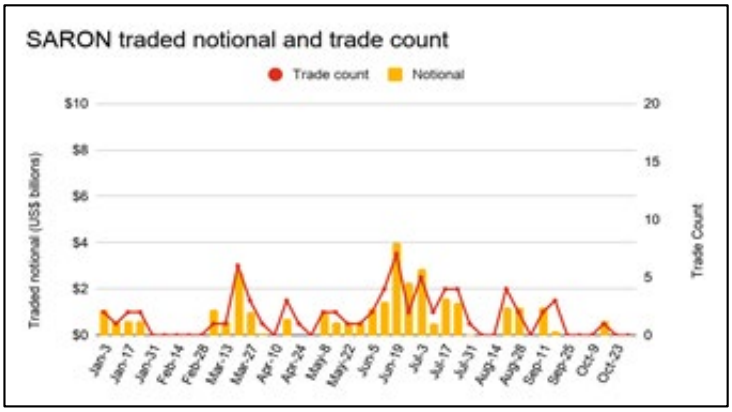
SONIA futures trading has seen steadily high trading volumes, with open interest now at an all time high. The past two weeks saw the first trading activity in CurveGlobal's new 1 Million Three Month SONIA futures (i.e., contracts based on a notional amount of GBP 1,000,000), which had been introduced in September of this year.

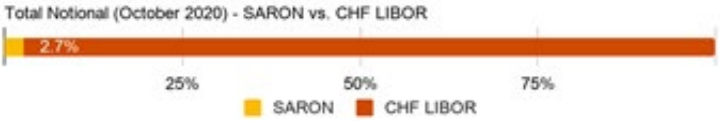
Swaps trading









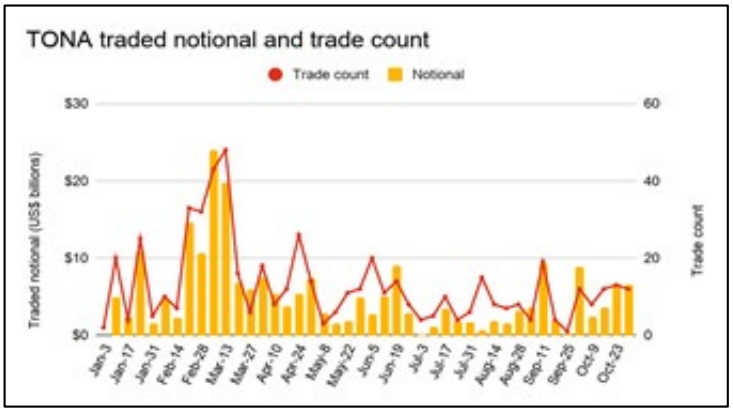


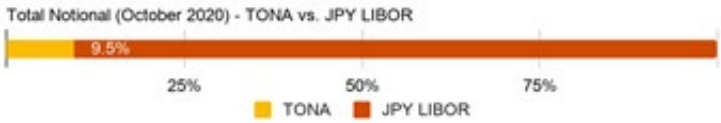
Our take:

October 27 marked the Bank of England's (BOE's) and Financial Conduct Authority's (FCA's) recommended date for a change in the quoting convention of GBP sterling interest rate swaps in the interdealer market from GBP LIBOR to SONIA. While trading activity had picked up in advance of that date, volumes and notional reported in the days following the change have yet to point to a wholesale shift in the market. While SONIA swaps trading has eclipsed that of GBP LIBOR for the past three months, over 40% of GBP swaps trading continues to be conducted in LIBOR.

In other SONIA swaps trading news, JP Morgan served as the liquidity provider in the first electronic execution of SONIA swaps against gilt futures.

Trade counts and notional €STR swaps are finally showing some sustained momentum, after trading in the first half of 2020 could at best be described as sporadic.





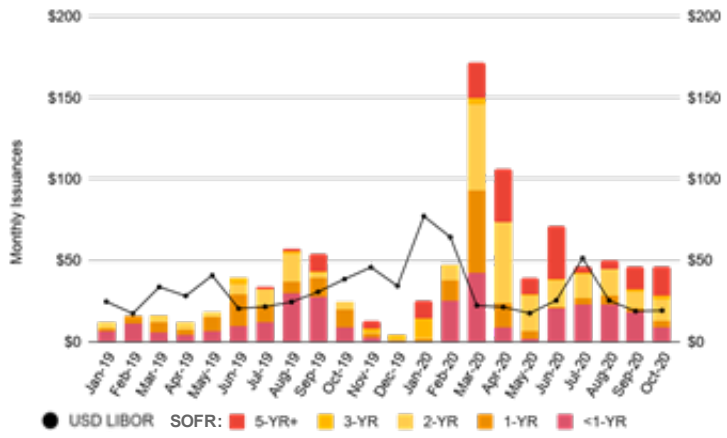
Source: analysis.swapsinfo.org (Interest rate and credit derivatives weekly trading volume: Week ending October 30, 2020, accessed November 2, 2020)

3 RFR adoption: Cash products

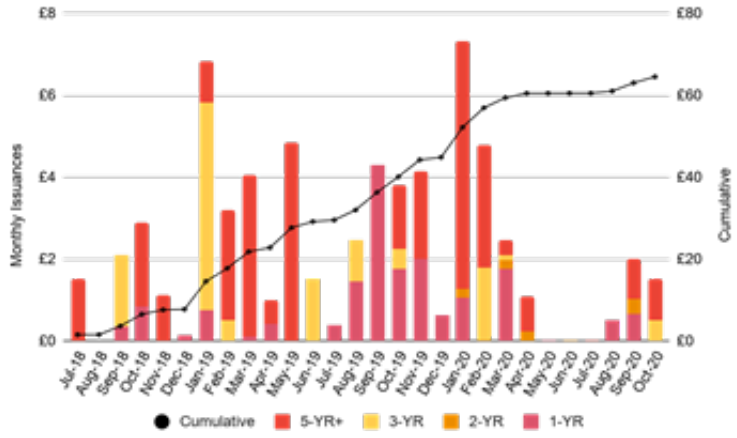
FRN issuances *(as of October 30, 2020)*

Source: Bloomberg

USD FRN issuances (in billions)



SONIA FRN issuances (in billions)



Our Take:

For the first time since May, over half (55%) of SOFR FRN issuances for the month of October have come from non-GSEs. Further, the majority of FRNs issued last month came in maturities of five years or longer. The total issued amounts of FRNs referencing SOFR have been more than double those in FRNs referencing USD LIBOR in each of the past three months. Looking ahead to the ARRC's stated target for an end to issuances of LIBOR referencing FRNs by the end of the year, we expect this trend to continue.

After a slowdown during the summer months, there have been SONIA FRNs issued in each of the past three months. There have been a total of only €3.9 billion in €STR FRN issuances to date, with all issuances in maturities of three years or less.

Notable cash product issuances and other RFR adoption

RFR	Company	Detail	Resources
SOFR	CoBank	CoBank's extension of a term loan is an example of simultaneous addition of ARRC Fallback language.	Press Coverage
	JPMorgan	Marketing the first prime mortgage-backed security (MBS) to reference SOFR.	Press Coverage
	Morgan Stanley	Will link its inaugural social bond to SOFR.	Press Release
	Freddie Mac	Continued its issuance of SOFR-linked K Deals.	Press Release
		Completed the first single-family credit risk transfer offering indexed to SOFR.	Press Release
	Fannie Mae	Issued the first multifamily and single-family SOFR ARM MBS.	Press Release
	Bank of America	Executed a $8.5 billion SOFR FRN issuances in five tranches.	Press Release *(by outside counsel)*
SONIA	Barclays	Informed holders of its global covered bond program transition to SONIA.	Bondholder Notice
SORA	OCBC Bank	Issued the first SORA-based loan in the energy sector.	Press Release

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)

- Updated its paced transition plan to reflect the completed SOFR discounting transition.
- Updated its FAQ regarding its RFP for a vendor to publish SOFR term rates.
- Published minutes from its September 9 meeting and an agenda for its October 21 meeting.

WG on Sterling RFRs

- Published summaries of publicly available RFR calculators and key attributes of currently published beta versions of SONIA term rates.

WG on Euro RFRs

- Published its October newsletter, announcing it would publish consultations on EURIBOR Fallback trigger events and EURIBOR Fallback rates based on €STR for cash products in November.

NWG on CHF Reference Rates

- Published the full minutes and materials from the WG's Sep 29 meeting.

Cross Industry Committee on JPY IR Benchmarks

- The committee has elected a new chair.

Canadian Alternative Reference Rate working group

- The Canadian Fixed Inc. Forum expanded CARR's mandate to include analysis of the efficacy of CDOR as a credit-sensitive benchmark.

Steering Committee for SOR Transition to SORA (SC-STS)

- Announced a timeline and set of target dates for the transition to SORA. The committee also updated its benchmark transition checklist.

Regulators

- **FSB:** Published a global roadmap for the transition from LIBOR.
- **US Regulators:** Sent a letter to the Credit Sensitivity Group, indicating the official sector did not plan to endorse a credit-sensitive rate.
- **New York State Senate:** The ARRC's proposal for legislative relief for legacy LIBOR exposures has been introduced in NY's senate.
- **FASB:** Published a proposed ASU to clarify the scope of provided relief, such that contracts impacted by the transition to ARRs would be eligible for certain relief even if they do not reference LIBOR directly. Comments on the exposure draft are due by November 13. Launched new benchmark reform project page with information on related projects, including the scope refinement & fair value hedging.
- **FHFA:** Sent a letter to FHLBanks with the directive to adhere to the ISDA IBOR Fallbacks protocol no later than by year-end.
- **UK Parliament:** Published Financial Services Bill 2020, which would amend the BMR to grant the FCA powers to address tough legacy contracts through the possible creation of a synthetic LIBOR. Additional information was published in HMT's supporting policy statement.
- **Bank of England:** Announced that it had signed up to the ISDA IBOR Fallbacks Protocol.
- **European Parliament (Think Tank):** Published its initial appraisal of the EC's review of the BMR.
- **FINMA:** The Swiss banking regulator urged firms to sign the ISDA IBOR Fallbacks Protocol.
- **Bank of Japan:** In its latest Financial System Report, the BoJ suggested it would continue to monitor the "degree of preparation of individual financial institutions and, as necessary, individually encourage them to accelerate their preparations."
- **HKMA:** Wrote to CEOs of supervised institutions reminding them to adhere to customer protection principles during LIBOR transition.
- **CFTC:** Heath P. Tarbert, chairman and chief executive, tweeted his approval of the successful SOFR discounting transition.

Industry groups, infrastructure providers and other items

- **ISDA:** Launched the IBOR Fallbacks Supplement and Protocol. Scott O'Malia commented in ISDA's derivatiViews blog. The list of adhering parties is updated daily. Supporting publications include an introductory animation and webinars on the protocol's scope and mechanics, methodology and publication of fallbacks and the bilateral templates, ISDA Create and IHS Markit Outreach 360. Published its Q3 report on the transition from LIBOR to RFRs.
- **Swiss Banking:** Published the Benchmark Amendment Agreement and updated definitions applicable to Swiss Master Agreements.
- **Quick Corp.:** Began publication of prototype Tokyo Term Risk-Free Rates (TORF), calculated based on JPY OIS.
- **LCH:** Announced that the SOFR discounting switch was a success and published final results of the compensating swaps auction.
- **CME:** Announced that the basis swap auction process as part of the SOFR discounting transition had been completed.
- **ICE Futures Europe:** Asking for feedback (by November 13) on its proposal to transition open GBP LIBOR-based futures to SONIA in case of LIBOR cessation.
- **LSTA:** Hosted a call on LIBOR remediation with buy-side members. A recording is available on LSTA's website (member-access only). Published its presentation slides for its LIBOR transition update at this week's LSTA Annual Conference (member-access only). Commented on the IRS' revenue procedure intended to provide relief from some of the tax impacts of LIBOR transition.
- **LMA:** Updated its list of syndicated and bilateral loans referencing RFRs. Published a note on the revised replacement of screen rate clause and pre-cessation trigger (member-access only).
- **AFME:** Published EURIBOR benchmark modification language for inclusion in securitization contracts.
- **ICMA:** Published minutes from the September meeting of the LIBOR Transition Working Party.
- **SFA:** Discussed LIBOR transition progress in the FRN markets.
- **CRE Finance Council:** Reported on draft legislation circulated by Rep. Brad Sherman (D-CA), chair of the House Capital Markets Subcommittee, which is intended to address the issue of legacy LIBOR-based contracts without adequate fallback language.
- **Freddie Mac:** Announced it had completed its First Single-Family Credit Risk Transfer Offering Indexed to SOFR.
- **Federal Farm Credit Banks Funding Corporation:** Announced that 83% of LIBOR-linked FRNs were swapped for bonds containing ARRC's hardwired fallback language as a result of its voluntary exchange offer.
- **Government Finance Officers Association:** Issued a member alert on LIBOR transition.
- **Lending Standards Board (with UK Finance):** Published a guidance booklet on how firms can support SME customers during the transition away from LIBOR.
- **Bank Policy Institute:** Bill Nelson, the institute's chief economist, is suggesting that a replacement for LIBOR should not only be credit-sensitive, but also liquidity risk-sensitive.
- **CurveGlobal:** Sponsored a report on industry readiness and remaining risks and challenges related to the transition from LIBOR.

LIBOR transition target dates

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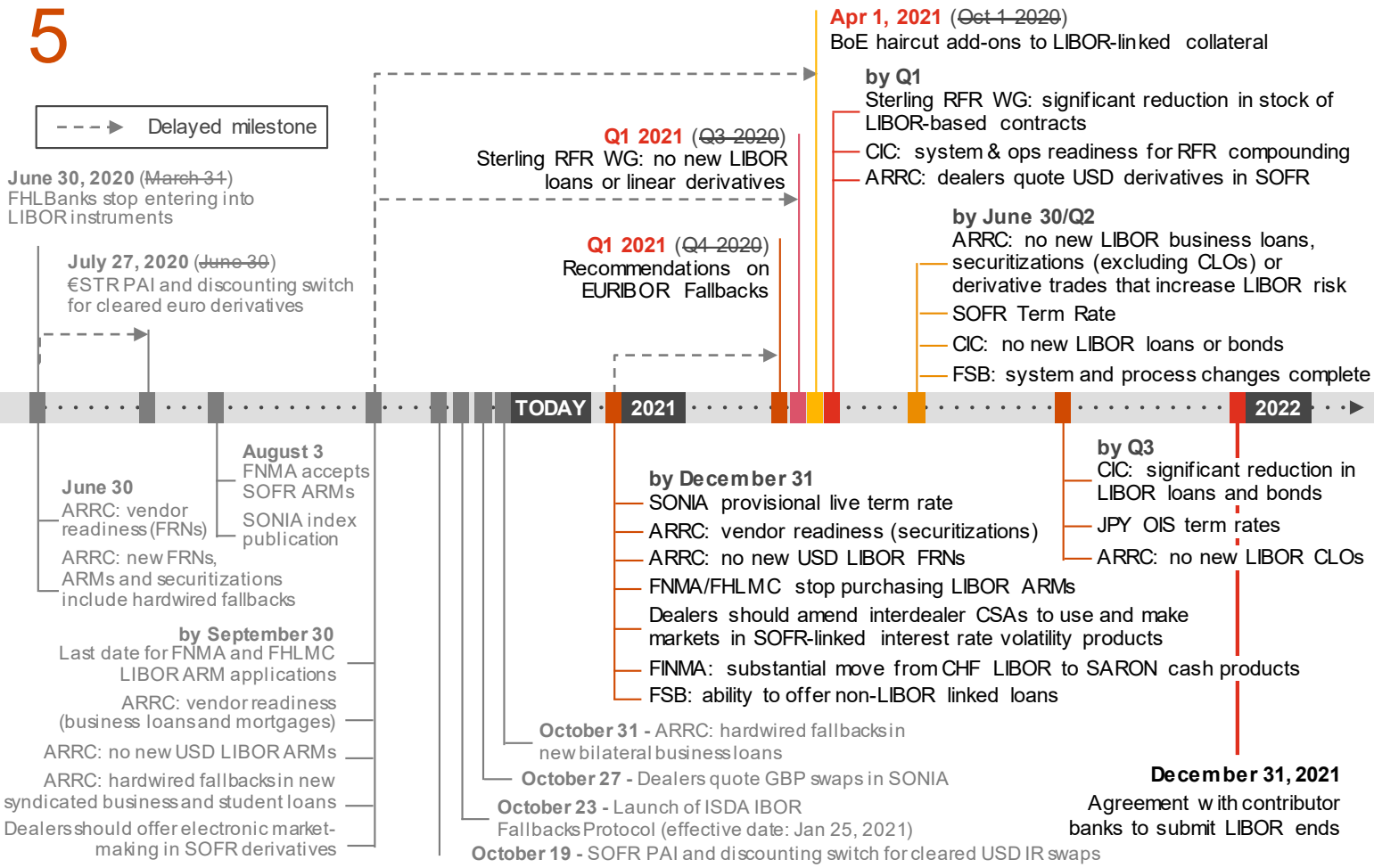

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