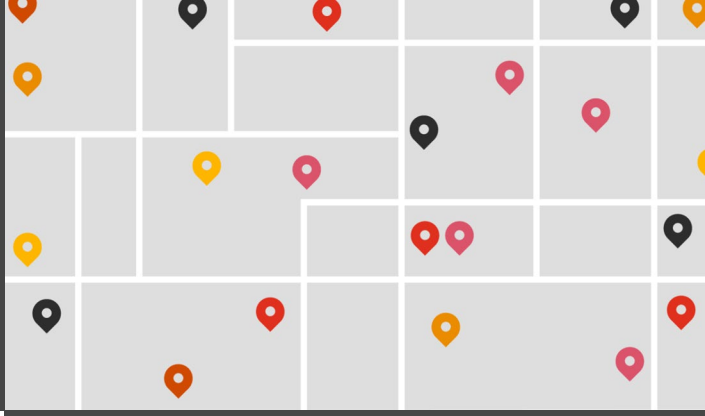
LIBOR Transition

Market update: September 1-15, 2020



472 days to December 31, 2021

1 Highlights

GBP Sterling business loan conventions

What happened? The WG on Sterling Risk-Free Rates (RFRs) issued guidance on conventions for the use of SONIA in bilateral and syndicated business loans. The WG suggests the use of SONIA compounded in arrears, recommending a five-day lookback without an observation shift (i.e., interest due is based on a period that begins five business days before the interest rate period and ends five business days before the payment date), thereby allowing for the interest payment to be known prior to the due date. The WG also notes that, in the case of interest rate floors, it may be necessary to apply the floor to each daily interest fixing prior to compounding. Finally, in the case of prepayment, accrued interest should be paid at the time of principal prepayment.

Supporting documents that were published along with the WG's recommendations include a presentation on the different loan conventions, summary results of an earlier market survey and a spreadsheet of worked examples.

As previously communicated by the WG, market participants should be ready to offer non-LIBOR loan products by the end of Q3 2020.

Our take: The number of publicly disclosed SONIA-based bilateral business loans is still in the single digits. It remains to be seen whether the WG's recommendations can provide a needed boost. As is the case with the ARRC's recommendation for loan conventions, the WG's recommendations do not form a definitive market standard. It does however, endorse the conventions chosen for most of the few new RFR loans issued to date. We believe that there will inevitably be market participants who will find themselves in a situation in which a different approach is appropriate.

While the WG's recommendation should reaffirm many firms' chosen conventions for new SONIA-indexed loans, they do

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not reflect a unified market standard. No matter what a firm's preference may be, firms will likely need to support multiple conventions.

The same holds true for the US Dollar loan market. While we are still awaiting the ARRC's recommendations for bilateral business loans, its guidance on syndicated loans effectively provided a broad menu of convention choices to market participants while endorsing the use of either daily simple or compounded in arrears SOFR based on an lookback (unstated period) without observation shift. Whether in the US or in the UK, in order to meet the target dates articulated by the different working groups, market participants will need to make their own choices based on their specific needs — rather than waiting for the market to settle on a single convention.

Transition guidance for legacy LIBOR-based GBP Sterling loans and bonds

What happened? The WG on Sterling RFRs published papers on the transition of GPB LIBOR referencing loans and bonds. The former paper is directed at wholesale loan market participants, including lenders, borrowers and investors. The latter paper provides guidance to issuers on the transition of existing GBP LIBOR-based bonds to an alternative reference rate.

The WG strongly suggests transitioning business loans on a pre-emptive basis, rather than relying on contractual fallback language to switch the reference rate at the time of LIBOR's cessation. Specifically for borrowers, the WG expects the guidance to provide a starting point for an informed discussion with lenders on possible contract amendments. Borrowers, as well as other market participants, are encouraged to:

- Review fallback and other contractual amendment provisions in outstanding GBP LIBOR loans
- Identify an alternative reference rate to be used for each loan, taking into account the WG's recommendation of SONIA as the alternative to GBP LIBOR
- Familiarize themselves with the methodological and economic differences between GBP LIBOR and SONIA
- Analyze systems and operations capabilities and readiness to accommodate alternative reference rates
- Document the transition of the loans
- Undertake due diligence on any changes that are proposed by the loan parties

For parties who wish to actively transition loans prior to LIBOR's actual cessation the WG recommends the use of a built-in switch mechanism, created through the inclusion of a mutually agreed-upon contractual provision that would automatically switch the loan from GBP LIBOR to a specified alternative reference rate.

The WG's paper on the transition of GBP LIBOR-based bonds provides a broad summary of the consent solicitation process, i.e., obtaining agreement to a change in contractual terms from a majority of bondholders.

Our take: Firms should not rely on updated fallback language to transition legacy LIBOR-based loans to an alternative reference rate. As firms develop their transition strategy, they should consider not only the likely benefits of transitioning contracts on terms they can agree on with their counterparties but also the potential challenges of operationalizing the processing of fallbacks for a large number of contracts.

Large corporates would be well advised to heed the same advice and should look to transition legacy LIBOR-based loans proactively, especially if they hedge their exposures with derivatives. Given the differences in conventions, potential timing differences of when certain fallback provisions are triggered and the possible downstream effects on corporate cash flows, operations or even hedge accounting, corporates that wait might find it increasingly difficult to mitigate the associated risks, including a transfer of value.

The WG's effort to directly address borrowers is likely only the beginning of increased efforts to increase awareness and involve corporates in transition efforts to a greater extent. The speed of the overall transition is determined by the slowest movers — and a proactive transition will require active participation from all parties. Lenders who are looking to increasingly engage their customers in discussions around the transition will find the WG's guidance document useful in facilitating such conversations.

ARRC RFPs for vendors to publish spread adjustments, term rates

What happened? The ARRC issued two separate RFPs seeking vendors to publish its recommended LIBOR fallback spread adjustments and forward-looking SOFR term rates, should the ARRC decide to endorse a SOFR term rate.

The ARRC's RFP for the publication of spread adjustments suggests that the vendor will calculate and publish on a daily basis the ARRC-recommended spread adjustments and spread-adjusted rates that correspond to the various tenors of LIBOR currently in use today. The published data would include

spread-adjusted rates for different versions of SOFR, such as SOFRs compounded in arrears, daily simple SOFR, in advance SOFRs and SOFR term rates. Such information would be available to the general public at no cost, with publication expected to begin by March 31, 2021.

The RFP for the publication of SOFR term rates requires the prospective vendor to propose a methodology and data sources to calculate 1-month and 3-month SOFR term rates on a daily basis, with the publication of 6-month or 1-year term depending on feasibility. Publication is targeted to begin by June 30, 2021.

Responses to the RFPs are due on October 16 and October 31, 2020, respectively.

Our take: The RFP issuances might be considered a formality at this point but nevertheless reflect further tangible progress in the transition away from LIBOR. While expected, the prospect of a publicly available spread-adjusted SOFR that can serve as a reference in contracts should provide additional certainty for firms awaiting confirmation on the future availability of an official data source for a calculated spread adjustment.

The most important caveat, however, remains that the issuance of the RFP by no means guarantees that a term rate will actually be available by the end of Q2 2021. Further, firms that continue to delay the issuance of new SOFR loans in the hopes for a SOFR term rate are unlikely to meet the ARRC's target date for cessation of issuances of new LIBOR business loans, set for June 30, 2021.

Whether they prefer a term rate or not, firms that do not establish the capability to lend using SOFR in arrears might put themselves at a competitive disadvantage. It is difficult to envision a scenario in which SOFR in arrears loans do not become a part of the commercial lending market. The LSTA, for instance, only recently published a concept credit agreement referencing daily simple SOFR or daily compounded SOFR. Firms should employ the available tools and guidance to establish capabilities to lend using SOFR in arrears now, even if they plan to employ a SOFR term rate once it becomes available.

Discounting switch impact on swaptions

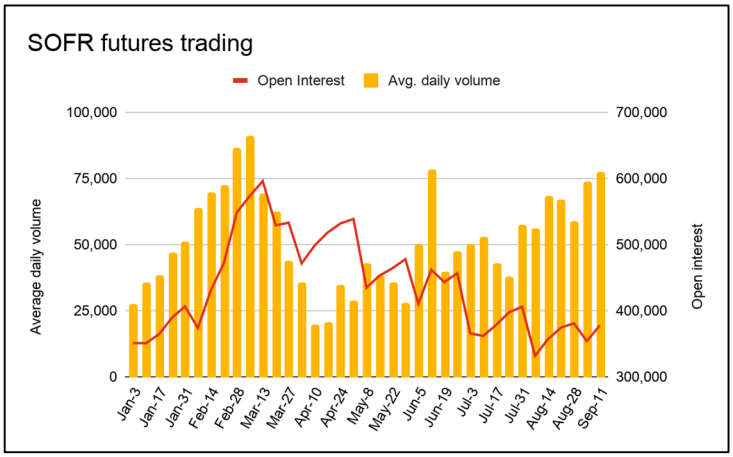
What happened? The ARRC published an update to its recommendations for an exchange of voluntary compensation for swaptions impacted by the upcoming SOFR price alignment interest (PAI, the interest paid on variation margin) and the discounting switch from the effective federal funds rate (EFFR) to SOFR. To account for the likely change in valuation of swaptions as a result of the switch, the committee had previously recommended that counterparties bring affected legacy swaptions into scope for ISDA's Supplement 64 (which allows parties to specify a discount rate for the cash settlement of swaptions) and exchange cash compensation to offset any change in valuation.

Conceding that a number of market participants are unlikely to follow its recommendation for such a voluntary exchange of compensation, the ARRC amended its original proposal to suggest that parties that cannot agree on exchanging compensation at the very least amend their legacy swaptions to bring them into scope for ISDA's Supplement 64 and specify SOFR as the discount rate.

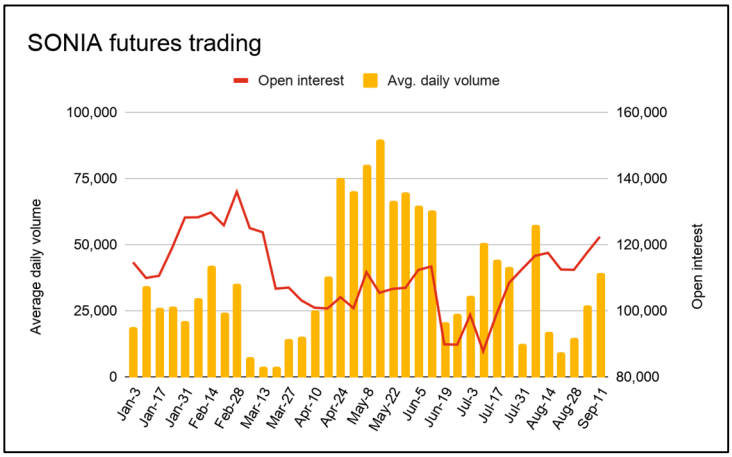
Our take: As we had anticipated, the level of adoption of ARRC's voluntary compensation recommendations has apparently been limited. As the behavior of each party to a contract may be affected by whether it would be a payer or receiver of compensation — combined with the lack of a legally binding mandate — this outcome should come as no surprise. The ARRC's updated recommendation effectively suggests that market participants still take advantage of ISDA Supplement 64 and specify SOFR as the discount rate, which, although not resolving the current compensation debate, would nevertheless provide clarity with respect to the valuation of legacy swaptions following the discounting switch and reduce the likelihood of future legal disputes among counterparties.

2 RFR adoption: Derivatives

Futures and options



Source: CME, ICE (accessed September 15, 2020)



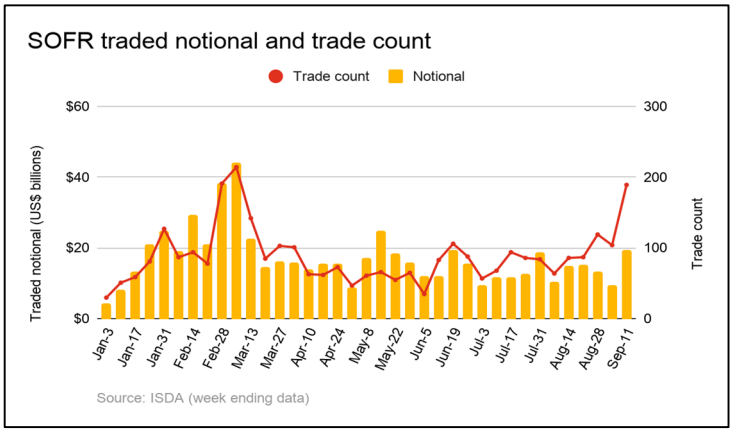
Source: CME, LCH, ICE (accessed September 15, 2020)

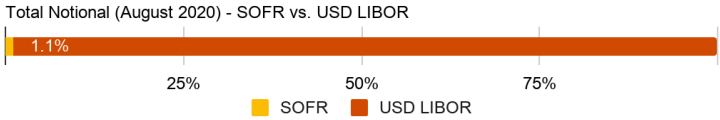
Our take

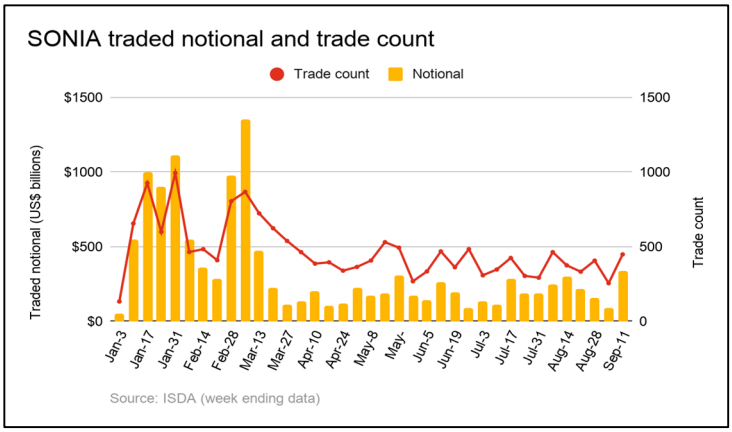
Average daily trading volumes in SOFR futures have steadily continued upward over the past few weeks, although open interest remains far below levels seen in February. As trading volumes continue to increase, open interest should increase.

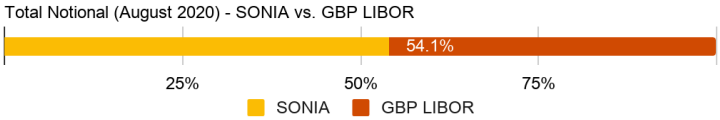
For the first time since July, last week saw a meaningful number of 1M SONIA Futures being traded at ICE. Combined with a significant uptick in 3M trading volumes, these increases drove a sharp uptick in both volumes and open interest in SOFR futures, both of which have seen week-over-week increases in each of the past three weeks.

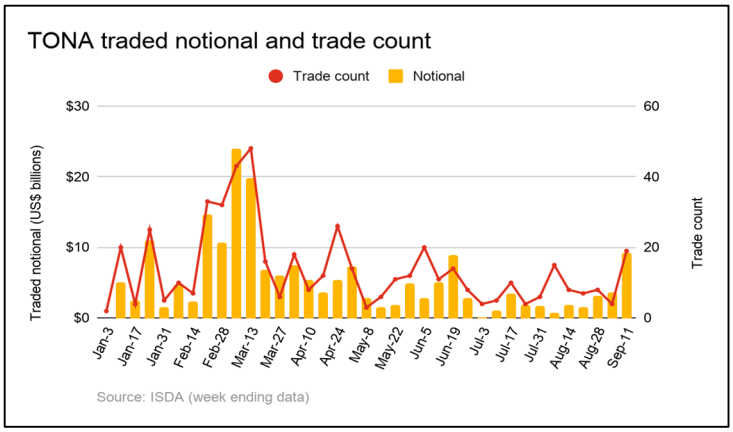
Swaps trading

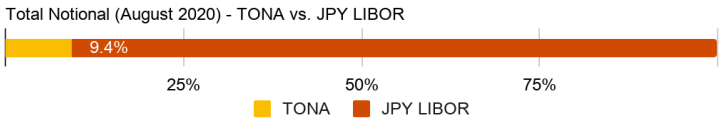


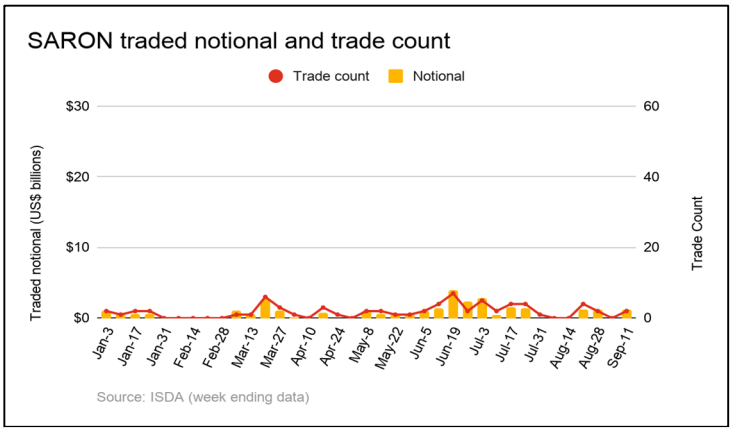


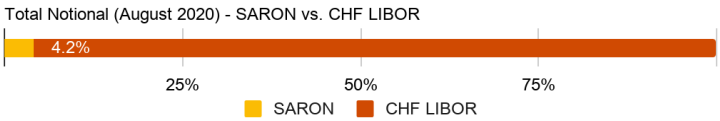








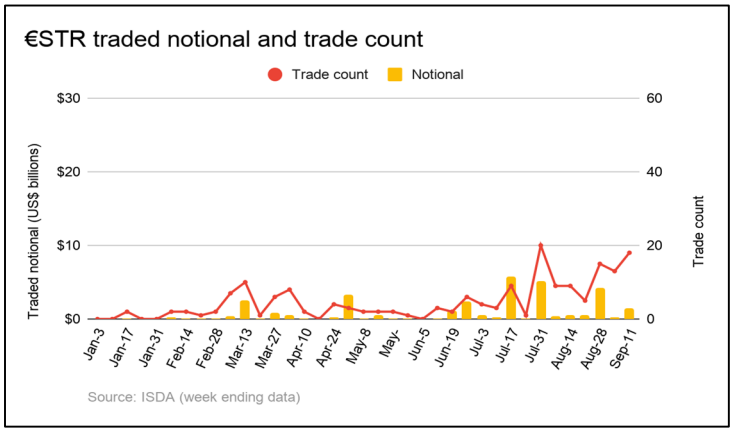


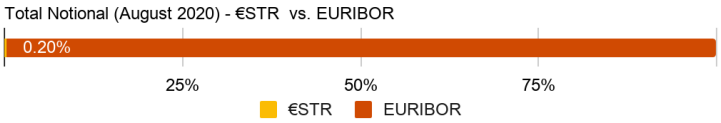


Our take:

Trade counts and notional for SOFR, SONIA and TONA swaps increased sharply last week, with volumes in SOFR trading almost matching levels last seen in the beginning of March. All three of the RFRs also saw their total notional increase compared to their LIBOR counterparts. In the case of GBP Sterling, the majority of notional is now again traded in SONIA.

€STR continues to lag behind, perhaps somewhat unexpectedly, given the recent PAI and discounting switch from EONIA to €STR. The following weeks should provide some indication whether the lackluster €STR volumes can be attributed to the slower European summer months.





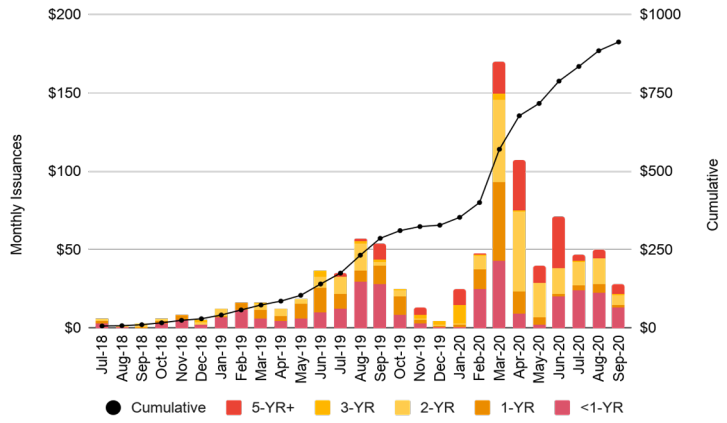
Source: analysis.swapsinfo.org
(Interest rate and credit derivatives weekly trading volume: Week ending September 11, 2020, accessed September 15, 2020)

3 RFR adoption: Cash products

FRN issuances *(as of September 11, 2020)*

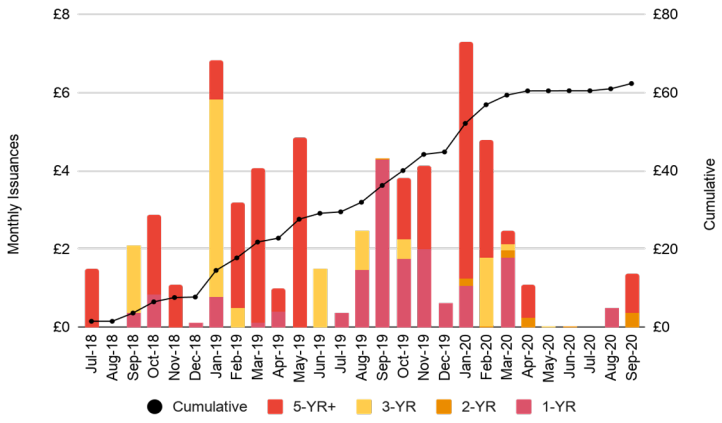
SOFR FRN issuances (in billions)

- Over 75% of issuances in the first two weeks of September came from GSEs, accounting for just over $21 billion of the almost $28 billion in new FRNs. Almost half of that total came in issuances of maturities greater than 2 years, i.e., beyond LIBOR's presumed cessation date.
- 10 FRNs came from first-time SOFR issuers.



SONIA FRN issuances (in billions)

- We are beginning to see at least some activity returning to the SONIA FRN market, with four issuances totaling £1.9 billion over August and September.



Source: Bloomberg

€STR FRN issuances have been slow to pick up. There have been a total of €3.9 billion in 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 and other RFR adoption

RFR	Issuer	Detail	Resources
SOFR	World Bank (IBRD)	Issued a $1.5 billion FRN tied to the SOFR index.	Press Release
	Chatham Financial	Executed the first Freddie Mac SOFR interest rate cap for a commercial real estate client.	Press Release
SOFR / SONIA	HSBC (coordinator)	Led a syndicate that refinanced two multi-currency credit facilities for GlaxoSmithKline, linked to both SONIA and SOFR.	Press Coverage
SOFR / SORA	United Overseas Bank	Extended a S$200 million dual tranche term loan to property developer CapitaLand based on compounded averages of daily SORA and SOFR.	Press Release
SORA	DBS	Launched the first business property mortgage loan referencing SORA.	Press Release

For additional detail on employed conventions and other parameters of recent RFR-based loans see also the LMA's recently 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 an update to its recommendation for voluntary compensation for swaptions impacted by the SOFR PAI and discounting switch, suggesting that counterparties that cannot agree on an exchange of compensation before October 16, 2020 should amend their legacy swaptions to bring them into scope for ISDA's Supplement 64 and specify SOFR as discount rate.
- Issued an RFP for a vendor to publish forward-looking SOFR term rates.
- Issued an RFP seeking a vendor to publish the ARRC's recommended LIBOR fallback spread adjustments and spread-adjusted rates.
- Wrote to the US Treasury and IRS requesting guidance concerning the SOFR PAI and discounting switch, suggesting that the switch should not result in a taxable exchange of any financial contracts.
- Updated its recommended best practices to include separate target dates for the inclusion of hardwired fallback language in syndicated and bilateral business loans, September 30 and October 31, respectively.

WG on Sterling RFRs

- Published a statement on standard market conventions for sterling loans based on compounded in arrears SONIA, recommending the use of a five-day lookback without observation shift.
- Released a series of documents to support firms in the transition of existing LIBOR-linked cash products, including guidance for the transition of loans and bonds as well as a recommendation for the use of the historical five-year median spread adjustment methodology to calculate a SONIA spread adjustment for cash products.
- Published its August 2020 newsletter and minutes from its June 23 meeting.

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

- Chair Samuel Tsien provided the keynote address at the recent ABS roundtable, encouraging market participants to actively continue their transition efforts.

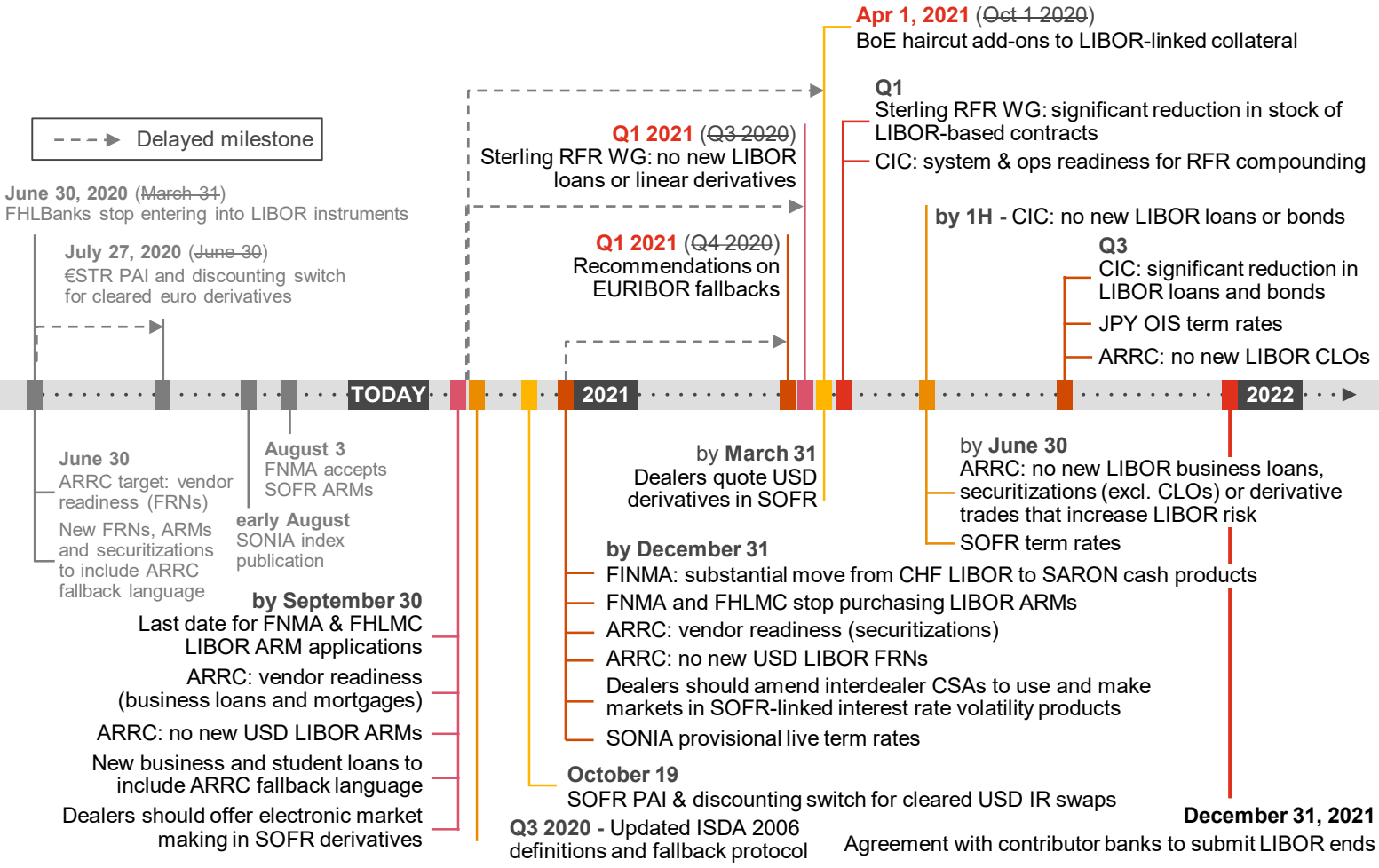
Regulators

- **Bank of England:** Announced a webinar for September 18, held in collaboration with the Association of Corporate Treasurers (ACT), the Confederation of British Industry (CBI) and the Financial Conduct Authority (FCA).
- **Monetary Authority of Singapore:** Jacqueline Loh, Deputy Managing Director, suggested in a speech at the recent ABS roundtable that banks' senior management should expect increased engagement from the regulator in the coming months, especially at banks that do not keep pace with industry timelines.
- **Financial Reporting Council:** Is requesting comments on its draft endorsement of IASB's Phase 2 benchmark reform amendments. The comment period ends September 28.
- **EFRAG:** Submitted its endorsement of IASB's benchmark reform phase 2 amendments to the European Commission.
- **Financial Services Agency:** Presented on LIBOR transition at a meeting of the Japan Business Federation (Keidanren). (in Japanese)

Industry groups, infrastructure providers and other items

- **LMA:** Published (member-access only) an exposure draft multicurrency rate switch facility agreement, based on a lookback without observation shift. Feedback is requested by September 25. It also published an updated webinar on the transition from LIBOR in the loan markets, covering developments since its last webinar in May of this year, and updated its list of syndicated and bilateral loans referencing RFRs.
- **LSTA:** Published (member-access only) a SOFR concept credit agreement referencing either daily simple SOFR or daily compounded SOFR. In a blog post, it also summarized some of the technical aspects of the conventions discussed in ARRC's recently published appendix to its recommendations on SOFR conventions for syndicated loans.
- **ISDA** (w/ ClarusFT)**:** Published its RFR Adoption Indicator for August 2020.
- **LCH:** Confirmed that on September 18 it will begin publishing the indicative portfolio of basis swaps to be auctioned off immediately following the SOFR PAI and discounting switch.
- **ICAEW:** Launched a new dedicated microsite titled "LIBOR transition - what you need to know."

5 LIBOR transition target dates



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