ARRC
Alternative Reference Rates Committee | Newsletter

October-November 2019

This periodic newsletter provides an update for those with an interest in the work of the Alternative Reference Rates Committee (ARRC), keeping you well informed on key news relating to alternative reference rates transition in the U.S. and global markets.

ARRC Developments

- The ARRC welcomed a consultation about the publication of Secured Overnight Financing Rate (SOFR) averages and a SOFR index, issued by the Federal Reserve Bank of New York (New York Fed), in cooperation with the Treasury Department's Office of Financial Research (OFR). Additional details on the announcement are available in the "U.S. Developments" section below.
- The ARRC released recommended contractual fallback language for new U.S. dollar (USD) denominated closed-end, residential adjustable-rate mortgages (ARMs). These provisions were developed with the goal of reducing the risk of serious market disruption in the event that LIBOR is no longer available.
  - Along with this, the ARRC released a summary of all five sets of recommended fallback language it has issued to date for: ARMs, bilateral business loans, floating rate notes, securitizations, and syndicated business loans.
  - Fannie Mae and Freddie Mac also announced that they will use the ARMs language. ARRC Chair Tom Wipf welcomed their decisions noting that they mark "a consequential vote of confidence in the ARRC's work" and "will go a long way in our efforts to safeguard mortgages so lenders, investors, and consumers are ready when LIBOR inevitably becomes unusable after 2021." Additional details on their announcement are available in the "U.S. Developments" section below.
- The ARRC released the Appendix to the SOFR Floating Rate Notes (FRNs) Conventions Matrix. The matrix, issued in August 2019, identifies considerations relevant to using SOFR in new FRNs and was accompanied by the SOFR FRNs Comparison Chart. The new Appendix builds upon these documents and is an additional resource for market participants.
- The ARRC welcomed the United States Department of the Treasury (Treasury) and the Internal Revenue Service's (IRS) release of proposed regulations. These regulations came in response to a letter issued by the ARRC in April 2019 requesting guidance on potential tax issues associated with the move away from LIBOR and other Interbank Offered Rates (IBORs) to alternative reference rates. Additional details on the proposed regulations are available in the "U.S. Developments" section below.
- The ARRC and Securities Industry and Financial Markets Association submitted a comment letter in response to the Financial Accounting Standards Board's (FASB) request for comment on the proposed Accounting Standards Update (ASU), *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*. The letter included feedback on FASB's reference rate reform proposal regarding contract modifications, hedge accounting treatment and transition, and effective dates. As noted in detail in the "U.S. Developments" section below, in November, FASB's Board directed the staff to draft a final ASU for vote by written ballot.
- The ARRC released a letter to the U.S. Commodity Futures Trading Commission (CFTC) requesting interpretive guidance or no-action relief regarding the treatment under the Commodity Exchange Act and the CFTC's regulations of swaps that are amended or that are otherwise transitioned to alternative reference rates in connection with the potential discontinuation of LIBOR. This letter updates the ARRC's prior requests for interpretive guidance and relief issued in May 2019.

U.S. Developments

- The New York Fed, in cooperation with the Treasury Department's OFR, issued a consultation on the daily publication of three compounded averages of SOFR with tenors of 30-, 90-, and 180-calendar days. Additionally, the consultation proposes the publication of a daily SOFR index to support calculation of compounded average rates over custom time periods. The New York Fed proposes to initiate publication of the averages and index in the first half of 2020. Comments on the proposal are due by December 4, 2019.
  - In remarks at the Annual Primary Dealer Meeting, New York Fed Senior Vice President Lorie Logan encouraged feedback on the consultation, noting, "I encourage you to review the proposal and provide feedback, including about the tenors and compounding methodology for the new products. While the response to preliminary socialization of the program parameters has been positive, we recognize the importance of getting these averages right."
- In response to the ARRC's release of the ARMs fallback language, Fannie Mae and Freddie Mac announced that they plan to publish updates to their uniform ARM notes in the first quarter of 2020. These updates will incorporate the ARRC's recommended fallback language for all newly-originated ARMs.
- The Treasury and IRS issued proposed regulations providing relief to taxpayers by allowing them to avoid adverse tax consequences from changing the terms of debt, derivatives, and other financial contracts to replace reference rates based on IBORs with certain alternative reference rates. The proposed regulations address the possibility that modifying a financial contract to an alternative reference rate could result in the realization of income, deduction, gain or loss for Federal income tax purposes or could result in other tax consequences. Comments on the proposed regulations are due by November 25, 2019, though guidance in the regulations can be relied on immediately.
- The Federal Reserve Board, the Farm Credit Administration, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, and the Office of the Comptroller of the Currency announced a proposal to change the swap margin rules to facilitate the implementation of prudent risk management strategies at certain banks and swap entities. To aid in the transition away from LIBOR, the agencies proposed to allow certain technical amendments to legacy swaps without altering their status under the swap margin rules.
- The Federal Housing Finance Agency released a letter to the 11 Federal Home Loan Banks (FHLBs) to instruct them, as of December 31, 2019, to stop purchasing investments in assets tied to LIBOR that have a contractual maturity beyond end-2021. In addition, the letter communicated that, as of March 31, 2020, FHLBs should no longer enter into other LIBOR-based transactions, with limited exceptions, that have maturities beyond end-2021.
- In remarks at a Managed Funds Association conference, New York Fed President Williams addressed what the variability in repo markets means for SOFR. He said that the temporary SOFR spike this fall was unsurprising because "SOFR reflects rates on real-world transactions," and he explained that financial contracts generally refer to an average of SOFR. He noted that this event should not be used as an excuse to delay transitioning away from LIBOR because "like death and taxes, the end of LIBOR is unavoidable, and we must do all that it takes to prepare for a LIBOR-less future."
- During the FASB's November Board Meeting, the Board approved ASU *Reference Rate Reform (Topic 848),* to provide temporary, optional guidance to ease the potential burden in accounting for, or recognizing the effects of, reference rate reform on financial reporting. The Board is expected to issue a final ASU in early 2020.

International Developments

For more details on international efforts for reference rate reform, see the working groups in the U.K., Switzerland, Japan, Hong Kong the euro area, and the Official Sector Steering Group.

- The International Accounting Standards Board released amendments to some of its requirements for hedge accounting to support the provision of useful financial information by companies during the period of uncertainty arising from the phasing out of IBORs. The amendments come into effect from January 1, 2020 but companies may choose to apply them earlier.
- On October 2, 2019, the European Central Bank (ECB) began publishing the euro short-term rate (€STR). €STR reflects the wholesale euro unsecured overnight borrowing costs of banks located in the euro area.
- Also on October 2, 2019, the European Money Markets Institute (EMMI) began publishing the Euro Overnight Index Average (EONIA) under the reformed determination methodology in which EONIA equals €STR plus a spread of 8.5 basis points. EMMI will continue to publish EONIA until January 3, 2022, the date on which the benchmark will be discontinued, to facilitate a smooth transition from EONIA to €STR.
    - The Loan Market Association published a note, €STR publication and changes to EONIA, which provides guidance for market participants on the publication of €STR and the changes made to EONIA.
- The ECB's Working Group on Euro Risk-Free Rates published several updates, including:
    - A report containing recommendations on the transition to alternative reference rates. The report highlights the types of risks financial institutions face and issues recommendations in four key areas: (i) general risk management considerations; (ii) risk management implications of transitioning from EONIA to €STR; (iii) risk management implications of €STR-based fallback rates for EURIBOR; and (iv) additional risk management considerations for the asset management and insurance sectors.
    - Q&As on euro risk free rates addressing general benchmark rate questions, transition issues, fallback rates, and the development of term rates and derivative markets, among other topics.
- The Working Group on Sterling Risk-Free Reference Rates formed and published several updates, including:
    - A Senior Advisory Group to provide strategic support and encourage senior engagement at firms to help achieve the Working Group's deliverables and objectives.
    - Letters to the European Commission, Basel Committee on Banking Supervision, Prudential Regulation Authority and Financial Conduct Authority (FCA) regarding regulatory barriers to transition away from LIBOR and other IBORs. The letters request these groups consider the issues raised and take concrete actions to ensure a smooth transition.
- The Bank of England published several updates, including:
    - The October 2019 Financial Policy Summary and Record, which stresses the importance of accelerating the transition away from LIBOR to alternative reference rates. The Financial Policy Committee welcomes measures taken by regulators and encourages further potential policy and supervisory tools to reduce LIBOR exposures.
    - The minutes from the September SONIA Stakeholder Advisory Group. The group reviewed the role of the SONIA Stakeholder Advisory Group, market conditions, as well as SONIA borrowers, contingency arrangements and evolving uses.
- The FCA issued a summary of key Q&As on conduct risk arising from LIBOR transition, outlining expectations that i) firms should have a strategy in place and take necessary action during LIBOR transitions, and ii) customers are treated fairly by following FCA rules and guidance.
- The Cross-Industry Committee on Japanese Yen (JPY) Interest Rate Benchmarks released a statement soliciting potential future administrators of JPY term reference rates. As described in its public consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks, a gradual two-phase approach will be used to calculate and publish term structures based on JPY overnight index swaps. In the near term, the selected entity will calculate and publish prototype rates in Phase 1 (i.e., rates which are not to be referenced in contracts for various financial instruments and transactions).

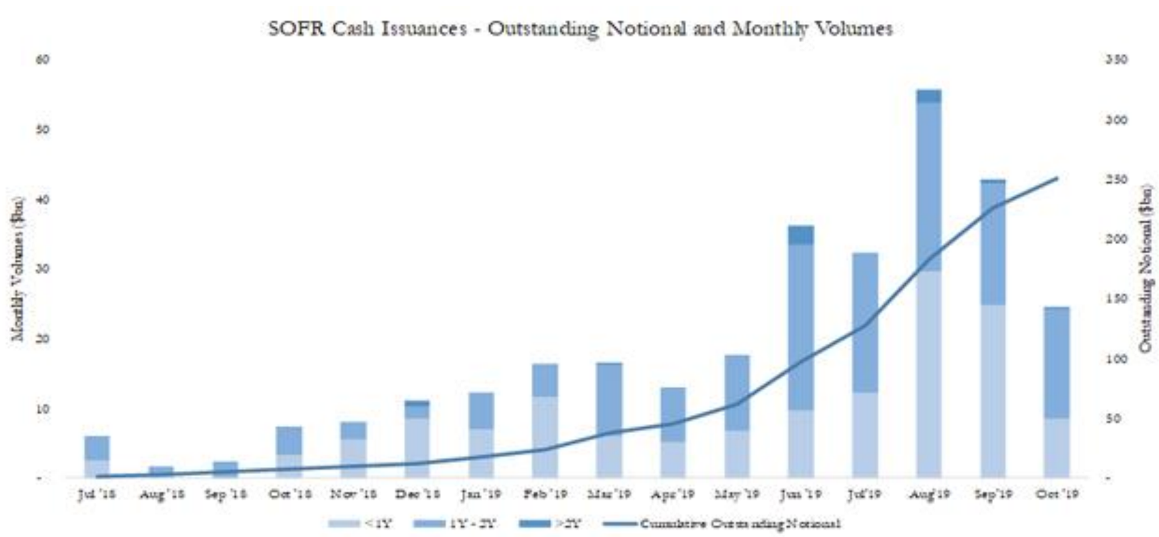
Market Developments

- J.P. Morgan executed its first bilateral SOFR-linked loan with Brazilian bank Itau BBA, noting this new loan transaction is a concrete step towards developing a SOFR loan market.

- The CME Group published a proposal for SOFR discounting and price alignment transition for cleared swaps. CME is targeting a discounting transition date of October 16, 2020, on which it will perform a special valuation cycle, calculating variation margin and cash payments as computed with SOFR-based discounting/PAI. CME plans to finalize its approach by December 2, 2019.
- The London Clearing House announced it is the first clearing house to offer clearing of euro-denominated swaps benchmarked to €STR, which were launched in response to strong market demand. LBBW and Morgan Stanley were among the first participants to clear derivatives using €STR.
- The International Swaps and Derivatives Association (ISDA) published a report summarizing responses to its May-July 2019 consultation on pre-cessation issues for LIBOR and certain other IBORs. Based on responses, ISDA will continue working toward a proposed solution for addressing non-representative covered IBORs and how to implement a pre-cessation trigger for fallbacks in such a scenario.
- ISDA published a report that summarizes responses to a consultation on the final parameters of adjustments that will apply to derivatives fallbacks for certain IBORs. The report follows two earlier consultations that found the overwhelming majority of respondents preferred the 'compounded setting in arrears rate' to address differences in tenor between IBORs and overnight risk-free rates, and the 'historical mean/median approach' to deal with differences in credit risk and other factors. The new report covers technical issues on specific methodologies for the two adjustments.
- The Co-Chairs of the Financial Stability Board's Official Sector Steering Group—New York Fed President John Williams and the U.K. FCA's Chief Executive Office Andrew Bailey—sent a letter encouraging ISDA to add a "pre-cessation" trigger alongside the cessation trigger as standard language in the definitions for new derivatives and in a single protocol, without embedded optionality, for outstanding derivative contracts referencing key IBORs. The letter notes that this is important "to reduce systemic risk and market fragmentation."

SOFR Market Liquidity

- $303bn notional in floating rate instruments tied to SOFR have been issued, with over $250bn outstanding notional at October month-end.

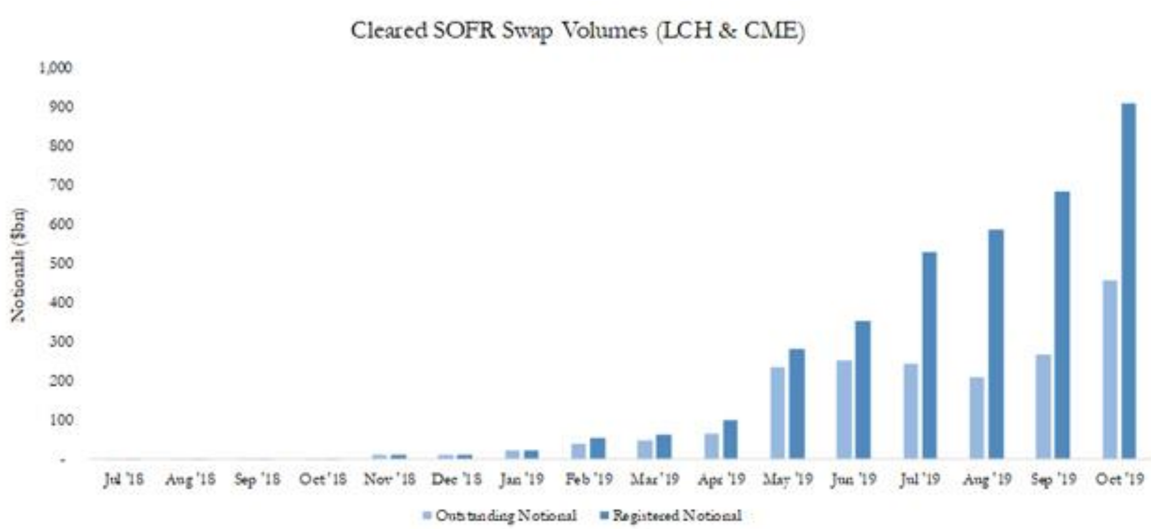


(As of October 31, 2019; Source: CME Group)

- In October, average daily notional volume of SOFR futures was over $168bn. At month-end, total outstanding open interest was over $1,956bn.

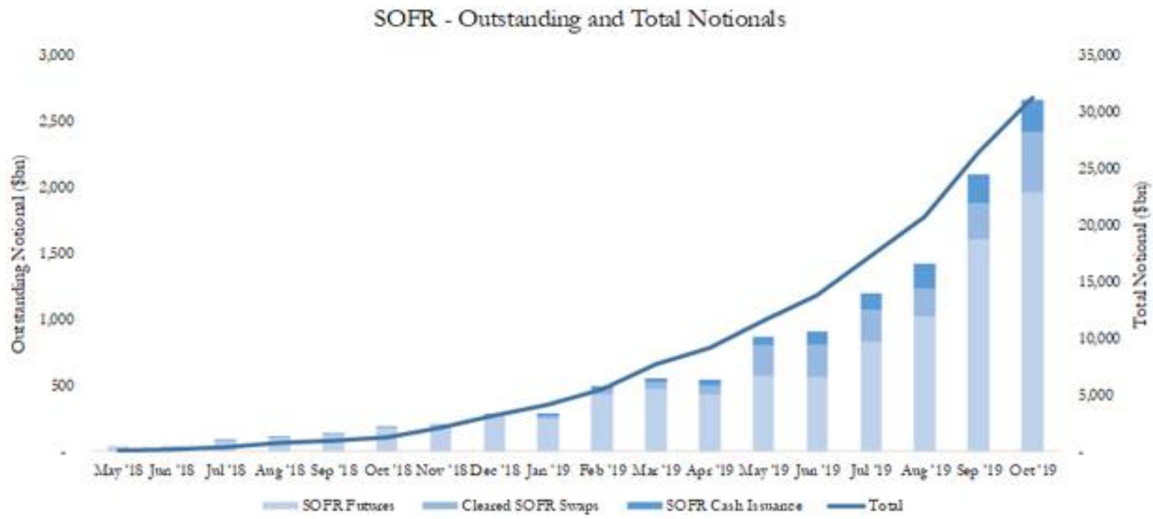
(As of October 31, 2019; Source: CME Group, ICE)

- SOFR cleared swaps have reached over $457bn outstanding notional. Combined registered notional volumes across LCH and CME exceeded $908bn.
    - For cleared swaps, outstanding notional represents the notional amount of all outstanding swap contracts live at LCH and CME. Meanwhile, registered notional in the chart below represents the aggregate notional amount of all new swap contracts submitted to and cleared through LCH and CME.



(As of October 31, 2019; Source: LCH, CME Group)

- Since the inception of SOFR in April 2018, total notional across all types of instruments has reached more than $31tn.
    - Total notional refers to the cumulative value of all open and expired SOFR transactions issued to date.



(As of October 31, 2019; Source: LCH, CME Group, ICE)

This newsletter is compiled by the ARRC's Outreach and Communications Working Group. If you have any questions please email the ARRC Secretariat at arrc@ny.frb.org.

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